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Securitization: What to Expect in 2016

WELCOME

REVISIONS TO RULE 2A-7: ABS ISSUES

Issuer Diversification

- General Rule: Up to 5% of total assets in securities of a single issuer (or only .5% in second tier securities of an issuer)

- Issuer diversification rules don’t apply to securities that are fully guaranteed by a non-controlled person

Impact of Amendments on Issuer Diversification

- An MMF must treat as a single issuer 2 or more issuers of securities owned by the MMF if one controls, is controlled by, or is under common control with the other (with more than 50% voting security ownership constituting control) (the "Affiliate Rule")
  - An exception has been provided, however, for ABCP conduits owned by affiliated equity owners if a primary line of business of those equity owners is owning and providing services to SPEs, the equity owners' activities with respect to the SPEs are limited to providing administrative or management services and no qualifying assets of the SPEs were originated by the equity owners

Ten Percent Obligors/The Look Through

- For Primary ABS, any person whose obligations constitute 10% or more of the principal amount of the qualifying assets of Primary ABS is deemed to be an issuer of the portion of the Primary ABS such obligations represent
- For Secondary ABS, if a ten percent obligor of Primary ABS is an issuer of Secondary ABS, any person whose obligations constitute 10% or more of the principal amount of the qualifying assets of such Secondary ABS also is deemed to be an issuer of the portion of the Primary ABS such obligations represent
- Stop after the "second look"

Impact of Amendments on Ten Percent Obligor Look Through

- The Affiliate Rule applies in determining what persons are 10% obligors of Primary and Secondary ABS

Restricted SPEs

- A “Restricted SPE” is an SPE that issues ABS if the securities that it issues (other than to its parent) are held by only one other SPE. As such, as a practical matter, a Restricted SPE issues Secondary ABS only

- An MMF can’t otherwise invest in a restricted SPE

- Restricted SPEs are ignored for purposes of the 10% obligor look through

  But . . .

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Impact of Amendments on Restricted SPEs

- "Restricted SPEs" are included for purposes of the Affiliate Rule

Guarantor Diversification

- General rule: 10% of total assets issued or guaranteed by any single provider of demand feature or guarantee
  - 2.5% limit on second tier guarantees
- Prevents too much exposure to an guarantor
- Amendment complicates this rule for ABS sponsors:
  - A sponsor of an ABS will be treated as a guarantor with respect to the entire principal amount of the ABS unless the MMF's board of directors has determined that the MMF is not relying on the sponsor's financial strength or its ability or willingness to provide credit, liquidity or other support

Impact on ABCP Conduits

- Conduit sponsor likely deemed to be a guarantor of all CP even if not providing "full support liquidity".
  - Now 10% limit will apply to conduit's paper and all obligations of conduit sponsor together plus 5% limit on conduit paper.
- Issuer diversification does not include conduit SPE customers except to the extent they are 10% obligors.
- Affiliate rule applies at conduit level and for purposes of calculating 10% obligor.
- Conduits may still wrap 10% obligors with unconditional guarantee and report same to avoid having reportable 10% obligor.
- RSPEs still need not be disclosed individually but must be included in aggregation with affiliate obligors to determine whether any 10% obligors exist.

ABS and ABCP Considerations

- Who is a "sponsor"?
  - No definition. Should risk retention definition and related expansive interpretation apply?
- For affiliate aggregation, look to voting securities for control. What constitutes "voting securities"?
  - Consider application to CLOs and other fund structures
  - Consider orphan SPEs – must they be aggregated with unrelated but commonly owned orphans?

