



American Securitization Forum¹ Discussion Points
Swap and Margin Rules
July 6, 2011

General Discussion

- The proposed common rules, among other things, generally require covered swap entities to collect initial and variation margin from their counterparties for non-cleared swaps, depending upon the type of counterparty, and limit the type of eligible collateral for margin to immediately available cash funds, treasuries and for initial margin only, senior debt obligations of certain government sponsored entities (hereinafter, "Liquid Margin").
- We believe that the application of the proposed common rules to structured finance swaps is not required by the Dodd-Frank Act, will not serve the policy embedded in the Dodd-Frank Act to reduce systemic risk and will lead to less liquidity in the structured finance market. Structured Finance Swaps were not a corner of the swap market requiring legislation following the 2008 crisis and have more than adequate built-in protections against systemic risk.

Background on Structured Finance Use of Swaps

- Although there is no universal definition of "structured finance", the Bank of International Settlements definition is instructive, which is as follows: Structured finance instruments can be defined through three key characteristics: (i) pooling of assets (either cash-based or synthetically created); (ii) tranching of liabilities that are backed by the asset pool; and (iii) de-linking of the credit risk of the collateral pool from the credit risk of the originator, usually through the use of a finite lived, standalone special purpose vehicle ("SPV").
- Interest rate and currency derivatives are among the most commonly used swaps for structured finance participants. Typically, structured finance participants use swaps to hedge floating interest rate liabilities. Swaps are an integral part of the structured finance and securitization structures; in particular, with respect to mortgage-backed

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securitizations, interest rate swaps enable structured finance SPVs to hedge liabilities relating to the underlying asset of 30-year fixed-rate mortgage loans.

- Structured finance swaps are not used for speculative purposes and structured finance participants typically use few structured finance swaps per structured financing.
- Other important features of structured finance swaps include that they do not have a predetermined notional amount and other than in a default situation, they are usually senior in the waterfall to the other obligations of the structured finance SPV. Structured Finance Swaps are often overcollateralized with the collateral of the securitization (the receivables). Attachment 1 shows an example of an automobile loan securitization. The example shows that at t-1 under scenario 2, which assumes a 1.5x maximum interest rate movement, without liquid margining, the structure would have 3.9 times as many assets as (in terms of receivables) it would need to cover the required collateral on the swap, which level of collateralization is by far higher than the default initial and variation margin levels contained in the releases proposing the margin rules.

Implications for Applying the Proposed Rule to Structured Finance

- As special purpose vehicles, the structured finance SPVs would not be able to comply with these requirements standing alone. Structured finance SPVs do not typically have access to Liquid Margin as would operating vehicles.
- Applying Liquid Margin requirements to structured finance SPVs would present the sponsoring group with a choice to either retain more of the economic risk of the structured finance issuances or forego such issuances.
- The regulation of retention of economic risk by sponsoring groups is the subject of other provisions of Dodd-Frank, notably Section 941. There is no legislative intent demonstrating that the Title VII derivatives provisions were intended to be applied on top of the risk retention requirements contained elsewhere in Dodd-Frank.
- The application of a Liquid Margin requirement may render many structured financings uneconomic as the structured finance SPV would be required to post cash and liquid securities which it does not have.
- Requiring the posting of liquid collateral would affect the cash flow analysis for a structured financing and ultimately reduce the amount of loans or other financing for the assets underlying the structured financing. This would have an effect on the real economy—including auto loans and credit card loans—at a time when the economy is still trying to recover.
- Attachment 1 reflects the foregoing point. Attachment 1 assumes an interest rate swap related to an automobile securitization offering, that the size of the automobile securitization offering and related notional amount of the swap is \$100, the duration of the offering is 4.25 years, the required initial margin is 2% of the notional amount

(which is consistent with the standardized minimum initial margin requirements on Appendix A of the Release), the offering and swap notional amortize according to historical prepayment levels and variation margin is posted dollar for dollar with no threshold. Attachment 1 shows the effect of posting Liquid Margin under two scenarios.

