

MEMORANDUM

TO: File No. S7-14-11

FROM: David Beaning
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Office of Structured Finance
Division of Corporation Finance
U.S. Securities and Exchange Commission

RE: Conference call with SFIG representatives

DATE: May 13, 2014

On May 8, 2014, Katherine Hsu, Arthur Sandel, David Beaning and Lulu Cheng of the Division of Corporation Finance and Sean Wilkoff and Igor Kozhanov of the Division of Economic and Risk Analysis participated in a conference call with the following representatives of the Structured Finance Industry Group, Inc. (“SFIG”): Richard Johns, Kristi Leo and Sairah Burki of SFIG; Stuart Litwin of Mayer Brown LLP; Phoebe Moreo of Deloitte & Touche LLP; Ken Morrison of Kirkland & Ellis LLP; Jon Zucconi of Credit Suisse; Samuel Smith of Ford Motor Credit; Matt St. Charles and Ryan Farris of Ally Financial; and John Di Paolo and Gary Horbacz of Prudential Fixed Income.

The following staff of other federal regulators also participated: Joe Smith, Carter Evans, and Kevin Korzeniewski of the OCC; Suzie Clair, Kathy Russo, Tom Lyons, Rohit Dhruv, Preston Gilmore, William Haston, Greg Eller, Stephen Lake, Tim Millette, George Alexander, Elliott Pinta, and James Boria of the FDIC; Flora Ahn, April Snyder, David Alexander, Matthew Suntag, Donald Davis and Donald Gabbai of the Federal Reserve Board; Ron Sugarman and Tom Joseph of the FHFA; Samuel Pearson-Moore and Camille Acevedo of HUD; and Beth Mlynarczyk, Olga Gorodetsky, Sharon Haeger and Ankur Datta of the Department of the Treasury.

The participants discussed topics related to the Commission’s August 28, 2013 joint proposed rules regarding credit risk retention. Handouts are attached to this memo.

Attachments



Risk Retention Re-Proposal

Follow-up on Participations

May 8, 2014

Types of Participations

- Type 1: Issuing Entity owns receivables; sponsor or depositor retains a 5% participation in the cash flows
 - This is a vertical interest in the receivables rather than a vertical interest in the securities
 - This is the “most representative” of representative samples
- Type 2: Sponsor owns receivables and transfers a 95% participation to the issuing entity
 - Type 2a: Sponsor is a bank
 - The FDIC has explicitly provided a safe harbor for participations without recourse (12 CFR 360.6(d)(1))
 - Assures that participations by banks will be respected, even in a receivership
 - Type 2b: Sponsor is not a bank
 - If issuing entity holds a participation, courts have recognized that participations are treated as “true sales” of the interest transferred, even in bankruptcy under appropriate circumstances
 - See, for example, *In re Coronet Capital Co.*, 142 B.R. 78 (Bankr. S.D.N.Y. 1992)

Past “Type 2b” Participations

- In our last call, regulators asked for more detail about past securitizations involving “Type 2b” participations
- Lawyers at Mayer Brown are aware of multiple transactions of this type
 - Most of these transactions, but not all, were for a single client
 - Reasons for this structure:
 - Accounting sale was achieved in all cases under FAS 140
 - Sometimes assets would otherwise have been difficult to transfer:
 - In some cases, more costly formalities would otherwise have been required under law
 - Transfers of some commercial receivables would have required consent of obligors
 - All of these transactions were unrated, with financing provided by banks or “post-review” ABCP conduits

Helpful Additional Request

- It would be helpful for the SEC to provide a clarification of Rule 190, Rule 15d-23, Form S-3 eligibility criteria and Rule 3a-7
 - A helpful statement in the Adopting Release would be sufficient
 - Would make clear that either:
 - A public offering of ABS backed by a 95% participation would not require separate registration of the participation and would be treated as a securitization of the underlying loans rather than as a securitization of an underlying security; or
 - Treat the participation just like a SUBI interest (in an auto lease ABS) or Collateral Certificate (in a master trust)
 - Allow registration of the participation on Form S-3, and treat the participation as a Rule 3a-7 “qualifying asset”
 - No separate reporting required under Rule 15d-23



