



Risk Retention Re-Proposal: Seller's Interest Option for Revolving Master Trusts

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Introduction

On August 28, 2013, the SEC, FDIC, Federal Reserve, OCC, FHFA and HUD (the **Joint Regulators**) issued a second Notice of Proposed Rulemaking (the **Re-Proposed Rule**) in connection with the requirement under Section 941 of Dodd-Frank that they jointly implement rules to require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security (**ABS**), transfers to a third party.

The Joint Regulators prepared the Re-Proposed Rule in response to comments received on the risk retention regulation that they initially proposed on April 29, 2011 (the **Original Proposed Rule**). Comments on the Re-Proposed Rule are due on October 30, 2013.

Introduction (continued)

Re-Proposed Rule

The Re-Proposed Rule would require a sponsor of most securitizations (including privately-placed issuances) to retain at least 5% of the credit risk related to that securitization and would restrict the transfer, hedging or pledge of the risk that the sponsor is required to retain.

Seller's Interest Option for Revolving Master Trusts

Consistent with the Original Proposed Rule, the Re-Proposed Rule includes a “seller’s interest” risk retention option specifically designed for revolving master trust structures. The Joint Regulators have re-proposed that option with some important modifications intended to better reflect the way in which revolving master trust securitizations operate in the current market, but more changes are needed.

At-a-Glance Comparison of Original vs. Re-Proposed Rule

Original Proposed Rule	Re-Proposed Rule
Seller's Interest Option	
1. Available only to revolving asset master trusts .	1. Available to all revolving master trusts (assets need not be revolving).
2. All ABS interests must be backed by a common pool of assets .	2. Same. Seller's interest option is not available to "series trusts."
3. "Seller's interest" defined, in part, as " pari passu with all other ABS interests ... with respect to the allocation of all payments and losses prior to an early amortization event"	3. "Seller's interest" definition modified to be " pari passu to each series of investors' ABS interests ... with respect to the allocation of all distributions and losses ... prior to an early amortization event"
4. "Seller's interest" definition did not address transactions in which collections allocable to the seller's interest are subordinated to the investor interests.	4. Regulators are considering the treatment of subordinated seller's interests (whether they should count towards the 5% seller's interest requirement on a face-value vs. fair-value basis).
5. Seller's interest measured as a percentage of the unpaid principal balance of the pool assets .	5. Seller's interest measured as a percentage of the unpaid principal balance of the outstanding investors' ABS interests and on a face value (rather than fair-value) basis, so long as master trust does not issue senior interest-only bonds or premium bonds.
6. Seller's interest test must be satisfied at each closing and until all ABS interests are paid in full .	6. Seller's interest test must be satisfied at each closing and at every seller's interest measurement date specified in transaction documents, but no less than monthly, for as long as ABS are held by unaffiliated persons.

At-a-Glance Comparison of Original vs. Re-Proposed Rule

(continued)

Original Proposed Rule	Re-Proposed Rule
7. Seller's interest must initially be held by the sponsor and may then be transferred to a "consolidated affiliate" of the sponsor.	7. Seller's interest may initially be held by one or more "wholly-owned affiliates" of the sponsor , which includes entities that, directly or indirectly, control, are controlled by, or are under common control with, a sponsor through ownership of 100% of the equity of the relevant entity(ies).
8. Seller's interest must represent a single interest in the master trust.	8. In the case of legacy trust structures , the seller's interest may represent multiple interests in the issuance platform , but the portion of the seller's interest held through the legacy trust must be proportional to the percentage of assets that collateral certificate(s) comprise of the issuing trust's assets.
9. Original proposed rule gave no credit for funds on deposit in excess funding accounts.	9. The required seller's interest may be reduced by the balance of a segregated excess funding account , subject to conditions, including that EFA absorb its allocable share of losses. <i>See table on slide 9 for more detail.</i>
Combining Seller's Interest with Horizontal Risk Retention	
10. Original proposed rule did not provide for combining the seller's interest option with any other risk retention option to meet the baseline risk retention requirement.	10. Permits sponsors to combine the seller's interest with either of two horizontal types of risk retention held at the series level: <ul style="list-style-type: none"> ▪ Retention of an eligible horizontal residual interest in every series issued by the master trust, in a form meeting the same criteria as apply under the standard risk retention requirement; or ▪ Retention of a horizontal interest in the excess spread of every series, subject to conditions. <i>See table on slide 10 for more detail.</i> <p>These forms of horizontal risk retention would be measured on a fair value basis and the sponsor would be able to reduce its seller's interest by a corresponding amount.</p>

