



American Securitization Forum¹
Calculating Risk Retention with Fair Value
January 23, 2013

INTRODUCTION

- We understand that the Joint Regulators are considering some form of “fair value” calculation for risk retention as a potential replacement for the premium capture cash reserve account (PCCRA) provision. If so, we believe this would be a significant improvement over the requirement to fund a PCCRA, as we remain very concerned that a PCCRA requirement would have significant and detrimental effects on the securitization market.² We have, however, identified certain considerations and principles that we believe should guide the Joint Regulators in their approach as they continue to develop any such fair value calculation.
- The considerations and principles outlined below are based on only a conceptual notion of this fair value calculation for risk retention, as we lack any material details regarding the technical elements of any such proposal. We expect, therefore, that additional or different considerations and principles may become relevant as we come to better understand the details of this fair value approach and consider its application across the securitization market. This, in turn, underscores that we cannot meaningfully comment on this approach without re-proposal of the revised regulations for further consideration prior to adoption.
- We would, therefore, be pleased to meet with representatives of the Joint Regulators to discuss the nature of this fair value calculation in more detail and to more fully describe the important considerations and principles outlined below, but we also strongly urge the Joint Regulators to re-propose revisions made in response to comments submitted on the Proposed Regulations, including any revisions relating to this fair value approach.³

¹ The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

² These concerns are outlined in detail in our original comment letter at http://www.americansecuritization.com/uploadedFiles/ASF_Risk_Retention_Comment_Letter.pdf.

³ As indicated in our original comment letter, the securitization market is diverse and complex, the Proposed Regulations are highly technical in nature, and grave consequences will follow if the risk retention regulations unnecessarily disrupt the marketplace or, worse yet, render segments of the securitization market economically impracticable.

CONSIDERATIONS AND PRINCIPLES GUIDING A FAIR VALUE APPROACH

- In formulating this fair value approach, it appears that the Joint Regulators may be trying to produce a single rule that will work across all asset classes. As indicated in our original comment letter, it is imperative that the risk retention regulations, including any rule relating to this fair value approach, be tailored to the unique characteristics of securitized assets and the structures historically used in securitizations, and that these regulations accommodate existing market practices that effectively align the interests of securitizers with those of investors.
- To accommodate the Joint Regulators' objective of a single rule, we outline below principles that we believe could work across asset classes.
- As a starting point, and as we have done in this outline, the Joint Regulators should use the term "fair value" rather than "market value," to reduce disclosure concerns that these relatively illiquid, first-loss interests have an actual "market value."
- This fair value calculation should apply only in the case of horizontal risk retention and should accommodate the unique features of different asset classes and transaction structures. We do not believe that a fair value calculation is at all relevant in the case of the other risk retention options (e.g., vertical, seller's interest and representative sample) since the value of the retained interest in each of those cases, by its nature, correlates directly with the value of the investors' interests (individually or in the aggregate).⁴
- The fair value calculation must be a one-time determination at the outset of the securitization transaction, as currently contemplated under the Proposed Regulations with respect to the horizontal risk retention option.

Equally important is the point in time at which this one-time determination is to be made. If this determination were to be made as of the closing date, issues arise because intervening events could occur between the time of pricing and closing of the transaction that could cause the fair value of the retained interest to change, which in turn could require re-balancing and re-pricing the positions of the securitizer and investors. If, on the other hand, this determination were to be made as of the pricing date, issues arise

⁴ In commenting on the Proposed Regulations, we have also requested that an additional risk retention option—the retention of a participation interest in the pooled assets—be included among the menu of options available to securitizers. We do not believe that a fair value calculation would be relevant in this case either. See our original comment letter (available through the link included in footnote 1 above), as well as our supplemental comment letter responding to questions posed by the Joint Regulators regarding the treatment of participation interests under the risk retention regulations (available at www.americansecuritization.com/WorkArea/DownloadAsset.aspx?id=7399).

Given the highly specialized nature of asset-backed commercial paper (ABCP) conduits, we continue to believe that risk retention should be applied to ABCP conduits in the manner set forth in our original comment letter at pp. 92-104 (Section VIII.C) (available through the link included in footnote 1 above). To that end, in cases where an ABCP conduit sponsor seeks to rely on originator-seller risk retention in order to comply with the Proposed Regulations, we believe that each of the general risk retention methods available generally to securitizers should also be available for transactions that are funded with ABCP. See also our supplemental comment letter responding to questions posed by the Joint Regulators regarding the treatment of ABCP conduits under the risk retention regulations (available at www.americansecuritization.com/WorkArea/DownloadAsset.aspx?id=6463).

because in many ABS transactions tranches of securities may be offered or sold at different times, and so there is not a single pricing date for all offered securities.