U.S. RISK RETENTION

Risk Retention

- Compliance already required for all new RMBS deals; compliance for all other deals beginning December 24, 2016
- Sponsor of a securitization transaction generally must retain at least 5% of fair value as of the closing date of all "ABS Interests" in the transaction
- Forms of Risk Retention:
  - Eligible vertical interest,
    - Can be either:
      - A single vertical security or
      - An interest in each class of ABS Interests issued as part of the securitization transaction
  - Eligible horizontal residual interest (or reserve account), or
  - Any combination of the above
  - Special rules for specific types of deals
- Requires description of methodology used to calculate fair values, including key inputs and assumptions like default rate and loss given default
- Exceptions/0% Risk Retention if securitization consists entirely of Qualifying Residential Mortgages, Qualifying Commercial Loans and Qualifying CRE Loans
  - Reduced risk retention (not lower than 2.5%) for "blended" pools of qualifying and non-qualifying loans

Preparing for Risk Retention

- Some truly private deals like warehouse financings are being structured as loans rather than securities
  - Risk Retention applies only to '34 Act ABS
- Fair value must be determined "in accordance with GAAP"
  - Will it be necessary to get anything from accountants? Will accountants provide it?
  - Will legal opinions be requested from issuer's counsel?

Variable Funding ABS

- When is required risk retention measured for a variable funding transaction (i.e., a transaction in which the investor has a maximum commitment, but the principal balance of the ABS fluctuates)?
  - The percentage of risk retention must be determined "as of the closing date of the securitization transaction"
  - SFIG risk retention guide recommends that each increase in the amount of ABS be treated as a separate closing date, with disclosures to be made a reasonable period of time prior to increase date (or on initial closing date if known)
  - Does this mean that risk retention is required for variable funding deals entered into prior to the compliance date?

Lessons from RMBS Market

- RMBS deals done since compliance date have used eligible vertical interest retention
  - Avoids fair value determination
  - Avoids disclosure
- Fund/manager issues seem to be sorted
- Banks have been willing to finance retained securities in full recourse financings
- Best practices on documentation and opinions are developing
- Consensus on transactions scoped out of the Rule

MADDEN, CASHCALL AND THINK FINANCE

Traditional Bank Origination Model

- Bank has authority under federal law to “export” interest rate and fees permitted by state law where the bank is located to borrowers located in any other state
- Retailers, marketplace lenders and others often partner with banks to originate consumer loans on their behalf to take advantage of exportation
- Structure of the traditional bank origination model
  - Bank originates the open-end receivables or closed-end loans in its own name at interest rate permitted by home state pursuant to agreed upon underwriting terms
  - Bank sells the receivables or loans to partner entity within 2-3 days and that entity bears the credit risk on the receivables or loans
  - Partner entity services the receivables or the loans

Traditional Bank Origination Model

- Concern that purchaser of the receivables or loans from bank could be considered the "true creditor" rather than bank and loan could be usurious under various state usury laws
- U.S. Court of Appeals for 8th Circuit (*Krispin v. May Department Stores* (2000)) and other courts have generally recognized bank as true creditor in revolving credit programs due to bank maintaining the account relationship
- Closed-end credit presents some additional risk because bank often lacks continuing relationship with borrower
  - *CashCall, Inc. v. Morrissey* (W.Va. 2014)(purchaser is the creditor)
  - *Sawyer v. Bill Me Later, Inc.* (D. Ut. 2014)(bank is creditor)
  - *Hudson v. ACE Cash Express, Inc.* (S.D. Ind. 2002)(bank is creditor)

Madden v. Midland Funding, LLC

- Decision by U.S. Court of Appeals for 2nd Circuit in Madden has raised concerns for purchasers of consumer loans. 2nd Circuit denied rehearing motion and case remanded to the District Court for consideration of choice-of-law and other points; petition for certiorari has been filed with U.S. Supreme Court
- Madden not a "true creditor" case but rather involved a debt collector purchasing charged-off credit card accounts from a national bank. Debt collector tried to collect interest at contract rate which exceeded NY's 25% criminal usury law
- Court denied debt collector the ability to rely on bank's federal preemption (exportation) authority
- Continuing relationship identified by 2nd Circuit as important factor in applying preemption. Bank did not have continuing interest in account in Madden
- Concern that subsequent purchaser of loans originated under bank origination model will not be able to collect interest at rate specified in loan agreement (or the principal amount of loan), unless bank has continuing involvement with borrower
- Industry focused on Madden but case has also highlighted true creditor issue for regulators, secondary market purchasers, rating agencies and others