At-a-Glance Comparison of Original vs. Re-Proposed Rule

(continued)

Original Proposed Rule	Re-Proposed Rule
Disclosure and Record Maintenance	
11. The sponsor must make calculations and written disclosures to potential investors a reasonable period of time prior to sale of the relevant ABS (and, upon request, to the relevant regulators), including the amount of the seller's interest that the sponsor is required to retain and is actually retaining.	11. Enhanced disclosure requirements in respect of each of the seller's interest and any permitted horizontal risk retention, including information required of sponsors retaining horizontal interests under the standard risk retention requirements (<i>e.g.</i> , fair value methodology, track record re closing date cash flow projections). <i>See table on slide 11 for more detail.</i>
12. The sponsor must retain these records, and provide them to relevant regulators upon request, until 3 years after all ABS interests have been retired.	12. Same.
Early Amortization of All Outstanding Series (Revolving Asset Master Trusts Only)	
13. Original proposed rule did not include special provisions regarding risk retention requirements following a trust-wide early amortization event.	13. A sponsor of a revolving asset master trust will not violate the rule if the seller's interest falls below the required level following a trust-wide early amortization event, subject to conditions re past compliance, etc. <i>See table on slide 12 for more detail.</i>
Transition Issues - Compliance by the Effective Date for Revolving Master Trusts	
14. Original proposed rule was silent on transition issues for revolving master trusts.	14. No grandfathering. Sponsors must comply with the rule with respect to the entire unpaid principal balance of the master trust's outstanding investors' ABS interests, regardless of when issued.

Concerns with Original Proposed Rule – How Addressed in Re-Proposed Rule?

Original Proposed Rule	Concerns Raised to Joint Regulators	Re-Proposed Rule
1. Entities Eligible to Use Seller's Interest Option		
<ul style="list-style-type: none"> ➤ Option available only to revolving asset master trusts. 	<ul style="list-style-type: none"> ➤ Option should be available to all revolving master trusts. 	<ul style="list-style-type: none"> ➤ Option available to all revolving master trusts, regardless of whether pool assets are revolving or non-revolving.
<ul style="list-style-type: none"> ➤ All ABS interests must be backed by a common pool of assets. 	<ul style="list-style-type: none"> ➤ No specific concern expressed. 	<ul style="list-style-type: none"> ➤ Release indicates that option is <u>not</u> available to “series trusts” (<i>i.e.</i>, trusts that issue different series of ABS backed by segregated, independent asset pools).
2. Definition of “Seller’s Interest”		
<ul style="list-style-type: none"> ➤ “Seller’s interest” defined, in part, as “<u>pari passu</u> with all other ABS interests ... with respect to the allocation of all payments and losses prior to an early amortization event.” 	<ul style="list-style-type: none"> ➤ Collections and losses are initially allocated between the seller’s interest and the aggregate investor interests, rather than between the seller’s interest and each other ABS interest. 	<ul style="list-style-type: none"> ➤ “Seller’s interest” definition revised to be “<u>pari passu</u> to each series of investors’ ABS interests”
	<ul style="list-style-type: none"> ➤ Allocation of collections and losses between seller’s interest and investor interests is <i>pro rata</i> during revolving periods, but allocation of principal collections (and, in some cases, finance charge collections) fixes during other periods, including scheduled principal accumulation/amortization periods. 	<ul style="list-style-type: none"> ➤ Concern not addressed. Definition continues to provide that seller’s interest is “<u>pari passu</u> ... with respect to the allocation of all distributions and losses ... prior to an early amortization event.”
	<ul style="list-style-type: none"> ➤ In some cases, collections allocable to the seller’s interest are subordinated to the investor interests. 	<ul style="list-style-type: none"> ➤ Joint regulators are considering the treatment of transactions in which collections allocable to the seller’s interest are subordinated to the investor interests (<i>e.g.</i>, whether such arrangements should count towards the 5% seller’s interest requirement on a face-value vs. fair-value basis).

