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Securitization – What's in Store for 2016?

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MODERATOR
Paul Forrester

Presentation

Paul Forrester: Thank you for joining Mayer Brown's Global Financial Markets Initiative Teleconference Series. Today's GFMI call is titled Securitization – What's in Store for 2016? And as our regular listeners will know, this is our highly popular annual review of scheduled or otherwise anticipated legal developments that affect securitization. My name is Paul Forrester and I'm a partner in the Corporate Finance and Securities practice of the firm, based in the firm's Chicago office and I'm pleased to moderate today's call.

Before beginning our presentation today, a couple of administrative matters. As regular GFMI listeners know, our GFMI calls are recorded, and we will be providing an audio link to all participants following today's call so that if you wish to listen to the teleconference again or share it with colleagues, you will be able to do so.

Also, even though our GFMI call format does not include a Q&A session, we certainly encourage you, if you have questions, to send them to us using the address GFMI@mayerbrown.com and your questions will be promptly forwarded to the appropriate lawyer. By the way, that is the same email address as was included on your invitation emails.

Now I'd like to briefly introduce our speakers for today's call, although they may be well known to many of you. Joining me are Stuart Litwin and Jon Van Gorp. Stuart Litwin is a partner and co-head of Mayer Brown's Structured Finance and Capital Markets practices. He is one of the leading lawyers in the United States in the representation of originators, investment banks, ABCP conduit sponsors, hedge funds, commercial banks and investors, in structuring, negotiating and documenting both US and international asset-backed and other securities transactions. Stuart's experience has involved the securitization of actually all asset types included in securitizations.

Jon Van Gorp is also a partner in Mayer Brown's Chicago office and is co-leader of the Banking and Finance, Structured Finance and Capital Markets practices of the firm. Jon's experience includes public and private securities offerings, asset sales, structured finance transactions, leveraged leases, derivatives, synthetic risk transfer programs, and financial insurance.

I'm pleased now to welcome our speakers to our call today and to turn the call over to Stuart to begin our formal presentation. Stuart?

Stuart Litwin: Thanks a lot, Paul, it's a pleasure to be here. 2015 was a year of unprecedented regulatory developments in the structured finance space, and so it's really exciting to be able to have the opportunity to talk to everybody today. Many of these developments will truly change the securitization markets in some huge ways. Of course, in selecting what we were going to present in a half-hour call, we had to be extremely selective, so we're going to try to cover most of the waterfront, but there are a lot of topics that we had to leave out just in the interest of time.

So the first place I'm going to start is with the implementation of the Regulation AB II changes. The compliance date has already arrived, it was November 23, 2015, and since that date, all new public ABS deals require compliance with the new Reg AB forms including registration statement, 10-Ds, 8-Ks, and 10-Ks. All issuers have had to file new registration statements and have them declared effective in order to do new public deals.

Most regular issuers have filed their new registration statement on form SF-3. Many of the registration statements, though, are not yet effective. They're almost there, so a lot of the regular issuers—many of them filed in June, July and August and they're still in the registration process. The process took longer than most issuers expected. There are a lot of reasons for that; unfortunately, we probably don't have enough time to get into those details right now, but they will soon become effective.

The current Regulation AB II changes don't include asset-level data yet; that will be required beginning November 23rd of this year, 2016, and it'll be required in the prospectus and ongoing reports. So what I want to focus on right now are some of the Regulation AB II topics to worry about right now for new public deals, and again, this is what everybody seems to be focused on now who is a regular issuer thinking about getting their first public Reg AB II deals into the market.

So probably the first thing is planning for the depositor CEO certification, and all issuers are going to now have to implement some internal process to get the depositor's CEO comfortable with the certification. And that certification is not just a typical 10b-5 certification; that certification is also, in effect, a certification that that depositor's CEO believes that the deal is going to pay off.

And part of that will involve due diligence procedures for the company itself in order to get comfortable with the certification, to go through every line, every sentence and every number in the prospectus, and ask the question, "What are we doing or what have we done in order to help us feel comfortable that that line, that sentence, or that number is right?"

Next, everyone for each public deal will have to engage an asset representations reviewer. If you hit a delinquency trigger and there's an investor vote, that reviewer will have to review at least all 60-day delinquent assets for compliance with the representations and warranties.

