Memorandum

The BondFactor Company

To: File

From: Mark Adelson

Date: 23 October 2014

Subject: Structured Finance Industry Group
2014 Fall Symposium (21 Oct 2014)

I. Rating Agency Rules

Kate Scanlin, Standard & Poor's

1. Credit ratings are a tool that helps inform investor decisions. There is $52 trillion of debt rated by Standard & Poor's. The SEC regulates the credit rating industry in the U.S. and regulators in other countries regulate it overseas. After the financial crisis, Standard & Poor's enhanced its rating criteria for many areas. The new criteria made it harder to achieve high ratings on certain kinds of securities. S&P also established credit conditions committees to monitor the changes in the credit environment in different regions.

2. The SEC has just released new rules for rating agencies.[1] The rules prohibit participation by sales or marketing personnel in analyzing a rating and they prohibit the influence of sales or marketing considerations in the analysis [Rule 17g-5(c)(8)]. The new SEC rules also require a rating agency to have policies, procedures, and internal controls covering the procedures and methodologies used for determining ratings [Rule 17g-8(a)(2)]. The procedures and methodologies for determining ratings must be approved by a rating agency's board of directors or similar body [Rule 17g-8(a)(1)]. A rating agency must have an analyst training regime [Rule 17g-9] and a formal governance structure. S&P is in the process of developing systems for complying with the new rules.

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[1] Securities and Exchange Commission, *Nationally Recognized Statistical Rating Organizations*, Release No. 34-72936, 79 Fed. Reg. 55078 (15 Sep 2014) http://www.gpo.gov/fdsys/pkg/FR-2014-09-15/pdf/2014-20890.pdf.

II. Third-Party Due Diligence

Alberta Knowles, E&Y

3. The new SEC rules for rating agencies include a provision that addresses third-party providers of due diligence services in connection with securitizations [Rule 17g-10]. The rule covers entities that provide third-party due diligence reports to rating agencies. There are five criteria for when an entity may be considered a third-party provider subject to the rule. An entity that reviews assets with respect to any of the following five items may be subject: (i) accuracy of information, (ii) conformity to underwriting standards, (iii) value, (iv) legal compliance, or (v) any other factor material to whether the related security will pay in accordance with its terms. The rule covers reports even if they are not actually provided to any rating agency. An issuer or underwriter must file a form containing both the review procedure and the results. Each third-party due diligence provider also must fill out a form and post it to the issuer's 17g website. It is not yet clear whether the rule requires filing or posting of interim reports. It is also still an open question as to whether legal opinions are within the scope of the rule. Accountants' reviews generally are not within the scope of the rule except that any loan file to tape comparison would be within the scope of the rule.

III. Regulation AB 2

Susan Thomas, Ford Credit

4. The SEC has updated Regulation AB.[2] The update to Regulation AB took 4½ years and attempts to address certain perceived abuses. The new rules replace the rating requirement for shelf registration eligibility. The new rules impose four new requirements in place of a rating: (i) CEO certification, (ii) an asset reviewer for delinquent assets, (iii) a dispute resolution mechanism, and (iv) an investor communication mechanism. Another requirement for shelf eligibility is being current on all required Exchange Act filings. Failure to file Exchange Act reports can trigger a 12-month suspension of shelf eligibility. Other filing defects can trigger a 90-day suspension.

5. The rules eliminate the use of a two-part prospectus (*i.e.*, base prospectus and prospectus supplement). Instead, they require a single prospectus. The rules provide for

[2] Securities and Exchange Commission, *Asset-Backed securities Disclosure and Registration*, Release Nos. 33-9638, 34-72982, 79 Fed. Reg. 57184 (24 Sep 2014) http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-21375.pdf.

standardized presentation of static pool data and require disclosure of financial data on certain parties responsible for repurchasing assets for breaches of representations and warranties. The rules impose a speed bump in the offering process; they require distribution of a preliminary prospectus three days before the first sale of securities. The rules also expand the required Exchange Act (periodic) reporting.

6. The new rules do not cover transactions offered under Rule 144A or private placements. The new rules require asset-level disclosures for RMBS, CMBS, and auto-loan/lease ABS. They do not require asset-level disclosures for credit card ABS, student loan ABS, or equipment lease ABS. The new rules do not require an issuer to file a cash-flow waterfall computer program (which had been proposed).

7. It is not yet clear whether or how investors will use all the new data required to be disclosed. New companies are likely to be formed to repackage and analyze the data. It remains to be seen whether consumers will react to the new disclosures.

IV. Derivatives

Preetha Gist, Chapman & Cutler

8. There were questions about whether securitization SPEs would need to register as commodity pools. The CFTC has ruled that securitization SPEs do not need to register.[3] The securitization industry has concluded that swaps with a securitization SPE do not need to go through centralized clearing. But there are other new proposals that set margin requirements for financial end users. A securitization SPE can be a financial end user and fall under the proposed margin rules[4] if it has more than $3 billion in uncleared swaps. A financial end user has to post daily variation margin. That requirement would effectively kill the use of derivatives in securitizations.

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[3] CFTC Letter No. 12-14 (11 Oct 2012)
http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-14.pdf;
CFTC Letter No. 12-45 (7 Dec 2012)
http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-45.pdf.