Commonwealth of Pennsylvania v. Think Finance

- On January 14, 2016, the U.S. District Court for the Eastern District of Pennsylvania issued a ruling on several motions to dismiss, which has raised concerns for purchasers of consumer loans under the traditional bank origination model
- Think Finance used "rent-a-bank and rent-a-tribe" arrangements to facilitate the origination of high interest, short-term consumer loans to Pennsylvania residents
- Pennsylvania AG alleged that Think Finance violated Pennsylvania's usury laws and engaged in other illegal lending practices and filed an action in November 2014
- Think Finance filed a motion to dismiss the claims raised by the Pennsylvania AG and the U.S. District Court denied the motion to dismiss
- Think Finance cites Madden case and further notes in its analysis of the claims that 3rd Circuit has distinguished claims against banks and claims against non-banks for purposes of federal preemption
- Think Finance presents similar concerns to those raised by Madden. Because it involves a traditional bank origination model, there are also true creditor concerns presented. The case remains at an early stage but bears monitoring as it moves forward

CashCall v. Maryland Commissioner of Financial Regulation

- Decision by Maryland Court of Special Appeals (October 27, 2015) in CashCall has raised licensing concerns for non-bank entities providing services in connection with loan originations by bank partners, including marketplace lending platforms
- Maryland Court of Appeals has agreed to hear an appeal of the decision
- CashCall involved a cease and desist action filed by the Maryland Commissioner of Financial Regulation (MCFR) against CashCall for violating the Maryland Credit Services Business Act (CSBA)
- CSBA requires a license to arrange consumer loans and prohibits licensees from acting as a broker for out-of-state payday lenders charging rates of interest in excess of those permitted by Maryland law
- CashCall filed suit to overturn the MCFR's order and $5.6 million penalty and the trial court ruled in favor of CashCall based upon precedent involving Jackson Hewitt
- CashCall raises a concern that a non-bank partner facilitating a bank's origination of consumer loans may require a loan broker license and the failure to obtain a license may adversely impact the non-bank partner and loans originated by the bank

Reaction to *Madden, CashCall and Think Finance*

- There is no magic bullet that will eliminate true creditor or Madden concerns
- These claims will likely arise in other Circuits over the next year and industry will be forced to defend bank origination model
- Industry reactions have been wide and varied
  - Not a single loan is invalid or unenforceable yet because of these decisions
  - Most lawyers think Madden and Think Finance (with respect to bank preemption analysis) are wrongly decided and fail to recognize "valid when made" doctrine and other precedent
  - Approaches have been varied, including:
    - Do nothing
    - Limit loans in excess of any state's usury cap to __% of the deal unless a satisfactory state legal opinion/memo can be delivered

Reaction to *Madden, CashCall and Think Finance*

- Increased interest in participations:
  - Bank holds loan for the life of loan. Agreement to pay money
  - If Krispin works, this is even better
  - FDIC Safe Harbor protects participations without recourse
  - Bank gets sale treatment and no capital required to be held
- Barriers to use of participations:
  - Would require significant changes in operations and renegotiation of existing financing arrangements
  - Unusual to securitize participations and would require education of rating agencies and investors
  - Do loan purchasers want to take this risk?

REG AB II
IMPLEMENTATION –
STATUS AND ISSUES

- Compliance Dates
  - Effective for public ABS offerings after November 23, 2015
  - Asset-Level Disclosures required for public ABS offerings in specified asset-classes after November 23, 2016
- Significant Proposals Not Yet Adopted
  - Public-style disclosure not required for private deals*
    - *Unless you are a bank relying on the FDIC Safe Harbor
  - Asset-level (or grouped) data for asset classes other than residential mortgages, commercial mortgages, auto loans, auto leases and debt securities

Shelf Eligibility for ABS Offerings

- Forms SF-1 and SF-3 replaced S-1 and S-3
- For Form SF-3, new eligibility requirements:
  - Transaction Requirements
    - Depositor CEO Certification
    - Asset Representations Reviewer Provisions
    - Dispute Resolution Provisions
    - Investor Communications Provisions
  - Registrant Requirements
    - Timely Filing