So what everybody has to do now is come up with the correct delinquency trigger, ideally a trigger of delinquencies that won't be hit and their explanation of why that trigger is appropriate, so everybody is working on that. A lot of folks are looking at other people's filings and what they've already filed with the SEC as part of their registration statements to see if anybody else has better ideas.

Then they have to negotiate the asset representations review agreement with their asset reviewer, and some of those topics that they're negotiating are the scope of the review. One of the most interesting things is that all the reviewers initially wanted to be able to resign, and that's really not something that most folks

are going to allow to happen. Of course, if there were ever a review, that might be the time that the reviewer might decide to resign, and that would be a particularly bad time to try to get somebody else in as a replacement.

We've also seen in the negotiations some really interesting trustee issues. So a lot of folks had in their registration statements provisions that the asset review would sort of have the indenture trustee in the middle of the process, and all of the trustees have made pretty crystal clear they don't want to be in the middle of it; they don't think it's necessary, and in fact, it might be easier for everybody to just take them out of the middle of the process.

The next implementation issue is planning for asset-level data, even though that's not something that has to be done for a new deal that would happen before November of this year. You can't wait to start planning for asset-level data. For most companies, trying to get programming changes made often takes a lot of lead time; you can't just do that on the fly later on, so it's really important for folks to be thinking about that now.

So back to the deals that are going to happen this month and next month. Some of the important changes are timing considerations and among those timing considerations, probably the most important is that you have to file your "Red Herring" prospectus at least three business days before you sell the securities, so at least three business days before pricing, and that's a new constraint for a lot of folks.

And what will happen in real life, I think, is that a lot of deals will file during the week prior to the formal announcement of the transaction and then have a couple of days of pre-marketing and then have the formal announcement on a Monday, and I think we'll wind up seeing a lot of deals being sort of bunched up with formal announcements on Mondays and then pricing on Tuesdays and Wednesdays, because I don't think people are going to want to have formal announcements and have the book open during weekends.

Another important consideration is that really everything has to be in that red herring other than price and price dependent information, so you really have to have it all done and have your deal fully baked before you take it out of the oven and present it to investors. If you have to make changes after you're already in the market, you need to have a 48-hour waiting period.

So those new considerations have really kind of crept into people's thinking about things like upsizing. Can you still upsize? And, I think, most lawyers have agreed that you can still upsize. The conditions that you might have to go through might not be as appealing as they used to be, but you definitely can still upsize.

And I think a lot of other folks are worrying about how much they can change in their actual deals beyond what they've given to the SEC in their registration statements without going back with a post-effective amendment. It's hard to have any fixed rules. I think you have to look at the changes and decide whether those are changes of the structural features, whether they're fundamental changes, whether they're changes in the credit enhancement, or anything else that's just so material that you need a post-effective amendment.

The last thing on the Reg AB II topics is there's still some unfinished business. So when the SEC came out with their original proposal, there were a number of asset classes that were included, for example: equipment loans and leases, student loans, and there was "a grouped data" proposal for credit cards. We know the SEC is still thinking about those, and they may wind up coming up with a proposal sometime this year.

I'm going to turn it over to Jon now to talk about risk retention.

Jon Van Gorp: Thanks, Stuart. And risk retention, by way of reminder, is perhaps one of the most unique regulations under Dodd-Frank

because, as opposed to being a direct regulation of an activity, it's an indirect regulation of the market by requiring securitizers to retain risk in the deals they do with the idea that by retaining risk their behavior is going to be better.

We're starting to see the implementation of this rule now, which has been long anticipated. As of Christmas Eve, required retention was in play for residential mortgage-backed transactions. All other issuances of asset-backed securities will be subject to the rule at the same date this year, 2016.

What we're seeing is varied approaches to the compliance options under the rule. As a general matter, risk retention requires 5% of the fair value of the ABS interests as of the closing date to be retained in a required risk retention format, and those formats can vary to some degree. They could be a vertical interest across the capital stack, kind of top to bottom. It could be a horizontal interest at the bottom of the capital stack or it could be a combination of those two, sometimes called L-shaped retention.

