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THE IMPACT OF US RULES ON THE GLOBAL LANDSCAPE AND HOW AUSTRALIAN ISSUERS WILL BE AFFECTED

The Australian Securitisation Journal recently interviewed ***Jason Kravitt*** *and* ***Jon van Gorp****, two US-based structured-finance lawyers from* ***Mayer Brown****, who are well known in this part of the world. The US regulatory picture is coming into focus and its influence on Australia's outbound global asset-backed securities (ABS) and residential mortgage-backed securities (RMBS) deals is also becoming clearer. The lawyers have some well-developed views on how these regulations will affect the ongoing renaissance of the global ABS and RMBS markets.*

PARTICIPANTS
◆ **Jason Kravitt** Founder, Structured Finance Practice
◆ **Jon van Gorp** Partner and Co-Leader, Structured Finance Practice
MAYER BROWN LLP

Tell us a little bit about yourselves.

◆ KRAVITT I am the founder of Mayer Brown's structured finance practice, which is one of the largest in the world. We are active in the US, Europe, Asia and South America. I am also one of the founders of the American Securitization Forum and a director of the Structured Finance Industry Group. About 15 years ago I was Co-Chairman of Mayer Brown.

◆ VAN GORP I am the Co-Head of our finance, structured finance and capital markets groups. I have participated in almost every outbound structured-finance transaction originating from Australia, beginning with Westpac Banking Corporation's inaugural cross-border transaction in 1998. I have represented the Australian Securitisation Forum (ASF) on several initiatives with US regulators.

How would you describe the regulatory mood in the US?

◆ KRAVITT When I am asked this question, I tell a story about Albert Einstein. Einstein was travelling on a train from London when the conductor asked him for his ticket. Einstein struggled to find it. Soon the conductor recognised Einstein and told him that he was free to travel without a ticket. Einstein, however, continued to search for the ticket. He told the conductor that he needed to find his ticket, otherwise he didn't know where he was going.

In the US, regulators now have a much better view of where they are going, and the finalisation of many of the new rules is reflective of this.

◆ VAN GORP I tend to agree with Jason, although there continues to

be a disconnect between some of the rulemaking initiatives and the underlying causes of the global financial crisis (GFC). We'll get into some of those later in our discussion.

The final US credit risk retention rules were released in early October this year. What are your views on these rules generally and, specifically, how will they influence the global ABS and RMBS markets?

◆ KRAVITT I'll let Jon discuss the impact of these rules on the global markets. In general, the final rules reflect some technical corrections of the proposed rules, but in large part the general principles of the rules remain intact. They focus on the quality of the underlying assets being securitised. The rules define assets that are safe for securitisation and exempt those assets from the risk-retention requirement.

This approach is intended to target those assets that US regulators believe were at the root cause of the GFC. The problem with this approach is that it is binary, and as a result it is likely to directly influence the types and costs of consumer credit available.

◆ VAN GORP Picking up on this theme, an odd result is that loans originated in another country may fail to achieve exempt status solely because of a local custom that has nothing to do with the underlying credit quality of the asset. For example, mortgage-loan underwriting criteria in Australia key on different factors from mortgage-loan underwriting criteria in the US. We raised this very point on behalf of the ASF with the US Securities and Exchange Commission.

Absent underwriting changes and some interpretive flexibility from US regulators, future Australian global ABS and RMBS deals issued into the US may need to comply with the US credit risk retention rules. This is because their assets, although of high quality, may not satisfy the technical requirements for being exempted from the rule.

Assuming this is the result, will compliance with the European risk-retention rule, CRD 122a, satisfy the US rules?

◆ KRAVITT Maybe, but not always. For example, CRD 122a allows representative samples and – in limited cases – synthetic methods of retaining risk. These options are not offered under the US rules. Furthermore, the US rules, like the European ones, don't recognise any other jurisdiction's corresponding rules as substitute compliance. Unfortunately, global deals could be faced with a highest-common-denominator problem if securities are sold in multiple jurisdictions.

◆ VAN GORP I agree. Another factor is that, for securitisers, compliance with European risk-retention rules is voluntary. Sales of noncompliant deals can still happen, but, as often disclosed in the offering materials, the European rules make it impractical for them to be purchased by European-regulated investors. This includes banks and investment firms and their consolidated affiliates, insurance companies and regulated investment funds, that are subject to the European risk-retention rules.