Depositor CEO Certification

- Certification by CEO of Depositor that, to knowledge
  - Prospectus has no false statements of material facts or material omissions
  - Prospectus "fairly presents" asset characteristics, deal structure and risks of owning the securities
  - Reasonable basis to conclude that securitization is structured (but not guaranteed) to produce expected cash flows at times and in amounts to service scheduled interest and ultimate principal on the securities
- Implementation Issues:
  - Identity of Depositor CEO
  - Creation and formalization of internal procedures

Asset Representations Reviewer

- Required provision in the transaction documents for the review of at least all 60+ day delinquent assets for compliance with representations upon trigger events
- Prospectus disclosure of reviewer’s identity, duties, compensation, indemnification and process to obtain review
- Implementation Issues:
  - Revising representations to make “testable”
  - Challenges for existing master trusts
  - Payment of ARR and ability to terminate
  - SEC’s views on ARR-related provisions
  - Setting the delinquency trigger
  - Voting timeline

Dispute Resolution Provisions

- Transaction documents must require that, if a repurchase request has not been resolved within 180 days from when such request was received, the requesting party has the right to refer the matter to mediation or third-party arbitration
- Implementation Challenges:
  - Trustee involvement in process
  - Making repurchase demands- specificity, process
  - Evolving SEC perspective

Investor Communications

- The party who makes the Form 10-D filings must include any request for an investor to communicate with other investors
- Implementation issues – not many (so far)

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Other Reg AB II Implementation Issues

- All public deals (including pre-Reg AB II deals) are required to use new Forms 10-D and 10-K
  - Delinquency and loss information in accordance with Item 1100(b) through no less than 120 days
  - Change in Sponsor interest in the securities
- Item 1105 – Static Pool
  - Graphic presentation
  - Description of how the static pool differs from the pool underlying the offered securities
  - Historical delinquency and loss information in accordance with Item 1100(b) through no less than 120 days

Other Reg AB II Implementation Issues – Offering Process

- Reg AB II changed the timeline for filings and delivery in connection with shelf offerings:
  - At least 3 business days prior to first sale – file preliminary prospectus with SEC
  - At least 48 hours prior to first sale – file any material changes to preliminary prospectus (note that material changes must be clearly delineated)
  - Upsizing considerations
- Preliminary prospectus filed pursuant to 424(h) must contain all information other than price-related and underwriting syndicate

Other Reg AB II Implementation Issues – Asset Level Data

- Required for offerings after November 23, 2016
- Does not apply to legacy deals
- Technical clarifications and guidance in process
- Implementation concerns
  - EDGAR System
  - Sponsor System
  - Investor Use of Data

REGULATORY CAPITAL

MORTGAGES AND REAL ESTATE

Mortgage Market will continue to be Dominated by GSEs

- GSEs remain dominant funding about 90% of all mortgage loans
- Major GSE reform unlikely before next election
- Incremental reform and evolution possible in the interim
  - Single security platform gaining momentum
  - Eligibility of risk transfer securities for purchase by mortgage REITs to create additional liquidity for de-risking process
- TILA/RESPA Integrated Disclosures (effective 10/3/15)
  - Market disruption from implementation and interpretive issues
  - CFPB letter to MBA re: cure and assignee liability (12/29/15)

Mortgage Market Away from GSEs Remains Fractionalized

- Non-QM market slow to develop because:
  - ATR rules have special QM safe harbor for loans eligible to be purchased or guaranteed by GSEs or insured or guaranteed by FHA, USDA or VA
  - GSEs are exempt from QRM standards in credit risk retention now applicable to mortgage loan securitizations
  - Lingering concerns about CFPB interpretation of ATR rules outside of the safe harbors
    - Most challenging for subprime mortgage loans
    - Super prime non-QM sought by banks as a balance sheet product with non-QM features (e.g. interest only loans)

Mortgage Market Away from GSEs Remains Fractionalized (cont.)