In earlier proposed versions of the rules there were some other options that were eliminated in the final rule and so it's fairly straightforward now in terms of what compliance methods can be used. The disclosure about risk retention is something that is being evaluated right now by the market and we'll start to see some residential mortgage-backed transactions that are complying with the rule in making the disclosures very soon.

One of the big concerns in the market has been the requirement to disclose fair value calculations on horizontal risk retention slices; therefore, it's our expectation that some people in the market who are very proprietary about their fair value measurements, particularly those securitizers who buy seasoned assets, may elect the vertical approach which has less disclosure required than the horizontal approach.

The other interesting point about horizontal versus vertical retention is whether the sponsor intends to finance the retained interest. It has to be done in a particular way to comply with the rules, but it seems to me that the bank market for financing vertical retention is going to be a lot more robust than the market for financing horizontal retention merely from a credit perspective.

There are some exceptions to risk retention, and right now the most notable one is the qualifying residential mortgage loan exception that allows certain high-grade securitizations of mortgage loans to sidestep the rule. It also allows GSE securitizations, as long as they're in conservatorship, to sidestep the rule. This is a very big exception to the rule and is something that will shape the mortgage market going forward.

The issues under risk retention, as we talked about before, are largely focused on the election of the form of risk retention and the disclosures in residential mortgage deals, but all asset-backed security sponsors are looking prospectively at the rules and thinking about how to optimize their approach.

One of the emerging issues is how warehouse financings, for example, are going to be treated under the rules and attempting to structure warehouse transactions as loans as opposed to issuances of securities to avoid needing to comply with the rule.

There are also a lot of issues about fair value determination and how that's done and whether accountants need to provide comfort letters so to speak with regard to those determinations. I suspect in the next few months a lot of those points will be developed.

I'm now going to turn to a related topic which is specifically GSE reform and emerging issues in the mortgage market. I think we continue to see a disconnect in the mortgage market between the stated goal of moving to a market with more private capital at risk and the reality of what's happening, which is the government through the

GSEs continues to dominate the new origination mortgage market.

My own view is that the state of the market is unlikely to change before the next presidential election and so I think at least for this year and probably even after the election, it will be "business as usual" in the mortgage market for new origination mortgages with the GSEs dominating that market. I think some of the reform ideas, though, that have been presented will continue to gain momentum this year.

The single security platform, where the GSEs would issue off a single issuance platform, will continue to gain momentum. There's another movement afoot that will gain momentum. That's the idea of bringing more private capital to the GSEs risk transfer transactions.

For those of you in tune with this market, these transactions are referred to by acronyms like STACRs, and there has been a big debate about whether REITs can be active participants in those securities. There's a movement afoot to make those securities eligible for purchase by mortgage REITs, who would be natural buyers of that risk. I think there will continue to be movement on that front.

One thing in the new origination mortgage market that's gotten a lot of attention has been the TRID rules, which represent a unification of disclosure between the Truth in Lending Act and in the Real Estate Settlement Procedures Act that's been overseen by the CFPB. There was a lot of pain in the new origination mortgage market as those rules on disclosure were implemented. And there was a lot of potential concern about violations and whether they could be cured and whether they would affect the secondary market for those loans that were originated with these disclosures during this early implementation phase where there might be accidental mistakes on disclosure.

The CFPB came out with a letter at the end of last year being very clear that they understand the complications of implementation. When originators are making a good-faith effort to comply, their review is likely going to be in the nature of correction and diagnostic, as opposed to punitive. That letter, I think, will have a lot of impact on re-opening the secondary market which had been slowed a little bit by the implementation of these disclosure rules.

Some general observations on the mortgage market are the following; I think that the non-QM or non-qualified new origination mortgage market where risk retention, for example, would apply will continue to develop but at a slow pace given the market's dominance on the government side and the willingness of the government to make loans with little money down deeper into the credit curve. That eliminates a lot of the market for the non-QM loans.

Non-QM loans being made are a worthy product for super-prime borrowers who are looking for non-QM features like interest-only loans. Non-QM subprime products, which people had expected at the beginning of the implementation rules, have been slow to develop. There continues to be a robust market for mortgage loan securitization, but it's much more fractionalized than it was in prior market upswings.