Risk Retention Re-Proposal Supplemental Materials Representative Sample

5/8/2014

Representative Sample

- While the risk retention re-proposal eliminated the representative sample¹ concept as an acceptable form of risk retention, many SFIG members, notably sponsors, believe the approach should be reconsidered
- There is potential that sponsors/issuers seeking to deconsolidate assets from their balance sheet could not retain any significant interest in the actual securitized pool as this ownership, together with the role of the servicer, could result in an inability to achieve deconsolidation under FAS 167
- Although the agencies stated in the preamble to their 2013 risk retention reproposal that the inclusion “of more of a vertical interest could reduce the significance of the risk profile of the sponsor’s economic exposure to the securitization vehicle,” representative sample is the only form of risk retention that allows all beneficial interests to be sold to third parties
 - Consequently, this basis of deconsolidation is the only one that has been tested in the market
- Investors would be able to consider this approach if appropriate safeguards are put into place to ensure that the actual risk retained by a sponsor/issuer is equivalent to that risk that would be retained under a “vertical slice” scenario:
 - Clear objectivity in the initial selection process
 - Blind servicing
 - Ongoing monthly reporting
 - An ability to compare meaningful “sample” and “pool” data. If required by Regulation AB, this would be asset-level data.²
- The following slides identify areas of consensus across the industry pertaining to eligibility and selection of pools, disclosure and monthly reporting, and operational aspects of the approach.
- We also highlight on slides 6-7, loan level/grouped disclosure, where we continue to see differences in opinion across the industry

¹This presentation on representative sample is tailored to static pools. Any applicability to revolving securitization structures would have to be discussed across broad industry participants in order to present a consensus recommendation, which includes full recognition of the nuances of revolving structures such as the mechanics of trust receivable additions.

²For the purposes of this discussion, references to “loan level/grouped” data are intended to reflect the requirements of the Regulation AB final rule.

Representative Sample: Consensus Positions

Eligibility & Selection of Pools

- In order to ensure true statistical representativeness, the representative sample would be available only for securitizations with 20,000 or greater unique loans, implying a representative sample of at least 1,000 unique loans¹
 - For asset classes which cannot support sufficiently large sample sizes, full reconsideration by the industry of all aspects of representative sample criteria must be undertaken
- The sponsor would use the below process to create the representative sample:
 1. Develop the initial pool eligibility criteria for selection of the “designated pool”
 2. Randomly select one pool incorporating the securitized pool and the representative sample from the designated pool
 3. Randomly select the representative pool from combined pool in Step 2
- The issuer would represent in the offering material that the above process has been followed; the representative sample is representative for all “material pool characteristics”; and that the representativeness of the sample has been validated (using a 95% two-tailed confidence interval) for all “material pool characteristics”

Representative Sample: Consensus Positions

Disclosure

At origination:

- The offering document would provide statistical data for the representative sample equivalent to the statistical data provided for the securitized pool
- AUP reports on the representative sample would not be required to be obtained and disclosed (due to auditor unwillingness to have these sorts of reports published)
 - Note, however, the Rule 193 and Item 1111(a)(7) review procedures and related disclosure would apply to public offerings

Monthly:

- In each servicer report, all performance and pool composition information that is provided for the securitized pool would be provided in the same fashion for the representative sample, which, depending on the asset class, could include:
 - Delinquency Table & REO
 - Gross Loss
 - Net Loss
 - Modifications
 - Repurchases
 - Pool Factor
 - Prepayment rate
- Information on the servicer report that relates to the outstanding securities (e.g., use of collections, outstanding balance of securities) is not applicable to, and would not be provided for, the representative sample