- Other mortgage products continue to be securitized
  - Non-performing loans (NPL) Re-performing loans (RPL)
  - Single Family Rental
  - Reverse Mortgages
  - Servicing Advances
  - Non-US mortgage loans
- Structured fundings of mortgage servicing rights becoming more commonplace
  - GSEs more receptive
  - Increasing interest rates support value of MSRs

MARGIN RULES FOR UNCLEARED SWAPS

Margin Rules for Uncleared Swaps

- On **October 22, 2015**, U.S. banking regulators issued final rules
- On **December 16, 2015**, the CFTC issued final parallel rules
- Exemptions for uncleared swaps entered into for hedging purposes by qualifying non-financial entities (including captive finance companies and their SPEs)
  - There are no general exemptions for other securitization SPEs
- The Rules require the posting of initial margin and variation margin
  - Initial Margin: at the time the swap is entered into
    - Generally required if entity and its affiliates have $8 billion of average daily notional amounts of Covered Swaps
  - Variation Margin:
    - Parties must calculate, post and collect collateral on a daily basis
    - Measured based on change in the mark-to-market value of a covered swap
- Compliance dates begin **September 1, 2016** and later depending on the size of the covered swap portfolio
- Big Issue: How to get Variation Margin into a bankruptcy-remote entity without violating substantive consolidation principles

BAIL-IN RULES

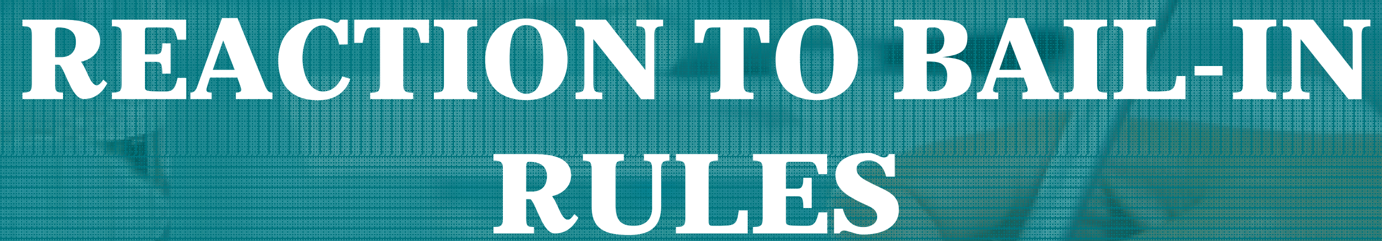
EU Bail-In Rule

- EU Bank Recovery and Resolution Directive (BRRD)
  - Response to financial crisis and taxpayer funded bailouts of large financial institutions
  - Requires banks and certain other participants in EU member states to write-down, cancel or convert into equity certain unsecured liabilities if necessary to recapitalize the bank
  - Applies to U.S. branches of EU banks but not EU branches of U.S. banks
- EU member states were required to implement by January 1, 2016
  - Liabilities existing before January 1, 2016 are generally not covered, but contracts entered into prior to January 1, 2016 could be covered if amended and new liabilities created
  - Exercise of bail-in power by EEA resolution authority is automatically effective in EU
- BRRD requires covered EU entities, including EU banks, to include contractual recognition provisions in certain contracts with non-EU parties
  - Contractual clauses provide notice of bail-in liabilities and the acknowledgement of the parties to the transaction and intended to avoid risk of U.S. or other non-EU court challenge or refusal to give effect to the bail-in
  - BRRD provides that covered EU entities may be required to provide an opinion regarding enforceability of contractual clauses in liabilities governed by non-EU law

EU Bail-In Rule

- While debt obligations incurred by an EU bank as an issuer or a borrower are clearly covered liabilities, coverage goes beyond these types of liabilities
- Loan Market Association's Recommended Form of Bail-in Clause and User's Guide provides the following examples of the types of liabilities covered by Article 55
  - lending commitments
  - indemnities typically given to the facility agent, security agent and issuing bank
  - requirements to share or turnover recoveries made from the borrower
  - confidentiality duties
  - requirement to obtain borrower consent/consultation prior to transfer
  - restrictions on a creditor's actions typically found in intercreditor documentation
  - administrative obligations, such as notifications of tax status or requirements to make other notifications or to supply or forward information
  - potential non-contractual liability under loan market documentation such as potential claims in negligence or misrepresentation
- What are the implications for U.S. financing arrangements?