Concerns with Original Proposed Rule – How Addressed in Re-Proposed Rule? (continued)

Original Proposed Rule	Concerns Raised to Joint Regulators	Re-Proposed Rule
3. Measuring the Amount and Duration of the Required Risk Retention		
<ul style="list-style-type: none"> ➤ Sponsor must retain a seller's interest of not less than 5% of the unpaid principal balance of the pool assets. 	<ul style="list-style-type: none"> ➤ In many transactions, the minimum required seller's interest is established by reference to the unpaid principal balance of the outstanding investor interests, rather than unpaid principal balance of the pool assets. 	<ul style="list-style-type: none"> ➤ Sponsor must retain a seller's interest of not less than 5% of the unpaid principal balance of the outstanding investors' ABS interests. ➤ Proposal to measure seller's interest on a face-value basis (rather than a fair-value basis) is based on premise that sponsors of revolving master trusts do not issue senior interest-only bonds or premium bonds. If such bonds were to be issued, seller's interest option would not be available.
<ul style="list-style-type: none"> ➤ Sponsor must meet the 5% test at the closing of the transaction and until all ABS interests are paid in full. 	<ul style="list-style-type: none"> ➤ Assets and liabilities of the master trust fluctuate continuously. Consequently, rule should make clear that the 5% required seller's interest is to be measured on a current basis, at closing and periodically thereafter in accordance with program documents. ➤ Securitizer should be subject to the 5% test only for so long as ABS interests are held by unaffiliated persons. 	<ul style="list-style-type: none"> ➤ Sponsor must meet the 5% test at the closing of each issuance and at every seller's interest measurement date specified in the transaction documents, but no less than monthly. ➤ Sponsor must meet the 5% test for so long as ABS interests are held by unaffiliated persons.

Concerns with Original Proposed Rule – How Addressed in Re-Proposed Rule? (continued)

Original Proposed Rule	Concerns Raised to Joint Regulators	Re-Proposed Rule
4. Who May Retain the Seller's Interest?		
<ul style="list-style-type: none"> ➤ Seller's interest must initially be held by the sponsor and may then be transferred to a "consolidated affiliate," which refers to an affiliate whose financial statements are consolidated with those of the sponsor. 	<ul style="list-style-type: none"> ➤ In many transactions, seller's interest is initially issued to, and held by, the depositor rather than the sponsor (2-step structures). ➤ Depositor may or may not be a direct or indirect wholly-owned subsidiary of the sponsor and may instead be an affiliate under common control with the sponsor. ➤ There may also be more than one depositor, each of which holds a portion of the seller's interest. 	<ul style="list-style-type: none"> ➤ Seller's interest may initially be held by one or more "wholly-owned affiliates" of the sponsor, which includes entities that, directly or indirectly, control, are controlled by, or are under common control with, a sponsor through ownership of 100% of the equity of the relevant entity(ies).
5. Legacy Trust Structures		
<ul style="list-style-type: none"> ➤ Seller's interest must represent a single interest in the master trust. ➤ Original proposed rule made no provision for legacy trust structures. 	<ul style="list-style-type: none"> ➤ Many issuance platforms are structured with one or more legacy trusts that hold some or all of the underlying receivables and an issuance trust that holds an interest (e.g., a collateral certificate) in each legacy trust and its underlying receivables. These entities should be treated as a single issuer and a unitary issuance platform under the rule. 	<ul style="list-style-type: none"> ➤ In the case of legacy trust structures, the seller's interest may represent multiple interests in the issuance platform, but the portion of the seller's interest held through the legacy trust must be proportional to the percentage of the assets that collateral certificate(s) comprise of the issuing trust's assets.