We believe, therefore, that the final rules should provide for a one-time determination made at the outset of the securitization transaction, between the time at which at least 10% of the offered securities have been priced and the closing date, so long as the date (or the manner of determination of the date) is disclosed to investors.

- The material features of the methodology by which fair value is calculated and the results of the calculation should be fully disclosed to investors.

One such methodology—a form commonly used in valuing first-loss interests in securitizations—is the discounted cashflows approach. Under this approach, an eligible horizontal residual interest could be valued by determining the discounted present value of future cashflows on the related ABS interest(s). Depending on the case, various components would be factored into the calculated value, such as the current amount of overcollateralization and the discounted present value of any expected excess interest to be received on the residual interest.⁵ So long as the sponsor discloses all components that it used to calculate the residual interest's value, such as the discount rate, prepayment speeds and other material assumptions that were used to calculate the value, determining an eligible horizontal residual interest's fair value in this manner should be permissible.

- If fair value is calculated in this manner and fully disclosed to investors, the securitizer's determination should enjoy the benefits of a "safe harbor," such that its good faith determination will not be second guessed after-the-fact (for example, if there were a substantial movement in the market at some later point in time).
- Beyond the fair value calculation itself, there is the question of what fair value is to be measured against to determine the baseline risk retention requirement. As with the fair value calculation, this measurement should accommodate the unique features of different asset classes and transaction structures and, in this regard, we remind the Joint Regulators that revolving asset master trusts face unique transition issues as they aim to comply with the final risk retention regulations.⁶ As noted above, details such as these are critical to our assessment and must be developed and clarified before we can provide meaningful comment on this approach.
- Special issues arise if the Joint Regulators apply this fair value calculation in the context of the more tailored risk retention option available for commercial mortgage-backed securities (CMBS). If this fair value calculation operates to require that the third-party purchaser hold an interest representing more than 5% of the par value of all of the ABS interests issued, then the CMBS option will effectively have been eliminated as a

⁵ As discussed in our original comment letter, in cases where the securitizer retains the first-loss interest and the next-most subordinate interest in the transaction (e.g., the most junior subordinate notes), we believe that such next-most subordinate interest should also be factored into the calculated value.

⁶ As discussed in our original comment letter, the baseline risk retention requirement for revolving asset master trusts should be measured in relation to each ABS interest in the issuing entity issued on or after the effective date of the final regulations. For a discussion of the transition issues confronting revolving asset master trusts, see our original comment letter at pp. 120-121.

meaningful alternative because an interest of that size would in many cases be so illiquid as to make it unmarketable.⁷

CONCLUSION

- As noted above, the considerations and principles outlined here warrant careful consideration by the Joint Regulators and are based on only a conceptual notion of this fair value approach. Consequently, we reiterate our willingness and desire to meet with representatives of the Joint Regulators to discuss this approach in more detail and, again, urge the Joint Regulators to re-propose revisions made in response to comments submitted on the Proposed Regulations, including any revisions relating to this fair value approach.

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Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact me at 212.412.7107 or at tdeutsch@americansecuritization.com, Evan Siegert, ASF Managing Director, Senior Counsel, at 212.412.7109 or at esiegert@americansecuritization.com, or ASF's outside counsel on these matters, Michael Mitchell of Chapman and Cutler LLP at 202.478.6446 or at mitchell@chapman.com.

Sincerely,



Tom Deutsch
Executive Director
American Securitization Forum

⁷ These liquidity concerns could be mitigated somewhat by allowing the sponsor and the third-party purchaser to share the 5% risk retention requirement. Another option may be to allow aggregation of the investments of more than one third-party purchaser in the eligible horizontal residual interest (or in such interest and in the next-most subordinate interest) to satisfy the 5% fair value retention requirement. Linking purchasers for this purpose would, however, likely have an adverse effect on market execution/pricing, because the market for such interests is by its nature limited to a relatively small number of investors in the first instance. Other options that would mitigate liquidity concerns include (i) limiting the duration of the retention requirement and (ii) allowing an initial third-party purchaser to resell its eligible horizontal residual interest to a subsequent third-party (and allowing further resales thereafter) where the subsequent third-party purchaser satisfies the basic review and other requirements applicable to the initial third-party purchaser.