So rather than having the market dominated by private label new origination mortgage securitizations, we now have several market segments. We have non-performing mortgage loan securitizations, re-performing mortgage loan securitizations, single family rentals, reverse mortgages, servicing advances, and non-US mortgage loans that are being securitized. These all form little esoteric markets in and of themselves which I think has continued to propel the mortgage securitization market, but in a much different way than in prior upticks that we've experienced.

I think mortgage servicing rights deals in 2016 will continue to be more attractive to the market; that is because the GSEs are becoming more

receptive to being a willing participant in the financing of mortgage servicing rights by their approved seller servicers, as well as an increase in interest rates, which is going to support the value of MSRs and make them more attractive to the financing market.

Before turning it back to Stuart, I'm going to quickly cover the Volcker Rule because that's another Dodd-Frank regulation that has had a significant impact on the securitization markets. The Volcker Rule prohibits banking entities from having interest in covered funds. And, surprisingly, that has a very unique application to the securitization market because many securitization issuers used investment company act exemptions, 3(c)(1) or 3(c)(7) in order to avoid the Investment Company Act application to their assets. And under the Volcker Rule, if those are the exemptions being relied upon, it's not clear that that entity would not be a covered fund. In response, the market has evolved in a way that most deals try to find an exemption from the Investment Company Act, other than 3(c)(1) or 3(c)(7), that is a clear way out of covered fund status which allows banks to freely invest in the asset-backed securities.

The other approach has been structuring any bank involvement as a loan as opposed to a securities purchase, going back to an idea we presented earlier on risk retention. That has, again, been adopted particularly in cases where an Investment Company Act exemption is not easily available other than 3(c)(1) or 3(c)(7). We started to see some law firms including our firm delivering should-level opinions on these loan interests not being ownership interests in a covered fund in warehouse securitizations, but in capital markets transactions that seems to be a less viable alternative than an exception from the Investment Company Act other than 3(c)(1) or 3(c)(7).

I'm going to turn it back now to Stuart, who's going to cover emerging issues related to the due diligence rules under Dodd-Frank.

Stuart Litwin: Not many emerging issues actually. There are all sorts of facts and circumstances issues that are hard to do on a call like this, but for purposes of this half-hour call, compliance began with the new due diligence rules on June 15th. We've now actually had a little bit of time to adjust and I think largely the market—issuers and underwriters and due diligence providers for the most part who are regular participants in ABS deals and securitization transactions—have adjusted to these rules.

Rule 15Ga-2 now requires filings for any third-party due diligence report obtained by an issuer or an underwriter in a rated ABS deal. It requires the filing of the form ABS-15G at least five business days before the first sale in the offering. The third-party due diligence provider also has to file Form ABS Due Diligence-15E to an NRSRO (a rating agency) that delivers a written request and to the issuer or underwriter, whoever is maintaining the 17g-5 site for posting on the 17g-5 website.

And both of those forms have to contain, among other things, the findings and conclusions of the due diligence report and, of course, so far I don't think I've seen a single due diligence report, a single ABS-15G that didn't attach a full copy of the report rather than trying to summarize the findings and conclusions. Nobody seems to want to or to have any interest in trying to summarize and potentially getting it wrong and having liability on it.

So the next topic on our call is the money market fund reform rules and proposals. This is a topic that hasn't gotten as much attention as a lot of other topics, but I think it's very important for a lot of companies who do a lot of securitization, particularly the biggest issuers in the market. So this will really affect the ability of big issuers to get warehouse financing in the market and how that will be disclosed to the market.

In 2014, the SEC adopted changes to the money market fund rules. The big changes that they adopted, like floating net asset values and liquidity fees and redemption gates for money market funds, don't really affect the asset-backed market at all. What really affects the asset-backed market, the securitization market overall, are the changes to the diversification rules for money market funds.

And the new diversification rules apply to new security purchases by money market funds beginning April 14th of this year so we're just a couple of months away. And the most important part of that is that for a money market fund, when thinking about how they're diversified with respect to the issuers of the securities they buy, it used to be that for an asset-backed security the only entity they'd ever think about was the issuer of that security, so just the SPE that issued that asset-backed security. But now on a go-forward basis, they have to aggregate not only that SPE but all of its affiliates and treat them as one group.