Concerns with Original Proposed Rule – How Addressed in Re-Proposed Rule? (continued)

Original Proposed Rule	Concerns Raised to Joint Regulators	Re-Proposed Rule
6. Funds on Deposit in Excess Funding Accounts		
<ul style="list-style-type: none"> ➤ Original proposed rule gave no credit for funds on deposit in excess funding accounts. 	<ul style="list-style-type: none"> ➤ Amounts on deposit in excess funding or special funding accounts should be included when measuring the amount of the seller's interest. 	<ul style="list-style-type: none"> ➤ The required seller's interest on any measurement date may be reduced by the balance of a segregated excess funding account, subject to the following conditions: <ul style="list-style-type: none"> i. the account is funded in event of a failure to meet the minimum seller's interest requirements under the program documents by distributions otherwise payable to the holder of the seller's interest; ii. the account is <u>pari passu</u> to each series of investors' ABS interest with respect to the allocation of losses on the pool assets prior to an early amortization event; and iii. following an early amortization event, funds on deposit in the account are applied to make payments to ABS investors in the same manner as distributions on the pool assets.

Concerns with Original Proposed Rule – How Addressed in Re-Proposed Rule? (continued)

Original Proposed Rule	Concerns Raised to Joint Regulators	Re-Proposed Rule
7. Combining Seller's Interest with Horizontal Risk Retention		
<ul style="list-style-type: none"> ➤ Original proposed rule made no provision for combining the seller's interest option with any other risk retention option to meet the baseline risk retention requirement. 	<ul style="list-style-type: none"> ➤ At a minimum, sponsors employing master trust structures should be able to combine the seller's interest with horizontal risk retention. ➤ A sponsor should receive credit where it retains all or a portion of the most subordinated class or classes of a series of ABS. ➤ A sponsor's first-loss, residual interest in excess spread, as well as its interest in certain trust account deposits, represent significant ongoing exposures to the performance of the pool assets, and are highly effective in aligning the interests of sponsors with those of investors. 	<ul style="list-style-type: none"> ➤ Permits sponsors to combine the seller's interest with either of two horizontal types of risk retention held at the series level: <ul style="list-style-type: none"> ▪ Retention of an eligible horizontal residual interest in every series issued by the master trust, in a form meeting the same criteria as apply under the standard risk retention requirement; or ▪ Retention of a horizontal interest in the excess spread of every series, whether or not certificated and whether represented by a single or multiple classes, subject to four conditions: <ol style="list-style-type: none"> i. each series must distinguish between its share of interest and fee cash flows vs. principal repayment cash flows; ii. the horizontal interest's claim to excess spread each period must be subordinated to all interest and principal due to more senior ABS interests in the series for that period, and is further reduced by the series' share of losses; iii. the horizontal interest must have the most subordinated claim, if any, to the series' share or principal repayment cash flows; and iv. the trust must remain a revolving trust. ➤ These forms of horizontal risk retention would be measured on a fair-value basis and the sponsor would be able to reduce its seller's interest by a corresponding amount.

Concerns with Original Proposed Rule – How Addressed in Re-Proposed Rule? (continued)

Original Proposed Rule	Concerns Raised to Joint Regulators	Re-Proposed Rule
8. Disclosure and Record Maintenance		
<ul style="list-style-type: none"> ➤ The sponsor must make calculations and written disclosures to potential investors a reasonable period of time prior to sale of the relevant ABS (and, upon request, to the relevant regulators), including the amount of the seller's interest that sponsor is required to retain and is actually retaining. ➤ The sponsor must retain these records, and provide them to the relevant regulators upon request, until 3 years after all ABS interests have been retired. 	<ul style="list-style-type: none"> ➤ No specific concern expressed. 	<ul style="list-style-type: none"> ➤ Enhanced disclosure requirements, in respect of each of the seller's interest and any permitted horizontal risk retention, including: <ul style="list-style-type: none"> i. the (a) value of the seller's interest retained at closing, (b) fair value of all investors' ABS interests issued in the securitization and dollar amount of any permissible horizontal risk retention retained at closing, and (c) unpaid principal balance or fair value (as applicable) that the sponsor is required to retain; ii. a description of material terms of the seller's interest and of any permissible horizontal risk retention; and iii. with respect to any permissible horizontal risk retention retained, the same disclosures as is required of sponsors retaining horizontal interests under the standard risk retention requirements, including: <ul style="list-style-type: none"> ▪ a description of the fair value methodology used, including the key inputs and assumptions used and the reference data set or other historical information used to develop those inputs and assumptions; and ▪ current information (within 60 days prior to closing) re the number of the sponsor's securitization transactions during the previous 5 years in which the sponsor satisfied risk retention requirements through horizontal risk retention and the number of payment dates on which actual payments to the sponsor in respect thereof exceeded projected cash flow as determined at closing.

