Communication Between Federal Reserve Board Staff and Auto Finance Council (AFC)
September 27, 2010

Participants: Karen Pence (Federal Reserve Board)

JJ Hornblass (AFC)

Summary: Staff of the Federal Reserve Board received from AFC an outline of current transaction risk retention practices by issuers of automotive loan-backed securitizations. A copy of the outline provided by AFC is attached below.

AUTO FINANCE COUNCIL

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September 27, 2010

Karen Pence
Chief, Household and Real Estate Finance
Federal Reserve Board
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Dear Ms. Pence:

The Auto Finance Council is very pleased to provide the Federal Reserve Board with this outline of how issuers of automotive loan-backed securitizations retain transaction risk.

The Auto Finance Council brings together top auto lending and leasing executives to help shape and improve the industry and its regulatory environment. Our members account for about 40% of the US auto financing marketplace.

Please note that the structuring of securitizations by some members of the Auto Finance Council differs from the structuring explained below, and that it should not be presumed that a member company of the Auto Finance Council has, will or must operate as outlined in this letter. Rather, this note was intended as a broad overview of the notion of risk retention in auto securitizations merely for explanatory purposes. Those who seek to understand the risk retention mechanisms in particular auto ABS deals, must investigate those specific transactions.

RISK RETENTION

With auto finance companies as the originators, servicers and sponsors of asset-backed securities, as well as the residual holders, the auto ABS model is *not* an “originate-to-distribute” model. The current risk-retention structure, in place for the past 20 years, involves retention by a subsidiary of the sponsor of a “horizontal slice” that is subordinated to the issued ABS — a highly effective model for keeping lenders’ “skin in the game.”

Specifically, one or more affiliates of the sponsor holds the “horizontal slice” residual interest — the residual interest that is subordinated to the most junior tranche of ABS issued to investors — making it the recipient of “bottom of the waterfall” payments. In other words, the issuer’s net return is tied to the performance of the loans backing the securitization. This clearly incentivizes lenders to conduct intensive loan underwriting, monitoring and servicing on their automobile loans, which, in turn, protects investors from losses as the issuer retains 100% of the first loss, which is calculated to equal a multiple of expected losses.

Risk retention in auto ABS transactions happens largely through four credit enhancement mechanisms: overcollateralization (OC), subordinated notes (sequentially paid), a non-declining reserve account, and excess spread.

1. Certificates or Overcollateralization (OC): This is the sum of the principal balance of loans/leases/floorplan that are in excess of bonds (Asset-Debt)
2. Subordinated Notes: A subordinated portion of the bonds retained by the issuer.
3. Reserve Account: Cash put into a designated account at the beginning of the transaction or during the transaction that is used to make required distribution payments when there is a shortfall in available funds
4. Excess Spread: The excess of the yield on the assets over the required yield on the notes, plus any required fees

The credit enhancement in the deals is based on multiples of expected losses (derived from an analysis of the issuer's historical losses) and the bonds' ratings. All four forms of enhancement are typically held or funded indirectly by the issuer, which would ultimately take the first-loss position in the transaction. Therefore, losses are first experienced by the issuer before an investor's position is exposed, better aligning the interests of issuers and investors.

The non-declining nature of the subordinated notes and reserve account, for example, allows the triple-A credit enhancement in the transaction to grow as a percentage of the declining outstanding principal balance each month. Take, for example, a transaction with a 4.35% Class B note and a 0.25% reserve account. As the triple-A bonds are paid down over time, the amount of absolute risk retained by the issuer remains constant, increasing the amount of credit enhancement as a percent of the outstanding principal balance.

The cash flow that would otherwise be released to the issuer is used to pay down the notes until the amount of OC reaches the target percent, and the OC never declines below a hard dollar amount (the floor). To illustrate: Say the transaction had initial OC of 1.00%, growing to a target OC of 2.00% of the aggregate outstanding principal balance each month. However, once the floor OC was reached during perhaps the 18th month after the transaction's original closing, the dollar amount of OC remains constant throughout the remaining life of the transaction.

The combination of the non-declining OC floor mechanic, subordinated notes, and non-declining reserve account allows the enhancement in these transactions to grow as a percentage of the outstanding receivables over time as the transaction de-levers. In the transaction referenced above, the total credit enhancement for the deal (risk retained by the issuer) began at 5.60% of the receivables funded and grew to more than 50% of the receivables by the end of the fourth year after the transaction's original closing.

REPRESENTATIONS & WARRANTIES

The representation and warranties in auto ABS transactions generally require that the loans meet stated underwriting criteria; otherwise the sponsor must repurchase the loan. The representations and warranties for auto ABS are much more limited than those in a mortgage transaction, for example. Auto reps and warranties pertain to specific aspects of the receivables, including the origination of the auto receivables; the obligors of the auto receivables; the accuracy and legality of the records, computer tapes and schedules containing information regarding the auto receivables; the financed vehicles securing the auto receivables; the security interests in the auto receivables granted to the depositor, issuing entity and the trust collateral agent; and specific characteristics of the auto receivables. Additionally, the issuer cannot issue securities that could materially adversely impact the ratings of the issued notes. Issuers also have to perfect title on the loans. If a loan is charged off and the issuer does not have title on the loan, it has to repurchase the loan.

The issuer will take the actions necessary to maintain the lien and security interest in the pool of assets. The issuer is limited in the types of distributions it can make to the servicer.

Beyond those requirements, there are normal reps and warrants, such as issuer is not bankrupt; issuer has not already encumbered the assets put in the trust; or issuer has the authority to enter into the transaction.

In other words, loans must meet stated criteria; otherwise issuers must repurchase the loans. It should be noted that the sponsor or the depositor rarely is required to repurchase accounts.

CONCLUSION

Beyond everything expressed above, there is a more abstract risk that every issuer retains that is perhaps impossible to quantify. And that is, should the issuer's loans backing a securitization not perform as expected, that issuer can expect a series of consequences that can range from higher credit costs to the outright inability to finance additional auto loans. This risk – tantamount to the risk of abject failure – is folded into the very fabric of the auto financing business and it leads lenders to look at each loan as potentially the loan that eliminates its ability to continue as an ongoing concern. We see this risk retention as the most profound of all.

Sincerely yours,

JJ Hornblass
Chairman