Hypothetically, let's assume that a money market fund in the past had bought a Class A-1 bond in a Ford auto loan 2015-B transaction. The only issuer the money market fund would have had to consider was the Ford 2015-B Trust and they just would have to make sure that when they bought that security, that that security by itself didn't exceed 5% of the fund's assets. But now the fund will have to aggregate everything they have that's somehow connected to Ford—all the other Class A-1 bonds in the other deals that they've purchased and other asset classes that they've purchased from Ford. But not only that but also other Ford corporate short-term debt and not only in the US, but if they've purchased anything that's outside the US, they'd also have to aggregate all of that.

And that may sound complicated but it actually gets even worse because a lot of money market funds buy asset-backed commercial paper and for asset-backed securities under the money market fund rules. Rule 2a-7, there is a look-through to 10% obligors. So if you buy an asset-backed security and there is a 10% or more obligor, the money market fund has to allocate some of its investment, the proportionate amount, to that obligor.

If that obligor was, say, 16% of the total assets of that SPE issuer, then the money market fund would have to allocate 16% of its investment to that 16% obligor. So what happens if there is a big Ford transaction in an asset-backed commercial paper conduit? Well, now suddenly that has to not only be looked at by a money market fund but it has to be aggregated with all of the other investments of the money market fund including other big Ford deals in other asset-backed CP conduits. So this could get very, very complicated.

And certainly a real question, "How many money market funds are even going to want to allocate any of their investment to something else other than the security that they're buying, and do they have the systems' ability to do so?" So it'll be interesting to see how this affects our market going forward, particularly the ABCP market.

I think in the interest of time I'm going to move to another new set of rules. This year, just in the last couple of months we now have margin rules for uncleared swaps. Those aren't effective yet, the compliance dates still haven't come into being yet, but a couple of years ago we had a lot of concerns about clearing for swaps that were included in securitization transactions. And if you had to clear your transaction, you would be forced to have margin for those transactions.

And so everybody tried to figure out some exemption or to structure their transactions in a way so that they wouldn't need to have clearing of the swaps. Well, now even if you've done all that work, you might in fact now have a margin rule for the uncleared swaps in those transactions. First the US banking regulators issued final rules for margin for uncleared swaps in October of this past year, 2015, and the CFTC

issued parallel rules just in December, just in the past month.

There are some exemptions for some uncleared swaps that are entered into solely for hedging purposes by qualifying non-financial entities. The most important for securitization purposes are captive finance companies and securitization entities that are owned by the captive finance companies will be exempt from all of these rules. They won't have to worry about margin for their uncleared swaps but there are no general exemptions at all for other securitization SPEs so these rules apply to securitization SPEs, generally.

What the rules require is posting of "initial margin" and "variation margin." Initial margin is the margin that has to be posted at the time a swap is entered into and for a lot of securitization transactions you won't need to have initial margin. The way the rules work is they look not only at the securitization SPE, but they look at all of the affiliates and they look at the—in effect, the aggregate book of covered swaps; that's all of the uncleared swaps and some other things that go into that definition.

And if that securitization entity and all of its affiliates have more than $8 billion of average daily notional amounts in their covered swap portfolios, then they'll have to put up initial margin, otherwise they won't. So that $8 billion number is an important number. That gets out a lot of folks from having to put up initial margin.

The second kind of margin that has to be posted for swaps and for securitization swaps, and in particular for our call is "variation margin." And that requires the parties to a swap transaction to calculate, post and collect collateral on a daily basis every day. That has to be measured based on the change in the "market to market" value of a covered swap, an uncleared swap.

So think about it. You've got securitization entities that typically have monthly reporting, monthly settlements, and somehow they're going to have to comply with daily margin requirements. It really is something that's completely foreign to SPE swaps and will have an effect.

Now the compliance dates for these rules begin September 1, 2016, but these get phased in so the biggest entities will wind up having a compliance date on September 1, 2016, but most of the compliance dates get phased in much later depending on the size of the covered swap portfolio.

The biggest issue with these rules is really going to be how are we going to make daily margin requirements work and how are we going to get that amount of money into a securitization SPE to post collateral in a way that's consistent with it being a bankruptcy remote entity without violating substantive consolidation principles? And we, at Mayer Brown, have been thinking about this for a while. We've got a lot of good ideas, but obviously many of those are still a work in progress.