Concerns with Original Proposed Rule – How Addressed in Re-Proposed Rule? (continued)

Original Proposed Rule	Concerns Raised to Joint Regulators	Re-Proposed Rule
9. Early Amortization of All Outstanding Series (Revolving Asset Master Trusts Only)		
<ul style="list-style-type: none"> ➤ Original proposed rule did not address risk retention requirements following a trust-wide early amortization event. 	<ul style="list-style-type: none"> ➤ Under some circumstances, following an early amortization, the seller's interest may fall below its minimum maintenance level. 	<ul style="list-style-type: none"> ➤ A sponsor of a revolving asset master trust will not violate the rule if its seller's interest falls below the required level following a trust-wide early amortization event if: <ol style="list-style-type: none"> i. the sponsor was in full compliance with its risk retention requirements on all measurement dates prior to the early amortization event; ii. the seller's interest remains <u>pari passu</u> or subordinate to each series of investors' ABS interests with respect to the allocation of all losses on the pool assets; iii. any horizontal interest relied upon to offset the minimum seller's interest continues to absorb losses as required under the rule; and iv. the master trust issues no additional ABS interests after early amortization to any unaffiliated person, either during early amortization or at any subsequent time.
10. Transition Issues – Compliance by the Effective Date for Revolving Master Trusts		
<ul style="list-style-type: none"> ➤ Original proposed rule was silent on transition issues for revolving master trusts. 	<ul style="list-style-type: none"> ➤ Further guidance needed re compliance requirements for revolving master trusts that have outstanding ABS that were issued prior to the effective date. ➤ Application of risk retention requirements across entire trust and outstanding ABS would disregard grandfathering and could preclude some sponsor's from combining seller's interest with other available risk retention options. 	<ul style="list-style-type: none"> ➤ Sponsors must comply with the rule with respect to entire unpaid principal balance of the master trust's outstanding investors' ABS interests, regardless of whether those interests were issued before or after the effective date of final rule.

Significant Concerns for Revolving Master Trusts Raised by Re-Proposed Rule

1. Definition of “Revolving Master Trust”

Release indicates that the seller’s interest option is not available to “series trusts,” a term that appears to have been borrowed from Reg AB and applied here. Does it make sense to restrict the seller’s interest option in this manner? Should SEC guidelines and interpretations regarding series trusts under Reg AB apply in this context as well?

2. Definition of “Seller’s Interest”

The allocation of collections and losses between the seller’s interest and investor interests is *pro rata* during revolving periods, but the allocation of principal collections to the relevant investor interests fixes during other periods, including scheduled principal accumulation and amortization periods. As a result, the re-proposed definition, which contemplates that the seller’s interest remain pari passu with respect to allocations of payments and losses prior to an early amortization event, conflicts with virtually every revolving master trust cash flow structure.

Significant Concerns for Revolving Master Trusts Raised by Re-Proposed Rule (continued)

3. Treatment of “Subordinated” Seller’s Interest

- Should transactions in which collections allocable to the seller’s interest are subordinated to the investor interests count towards the 5% seller’s interest requirement on a face-value or fair-value basis?
- This form of “subordinated” seller’s interest receives the same allocations of collections and losses on the pool assets as does a conventional seller’s interest, but the collections allocable to the seller’s interest on each payment date are subordinated to the investor interests. A subordinated seller’s interest, therefore, represents even greater “skin-in-the-game” than does a conventional seller’s interest — by exposing the holder to more than its proportional share of the credit risk relative to the share borne by the investor interests.
- Does it make sense then to measure the value of the subordinated seller’s interest on a basis that could require that a larger seller’s interest be retained than would be the case for a conventional seller’s interest? Would it be more appropriate then to count the subordinated seller’s interests towards the 5% seller’s interest requirement on a face-value basis?

