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Regulation AB and Swap Provider Disclosure: Part 2, Maximum Probable Exposure

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The only question left to answer is what is "maximum probable exposure," a term not defined in Regulation AB. In fact, it is probably not possible to reliably interpret this phrase by reference to its plain meaning, or even by consulting the adopting release, SEC Release 33-3518 (the "Release"). Upon reading a comment letter cited as a source in the Release, however, its meaning becomes clear. (There is a jurisprudential issue lurking in the way in which the key comment letter language has effectively become part of Reg AB for purposes of Item 1115 as a result, which I will leave for discussion another time.)

In the Release, the Commission referred to commenters that noted that participants in the derivatives markets routinely evaluate their maximum probable exposure to a counterparty, to make a credit decision as to counterparty risk, in the case of an unsecured contract, or to set required collateral levels, in the case of a secured contract, for example. These commenters suggested that relying on maximum probable exposure would be more consistent with market practice.

In the comment letter submitted by the American Securitization Forum, it is stated that while the precise method for determining maximum probable exposure may vary among market participants, a typical approach would be to determine the maximum net amount that the counterparty might be required to pay under a statistical analysis using a range of scenarios that are within two (or more) standard deviations from the base case. "Base case" is also not defined, but presumably refers to the shape of the yield curve (and corresponding assumptions about expected changes in interest rates) at the time the derivative was priced. Thus, in an interest rate swap, the "maximum probable exposure" would refer to the net amount that the counterparty would be required to pay to the issuing entity if the actual changes in interest rates over the term of the contract conformed to the least favorable interest rate scenario for the counterparty included in the range of scenarios statistically modeled by the sponsor and falling within two (or more) standard deviations of the pricing assumption scenario or "base case."

Note that the maximum probable exposure cannot be the same thing as the "probable exposure" to the derivatives counterparty. To use a specific example, the maximum probable exposure to an interest rate cap (a contract in which the cap provider agrees to make periodic payments with respect to a notional amount at a rate equal to the excess of LIBOR, for example, over a specified fixed interest rate from time to time, in return for a one time up-front payment or "cap purchase price") cannot be the cap purchase price. That amount only expresses the amount the cap provider expects to pay, plus a profit margin. But economic theory would indicate that the cap provider cannot charge a

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"purchase price" calculated on its "maximum" probable payment rather than its "probable" payment; if it did, competitors could come in at a lower price and still make a profit over time (because on average, the actual path of forward interest rates is likely to be more favorable to the counterparty than that indicated by the worst case scenario modeled within two (or more) standard deviations of the "base case" for each separate cap transaction.)

This is unfortunate because the cap price is a contract term known to the sponsor without the requirement of undertaking additional modeling, and it will be lower than the "maximum probable exposure," making it less likely that the derivative would hit the 10% or 20% threshold if the cap price were used.

The "maximum probable exposure" also cannot be the "replacement value" (or "Loss," in ISDA-speak) that the issuing entity would suffer if the derivatives contract were terminated early. This number will also be smaller than "maximum probable exposure."

On the other hand, the statistical approach embodied in the "maximum probable exposure" concept arguably comes closer to reflecting (on a conservative basis) the ABS investor's credit exposure to the derivatives counterparty during the term of the ABS securities than does using the cap purchase price or "Loss."

The ASR comment letter contains an example that assumes a 5-year interest rate swap, with LIBOR exchanged for fixed rate payments at a then current market rate, with a non-declining notional amount of $100,000,000. The letter notes that because the obligations of the floating rate paying counterparty are uncapped, under very extreme scenarios, the maximum *possible* exposure of the issuer to that counterparty could be in excess of even the notional amount (because LIBOR, as a theoretical matter, could continue to rise without limitation). To illustrate this I came up with the following example. If the fixed rate on the swap is 5% and LIBOR rises to 25% on day one of the swap and stays there for five years, then the net rate payable by the swap provider would be 20%, annual net payments would be $20,000,000, and the actual exposure would be $100,000,000 over the 5-year term. A greater increase in LIBOR would produce an actual exposure in excess of the $100,000,000 notional amount. However, the maximum *probable* exposure would typically be approximately $5 million in the example, according to the ASR.

As long as the maximum probable exposure to the counterparty for at-the-market swap contracts supporting asset-backed securities remains below 10% of the aggregate principal balance of the pool assets or the classes of asset-backed securities to which the derivative relates, as applicable, Item 1115 will have a very modest effect on the scope of disclosure by derivatives providers in ABS. In light of the difficulty that derivatives providers that are not U.S. Exchange Act reporting companies would have in supplying the financial statement disclosure required by Item 1115 when "maximum probable exposure" is greater than or equal to 10%, many market participants are probably counting on the 10% level never being hit.