The next topic that I want to mention is a piece of unfinished business in Dodd-Frank. It's the conflict of interest rules. Just simply to mention, those are still out there, Dodd-Frank Section 621. It requires rules but it would prohibit material conflicts of interest with ABS investors for a year after closing. It would apply in both public and private deals.

The SEC made a proposed rule, and the proposed rule was extremely broad to track the statute. The release that explained what the SEC was doing made very clear that the only kinds of things they were looking at were "short transactions" like the Goldman-Abacus deal. There were lots of comments.

It's certainly possible that final rules could be adopted at any time but I overheard someone say to me that the Office of Structured Finance at the SEC hasn't really seen anything about these rules which gives me some idea that these aren't going to come out in the next week or two. So there may be a little bit more time. If they

came out exactly as proposed, there would be a lot of uncertainty.

2016 Market Predictions

So then the last thing that Jon and I wanted to do was to just offer some predictions for 2016 based on what's on our desks, what we're seeing within our firm, and I'll offer some predictions and then turn it over to Jon to add any additional predictions that he might have.

So the first one on my list is, I think that the ABS market is going to thrive this year much like it did last year. Clearly there's been bumpiness in pricing and that has held some issuers back but I think the overall securitization market will do very well.

I think that probably the busiest quarter we're ever going to see in the history of the securitization market, in particular for lawyers, is going to be the fourth quarter of this year as I think that a lot of issuers are going to accelerate their timing of transactions to get them done before the risk retention rules kick in. So hold onto your seatbelts, this is going to be a very busy year and the fourth quarter will be an extremely busy quarter.

I think Auto ABS will absolutely continue to be the largest asset class in the market. Auto sales seem to be doing well. The economy seems to be doing better and for all of the auto issuers, there's really nothing better than asset-backed securities from a low cost funding standpoint.

I think all of the uncertainty in interest rates is probably going to cause there to be the potential for more floating rate ABS, but will they need swaps and will the complications of doing swaps get in the way? That remains to be seen.

I think a trend that we started seeing in 2014 and definitely continued through 2015, and I expect to accelerate in 2016 is that we're going to see more and more issuance by banks. Banks are very much faced with what I call the "frightful five." The frightful five are: (1) regulatory capital, (2) leverage ratios, (3) the liquidity coverage ratio, (4) the future net stable funding ratio, and (5) stress tests.

When you combine all of those things with low margin assets, it creates tremendous incentives for the bank to manage capital and leverage ratios to get low margin assets off their balance sheets so they don't have to hold capital against them. So I think we'll see a lot of deals where we have residual sales, other accounting techniques to get transactions off balance sheet.

I think the liquidity coverage ratio and the future net stable funding ratio will really make banks want to fund most of their assets, particularly their low-margin assets, with longer-term liabilities rather than funding them through deposits and other short-term liabilities.

Unsecured consumer loan ABS will be a bigger and bigger feature in the market, particularly as marketplace lenders—for consumer, for business—and folks continue to figure out ways to incorporate the Internet into lending and do electronic lending, I think we'll see more securitization of unsecured loans arising out of that.

And, Jon, do you want to add anything?

Jon Van Gorp: Well, we're kind of out of time so I guess I'll just echo what I said earlier about the mortgage markets; that they'll continue to factionalize the strong and my general observation is that what doesn't kill you makes you stronger. By that what I mean is that the alphabet soup of regulation that's come out under Dodd-Frank has not killed the industry. The industry has figured out how to adapt to it. In many ways it's made it stronger because a lot of investors now feel it's safe to invest in securitization because there are a whole lot of regulations, both direct and indirect that's protecting their interest so I share Stu's view that we're going to see a strong market in 2016 and beyond. Thank you very much for your participation in today's call.

Paul Forrester: Thank you, Stuart and Jon, for that excellent high-level review which I'm confident our call participants will find interesting and helpful. Just a couple of reminders, please keep a look out for the email to the link to the recording of today's call and certainly in light of the high-level nature as was mentioned of this review, we encourage you again, if you have questions, to send them to us using the address GFMI@mayerbrown.com. Thank you again for your participation. This concludes today's call. You may all now disconnect.

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