Operational Considerations

- The servicer would covenant to service loans in the securitized pool and in the representative sample on a “blind” basis at the asset level (i.e., those persons who interact with the debtor or make decisions regarding the debtor or the individual loan will not know whether or not the loan has been securitized)¹
 - The servicer would also covenant to service the loans in both the securitized pool and representative sample under the same contractual standards
- The sponsor would maintain policies, procedures and documentation of the type described in § __.8(c) of the 2011 proposal
- The sale and hedging restrictions in § __.8(f) of the 2011 proposal would be observed in a manner and for a time period consistent with other forms of risk retention

¹To the extent that ancillary parties are retained specifically with regard to the securitized pool (e.g. backup services) such parties would not need to be retained for representative sample purposes

Representative Sample: Loan Level Disclosure – Investor Perspective

- If sponsors held a vertical slice form of risk retention, investors would receive the same data for both the sold and retained pieces
 - To be put in an equivalent disclosure position, investors request the same level of aggregate disclosure for all receivables
- If required by Regulation AB, the provision of loan level/grouped data for the retained pool would provide information that investors deem critical to monitoring and assessing the sample pool
 - In order to perform their own due diligence to establish that the initial pool creation is truly representative, an investor would need to be able to compare specific loan level characteristics across both the retained and the securitized pools
 - While pre-determined stratification tables (e.g. FICO bands, geographic splits, APR bands) may allow some degree of comparison between pools, the relevant characteristics may change over time and could not be hard-coded into regulation
 - While ongoing reporting of key performance variables can give comfort to an investor that the two pools are performing on a correlated basis, should there be any divergence in pool behavior, investors need the ability to review the two pools to confirm they remain representative (i.e. that they have continued to be serviced on a blind basis) and therefore request monthly reporting
- Specifically, assuming Regulation AB results in a requirement of loan level data for securitized assets, investors request the following data for the representative pool:
 - At origination, a loan level file, in the form of Schedule L, for the representative sample and the securitization collateral pool in order to perform internal validation that the representative sample is representative and the representativeness of the sample is validated for all “material pool characteristics”
 - Post origination, a loan level file, in the form of Schedule L-D, for each loan in the representative sample

Representative Sample: Loan Level Disclosure – Issuer Perspective

- Issuers support the consensus view on Representative Sample as outlined on the prior slides
 - The level of disclosure, representations made, and ongoing monthly reporting are appropriate to demonstrate that issuers have retained similar risk
 - In addition to the consensus requirements for Representative Sample, reputational concerns and ongoing business relationships function to align investor and issuer interests

- Issuers believe there are significant benefits from a representative sample approach
 - As discussed on the first slide, a representative sample approach would help issuers achieve deconsolidation
 - Issuers may find that providing risk retention in this form is more cost effective than other types and thus may have more incentive to continue their securitization programs
 - When the risk retention period ends, it will likely be easier to “monetize” the representative sample (by putting them into a new securitization) than to try to sell retained securities from a vertical slice, as the market for those retained securities could well be very thin
 - Costs that vary according to the amount of securities created or rated will be 5% lower than in if a vertical slice approach is used

- However, there are some concerns with providing loan level data for the representative pool
 - Additional data granularity increases the likelihood that issuers and investors could have differing views on the causal factors related to pool performance over time (especially if the performance diverges between the two pools)
 - Issuers have similar privacy concerns around loan level data as provided in SFIG’s Regulation AB April 28th comment letter
 - In particular, there may be greater risk in providing loan-level data with respect to a representative sample as investors would not have any credit risk exposure/ownership interest in the pool and therefore may not be able to demonstrate a “permissible purpose” for Fair Credit Reporting Act purposes
 - Increased cost, complexity and administrative burden
 - Preparing and providing two tapes
 - Regardless of legal/regulatory requirements, most institutions require externally provided data to be comforted