The risk-retention requirements under CRD 122a, and the corresponding rules for regulated investment funds and insurance companies, regulate the investor, not the issuer – regardless of where the issuer is located. So parties originating a deal in Australia can choose not to comply with them – and disclose in the offering documents that they are not trying to comply. The US rules apply to all asset-backed securities sold in the jurisdiction, so in many ways they are more comprehensive than the European rules.

How will these rules will affect the global ABS and RMBS markets?

◆ VAN GORP More so than any other new regulations, these rules will have an immediate economic impact. It is a matter of deal economics rather than compliance costs. Because of the historical performance of the underlying assets and protections baked into an Australian securitisation, the residual interest retained by the sponsor is normally very small.

Therefore, to comply with the US rules, additional horizontal or vertical portions of the capital stack may need to be retained. This could have an economic impact on the deal. When coupled with potentially unfavourable currency-swap pricing, the cost of issuing into the US may be too steep for some issuers.

Regulation AB 2.0 was also just released in the US. What are your early reactions?

"The final rules do not apply to private deals, and that was a big relief to the market. I do expect some of the asset-based disclosure requirements for public deals to become market standard for the private market. But without a rule in place, there will be flexibility on how disclosures are made."

JASON KRAVITT

◆ *KRAVITT* The final rules do not apply to private deals, and that was a big relief to the market. I expect some of the asset-based disclosure requirements for public deals to become market standard for the private market. But without a rule in place, there will be flexibility on how disclosures are made.

Similarly, I expect that the asset-level diligence requirements that were already a part of Regulation AB will continue to become market standard for private deals. These are the rules that require disclosure of legal and accounting loan-level diligence that was conducted on the securitised pool.

◆ *VAN GORP* I agree. For the Aussie market, which, aside from the Macquarie SMART programme, has become mostly a private market, this is a huge relief. I expect that disclosure of asset-level legal and accounting diligence will become the standard for Australian global deals as it has for US deals.

Do you anticipate private deals executing at a higher cost?

◆ *KRAVITT* People always assume this, but often the pricing cost, if any, for a private transaction is very small.

◆ *VAN GORP* That's right. It may matter in some markets, such as US cards and auto, which are flooded with too much product for the Rule 144A private market to absorb. But it shouldn't matter very much, given the small amount of Australian ABS and RMBS that is issued into the US markets each year.

If public deals return to the Australian market, do you have any concerns about their ability to comply with Regulation AB 2.0?

◆ *VAN GORP* Not really. As with any new rules there will be a learning curve. But I don't foresee any showstoppers for the execution of Australian deals.

◆ *KRAVITT* One interesting point is the application of Australian privacy laws to the asset-level disclosure required by Regulation AB 2.0. This was a significant focus in the US, and some accommodations were made by the US privacy regulator to allow this to go forward. An open question is whether there will be issues with Australian privacy laws.

We notice that the waterfall computer programme originally proposed was not in the final rule. Can you add some colour on this?

◆ *KRAVITT* Investors didn't demand it, and there was enough negative feedback that it was easy for the Securities and Exchange Commission (SEC) to drop it.

◆ *VAN GORP* This is my memory too. I also think the computer programme was required to be submitted in a format that no investor used, so it was unlikely to be very useful if written into law.

Speaking of useful, can you give us an update on what is happening with the Rule 17g-5 rules that require the simultaneous posting to a website of information that is provided to engaged rating agencies? We have heard a rumour that so far, no non-engaged rating agency has accessed the information to provide an unsolicited rating.

◆ *VAN GORP* That rumour, to my knowledge, is true. Some rating agencies have published criticisms of other rating agencies' ratings, but those criticisms were made on the basis of publicly available information and not on the basis of information from a website.

◆ *KRAVITT* I agree that this rule has not proven very useful in practice. But it could be a solution to the Franken Amendment, which in the US may require rating agencies to be appointed by a credit rating agency board rather than chosen by the securitisation sponsor. In connection with the US regulators' ongoing study of this issue, US trade groups are advocating a potential expansion of the 17g-5 Rules as a more viable alternative to the appointment of rating agencies by a board. This issue should be resolved over the next year or so.

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JON VAN GORP

Should issuers still fear the Foreign Account Tax Compliance Act (FATCA)?

◆ *VAN GORP* Fear is a strong word but it is appropriate to approach it with caution. FATCA is generally being implemented in a decentralised manner as US regulators permit local authorities to craft local implementing rules.

In Australia, we expect much of the uncertainty associated with FATCA will be remedied once Australia issues its own local implementation guidance that takes into account the needs of the securitisation industry.