- In Scenario #1, we assume that interest rates have moved during the relevant time period by 95% of the historical movement in interest rates over such a period since January 1984. In Scenario #2, we assume that interest rates have moved during the relevant time period 150% of the historical movement in interest rates over such a period. In order to create a margin reserve under both scenarios there will be less cash flow initially to make loans under either scenario. In Scenario #1, there will be \$9.83 less available at inception to make loans, while in Scenario #2, there will be \$21.13 less available at inception to make loans.
- The cost of this reduced liquidity could conceivably be justified if it was achieved along with the benefit of a reduction in risk to the structured finance SPV's counterparty and a reduction overall in systemic risk. However, as described above, under current market practice, structured finance swaps are typically overcollateralized with the collateral-receivables that are the subject of the structured financing.

Proposed Solutions

- While there may be many ways of avoiding the result and the foregoing consequences of applying the Liquid Margin requirements to structured finance swaps, we believe that this could be done by either amending the proposed common rules to (i) permit, as they do with end users, thresholds that do not mandate margin for structured finance SPVs or alternatively, (ii) not require structured finance SPVs to use Liquid Margin, but instead to rely upon the senior cashflow priority of these swaps in the structured finance waterfall, consistent with current market practice.

Attachment 1—Example of a Liquid Margin Requirement on a Structured Finance Swap

Budgeting for collateral reserve allocated at time zero

95th percentile historical interest rate movement

	t=1	t=2	t=3	t=4
Size	\$100.00	\$100.00	\$100.00	\$100.00
Duration at inception	4.25	4.25	4.25	4.25
Required upfront	2%	2%	2%	2%
Required upfront \$	\$2.00	\$2.00	\$2.00	\$2.00
95% interest rate movement	2.87%	4.65%	5.37%	5.25%
Remaining duration at that time	3.25	2.25	1.25	0.25
Remaining balance at that time	\$81.94	\$62.97	\$43.01	\$22.04
Swap 95% mtm movement	\$7.63	\$6.59	\$2.89	\$0.29
Collateral haircut	98%	98%	98%	98%
Total required collateral	\$9.83	\$8.77	\$4.99	\$2.34
Effective existing overcollateralization	8.3x	7.2x	8.6x	9.4x
Funding cost (bps)	50	50	50	50
Collateral earnings (bps)	0	0	0	0
Negative carry (bps)	-50	-50	-50	-50
Total net running collateral cost \$	-\$0.05	-\$0.04	-\$0.02	-\$0.01
Total net running collateral cost (bps)	-4.92	-4.38	-2.49	-1.17

Budgeting for collateral reserve allocated at time zero

1.5x maximum historical interest rate movement

	t=1	t=2	t=3	t=4
Size	\$100.00	\$100.00	\$100.00	\$100.00
Duration at inception	4.25	4.25	4.25	4.25
Required upfront	2%	2%	2%	2%
Required upfront \$	\$2.00	\$2.00	\$2.00	\$2.00
Max x 1.5 interest rate movement	7.02%	7.94%	9.09%	10.69%
Remaining duration at that time	3.25	2.25	1.25	0.25
Remaining balance at that time	\$81.94	\$62.97	\$43.01	\$22.04
Swap max x 1.5 mtm movement	\$18.71	\$11.24	\$4.89	\$0.59
Collateral haircut	98%	98%	98%	98%
Total required collateral	\$21.13	\$13.51	\$7.03	\$2.64
Effective existing overcollateralization	3.9x	4.7x	6.1x	8.3x
Funding cost (bps)	50	50	50	50
Collateral earnings (bps)	0	0	0	0
Negative carry (bps)	-50	-50	-50	-50
Total net running collateral cost \$	-\$0.11	-\$0.07	-\$0.04	-\$0.01
Total net running collateral cost (bps)	-10.57	-6.76	-3.52	-1.32