REACTION TO BAIL-IN RULES



OTHER UPCOMING RULES

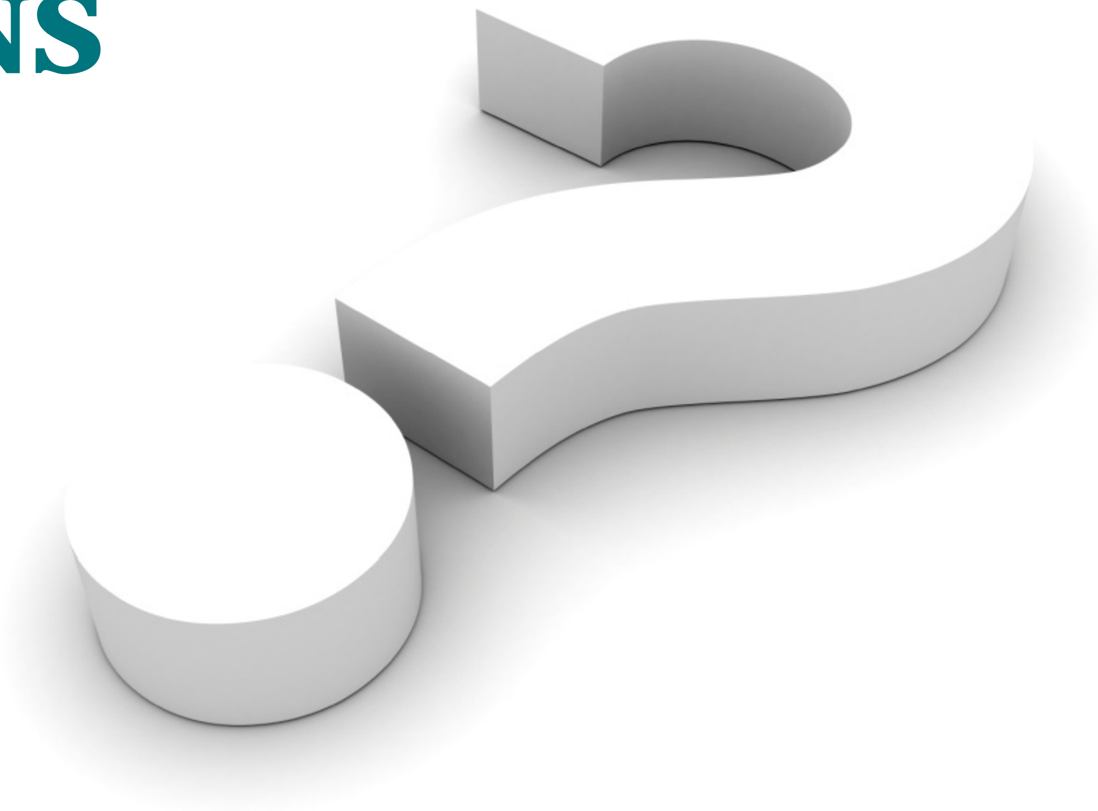
Basel "Step-In Risk" Proposal

- Basel Committee Dec. 2015 proposal. Comments due **March 17**
- "Step-In Risk": Risk that bank will provide support to unconsolidated entity without a contractual obligation
  - Concerns about reputational or franchise risk
  - Indicators of risk: Sponsorship, providing financing or critical services, decision making, operational ties, implicit recourse, rights to excess cash flows, branding
- Proposed result: either regulatory consolidation or additional capital
- Expected industry comments:
  - Accounting rules have changed to generally consolidate most SPEs that would have Step-In Risk
    - This should be an accounting question. Entities that are not consolidated probably are appropriate not to have additional capital requirements
  - Too expansive. Would require banks to potentially hold capital against every off-balance sheet entity they do business with
  - Some of the "indicators of risk" do not in fact indicate any Step-In Risk

Conflicts of Interest

- D-F Section 621 prohibits "material conflicts of interest" with ABS investors for year after closing
  - Both public and private deals
- SEC Rule was broad and vague, with only very narrow exceptions
  - But Release made clear that only short transactions were intended to be prohibited
- Synthetic securitizations might be completely prohibited
- Final Rules could be adopted at any time
- No idea how much uncertainty these rules could create

QUESTIONS



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