Significant Concerns for Revolving Master Trusts Raised by Re-Proposed Rule (continued)

4. Measuring the Amount of the Required Risk Retention

The sponsor must meet the 5% test at the closing of each issuance and at every seller's interest measurement date specified in the transaction documents (but no less than monthly). In comment letters on the original proposed rule, the industry indicated that, for purposes of measuring the seller's interest at closing, the relevant date should be the most recent previous measurement date specified in the transaction documents. It would also be helpful if the rule incorporated any "cure period" specified in the transaction documents within which a seller's interest that was below required levels may be remedied.

Significant Concerns for Revolving Master Trusts Raised by Re-Proposed Rule (continued)

5. Who May Retain the Seller's Interest?

The re-proposed rule provides that the seller's interest may initially be held by one or more "wholly-owned affiliates" of the sponsor. At the same time, the re-proposed hedging, transfer and financing restrictions would prohibit a sponsor from transferring any interest that it is required to retain under the rule to any person other than a "majority-owned affiliate."¹

It is not clear how these provisions are intended to interact, if at all. In any event, if a majority-owned affiliate of the sponsor is ultimately permitted to retain the required interest under the hedging, transfer and financing provisions, it seems that the same standard should be applied under the seller's interest option in the first instance.

¹ The term "majority-owned affiliate" refers to an entity that, directly or indirectly, controls, is controlled by, or is under common control with, a sponsor through ownership of a controlling financial interest in the entity (*e.g.*, more than 50% of the equity of the entity), as determined under GAAP.

Significant Concerns for Revolving Master Trusts Raised by Re-Proposed Rule (continued)

6. Funds on Deposit in Excess Funding Accounts

The re-proposed rule's proposal to give credit for funds on deposit in excess funding accounts only if, among other things, the account receives its *pro rata* allocation of losses on the pool assets conflicts with virtually every revolving master trust cash flow structure that employs an excess funding account or similar feature. The purpose of funds on deposit in excess funding accounts is to provide an additional source from which to repay outstanding ABS interests, typically following an early amortization event.

Significant Concerns for Revolving Master Trusts Raised by Re-Proposed Rule (continued)

7. Combining Seller's Interest with Horizontal Risk Retention

The re-proposed rule would permit sponsors to combine the seller's interest with either of two horizontal types of risk retention held at the series level, each of which has been customized to some extent to revolving master trust structures. Despite such efforts, the options are very narrowly drawn and do not appear to give credit for a range of retained interests that create meaningful skin-in-the-game. Examples include the following:

- Some master trust sponsors have created and retained a “super-subordinated” ABS interest that absorbs losses before any other investors' ABS interests are affected. In some cases, this super-subordinated ABS interest is not an interest in any outstanding series but instead is a series to itself or, in the case of some legacy trust structures, may be a subordinated interest in the same series as the collateral certificate. In each of these cases, a sponsor would not appear to receive credit for retaining this ABS interest because, as a technical matter, it does not represent an interest in *every* series.
- In many cases, a master trust sponsor may retain all or a portion of the most subordinated investor ABS interests in one or more outstanding series, but not in *every* series. Should the rule give credit for the retention of these interests, at least in an amount that is proportional to the percentage that each such series represents to the total series outstanding? Note that, in the absence of grandfathering, a sponsor would have to retain the most subordinated investor ABS interest in series issued both before and after the effective date of the final rule. Does this make a more compelling case?
- Should the rule make clear that, so long as the sponsor satisfies the 5% test, it need not be the only holder of the most subordinated investor ABS interests?

When measuring the amount of its required risk retention under the seller's interest option, should a sponsor have to include the unpaid principal balance of outstanding investors' ABS interests that it retains?

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