That said, because of this decentralised approach, each jurisdiction is likely to have its own

implementation guidance. Accordingly, issuers and investors will need to take the time to understand how FATCA will affect their deals and ensure that they have complied with local requirements.

We understand that the structured-finance markets have largely recovered in the US, yet the volume of RMBS deals is not even a fraction of what it was pre-GFC. Why is this?

◆ VAN GORP It is primarily attributable to two factors. First, in the US the government-sponsored enterprises (GSEs) – Fannie Mae, Freddie Mac and Ginnie Mae – are currently funding nine out of every 10 mortgages made in the US.

Secondly, new mortgage loans not funded by the GSEs – such as the so-called jumbo mortgage loans that exceed the GSEs' maximum loan amounts but otherwise meet their criteria – are usually originated by banks that hold the loans unsecuritised and fund them with deposits. Subprime mortgage loans are not being originated now in the US, although this market will return probably sooner than we expect.

◆ *KRAVITT* I agree. Until the US government steps back from dominating the mortgage market it will be difficult for private investors to participate economically. There is an intense and widespread debate in the US on the best way to have the government step back and private capital step up. We have had at least six major bills introduced in Congress and none pass, but we came very close in the Senate with the so-called Johnson-Crapo bill. Both Democrats and Republicans have agreed on these most important issues:

- There should be 5-10 per cent first -loss capital provided by the private market.
- A US government guarantee should be in second-loss position behind the first-loss capital.
- The US guarantee should probably be provided by an entity analogous to the FDIC, which insures bank deposits.
- The guarantee fees and interest rates should be set by – or keyed off – the private market.
- The TBD market should be preserved by means of the backup US guarantee.
- Securities should be issued from a common platform to which both small and large players should have equal access.
- The private market transactions should in some fashion and to some extent subsidise access to credit by under-served communities.

In the end, what torpedoed the Johnson-Crapo deal was the fact that Democrats and Republicans could not agree on how to give affect to the last item above.

The danger is that during the stalemate, the Democrats will support continuing the dominance of the GSEs over the mortgage market.

We've heard the term "Volckerisation". It sounds scary. What does it mean?

◆ VAN GORP I've heard that too! It does sound scary. It all goes back to the US Volcker Rule, sponsored by former Chairman of the Federal Reserve, Paul Volcker.

The idea is that banks should not invest in or sponsor private funds, private equity or other similar types of investments that introduce risk into the banking system.

As the law of unintended consequences predicts, the Volcker Rule captured more deals than originally expected. Caught in the web, for example, were collateralised loan obligation (CLO) deals that also had the ability to hold corporate bonds. Those deals are being reissued as 'all-loan' CLOs, and this process is being called Volckerisation.

◆ *KRAVITT* The reach of the Volcker Rule is proving quite significant. Suddenly the particular exemption that deals use to avoid registration under the Investment Company Act is relevant. For most term ABS and RMBS this is not an issue, but for CLOs, asset-backed commercial paper (ABCP) and some other asset classes, deals are being restructured to avoid Volcker Rule concerns.

What other regulations in the US are keeping bank CEOs up at night?

◆ *KRAVITT* The liquidity tests required under Basel III, which came on line in September, are proving to be very meaningful. They are intended to protect banks from running out of assets that can be liquidated to meet their immediate funding commitments. But because they are intended to address worst-case scenarios, they seem to require liquidity at a level higher than banks maintained before the rules went into effect.

◆ VAN GORP I agree. We are seeing many banks restructure their funding commitments, including in asset-backed warehouse facilities, to spread draws of available liquidity over a period of time. We are also seeing banks liquidate assets that do not count as high-quality liquid collateral under the new liquidity rules.

Thank you for your views on the US markets. Do you have any parting predictions for the future?

◆ *KRAVITT* Securitisation is here to stay, both in the US and in the global markets. Some deals will fall victim to regulations, but our hope is that the expanded scope of regulations will make the asset class safe for investors, which is important for the proper functioning of the market.

◆ VAN GORP As the last rules required by Dodd-Frank have been finalised, we have seen a real uptick in our practice. Good or bad, final rules allow people to structure deals with certainty, and that certainty has been lacking in the market for some time.

◆ FOR FURTHER INFORMATION PLEASE CONTACT:

Structured Finance Practice

Jason H. P. Kravitt
Founder and Partner
jkravitt@mayerbrown.com
+1 212 506 2622

Jon D. Van Gorp
Partner and Co-leader
jvangorp@mayerbrown.com
+1 312 701 7091

www.mayerbrown.com