[4] Commodity Futures Trading Commission, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 79 Fed. Reg. 59898 (3 Oct 2014)
http://www.gpo.gov/fdsys/pkg/FR-2014-10-03/pdf/2014-22962.pdf.

V. Volker Rule

Carol Hitselberger, Mayer Brown

9. The Volker Rule[5] restricts the relationship of a bank with any "covered fund." Relationships can include being an owner, being a sponsor (construed narrowly), or being an advisor or manager. Covered funds include any issuer that relies solely 1940 Act exemptions under § 3(c)(1) or § 3(c)(7). If an issuer is eligible under another exemption, such as § 3(c)(5)(C) or Rule 3a-7, then it is not a covered fund.

10. A quick "top 10" list of Volker Rule issues, from least to most important is as follows:

    i. What is included? Cash? Ancillary rights? Leased assets? Loan securitization exclusion.

    ii. Uncertainties about the ABCP safe harbor. What does "unconditional liquidity" mean?

    iii. Foreign funds, when are they excluded from the rule? Foreign non-covered funds?

    iv. The definition of covered transaction is broader than you think; it covers vanilla swaps and servicing advances.

    v. Credit default swaps.

    vi. LSE (loan securitization exclusion) and the conduit safe harbor require the issuance of ABS.

    vii. The ABCP conduit status is not the end of the inquiry; it is still necessary to analyze each deal in the conduit.

    viii. Rule 3a-7.

    ix. Legacy CLOs have significant issues.

    x. Banks want to require issuers to specify what 1940 Act exemption they rely on.

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[5] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Securities and Exchange Commission, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5536 (31 Jan 2014) http://www.gpo.gov/fdsys/pkg/FR-2014-01-31/pdf/2013-31511.pdf.

VI. Liquidity Rules

Rachel George, Chapman & Cutler

11. Before the financial crisis, the issue of bank liquidity was associated with potential withdrawals of a bank's deposits (*e.g.*, a run on the bank). The regulatory response was reserve requirements. But none of that worked in the financial crisis, when liquidity pressures did not come from deposit withdrawals, but rather from other directions.

12. The new LCR (liquidity coverage ratio) test[6] is based on the ratio of "high quality liquid assets" to "net outflows" over a thirty-day time horizon. For securitizations, the issue of the LCR is that the only instruments that qualify as HQLA are agency MBS. Also, net outflows include outflows of securitization vehicles, even if the vehicles are not consolidated. However, if a vehicle is consolidated on a bank's financial statements, then the bank can get credit for the vehicle's inflows. The LCR test treats credit and liquidity facilities as outflows. The test prescribes inflow and outflow rates for different assets considered in the calculation of net outflows.

13. The NSFR (net stable funding ratio) test has not yet been finalized by the U.S. regulators. The NSFR test considers the ratio of "available stable funding" to "required stable funding" over a one-year time horizon. Unfunded commitments count at 5% under the NSFR.

VII. Credit Risk Retention

Julie Gillespie, Mayer Brown[7]

14. U.S. regulators are approving the final rule on credit risk retention[8] today and tomorrow (10/21/2014 and 10/22/2014). The compliance period is one year for RMBS and two years for other assets. The rule did not have big changes from the 2013 proposed version. CLO mangers and ABCP program sponsors are "securitizers" and, therefore,

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[6] Office of the Comptroller of the Currency, Federal Reserve System, and Federal Deposit Insurance Corporation, *Liquidity Coverage Ratio: Liquidity Risk Measurement Standards*, 79 Fed. Reg. 61440 (10 Oct 2014) http://www.gpo.gov/fdsys/pkg/FR-2014-10-10/pdf/2014-22520.pdf.

[7] Mayer Brown, *Credit Risk Retention: Early Read* (22 Oct 2014) (summary based on presentation slides) http://proserv.informz.net/ProServ/data/images/Credit%20Risk%20Retention-Early%20Read.pdf.

[8] Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Securities and Exchange Commission, Department of Housing and Urban Development, *Credit Risk Retention*, SEC Release No. 34-73407 (22 Oct 2014) (pre-publication typescript). http://www.sec.gov/rules/final/2014/34-73407.pdf.

subject to the rule. The risk retention requirement is 5%, which can be in the form of an eligible horizontal residual interest (EHRI) or an eligible vertical interest.

15. An eligible horizontal residual interest (EHRI) must be subordinated as to both principal and interest. However, there is no restriction on the rate of cash flow. Fair value disclosure requirements have been made easier than in the 2013 proposal. The definition of an eligible vertical interest was substantially as proposed.

16. The final rule sets the definition of "qualified residential mortgage" (QRM) to equal the definition of "qualified mortgage" (QM) under the CFPB rules. The regulators did not adopt the so-called "QM-plus" idea that had been described in the 2013 proposal. Thus, there is no minimum down-payment for a loan to qualify as a QRM. There is a new exemption for community-oriented mortgage loans. The rules permit a blended (averaging) calculation of risk retention for deals that include such loans. There is also a new exemption for certain residential mortgage loans secured by three- and four-unit homes. Blended risk retention applies to those loans too. The regulatory agencies have scheduled a review of the QRM definition in four years and thereafter every five years.

17. The rule provides an exemption for qualifying auto loans and qualifying commercial real estate (CRE) loans. Blended calculation is permitted for deals that include such loans, subject to a floor of 2.5% risk retention. Auto loan ABS issuers are not likely to use the exemption because it is too restrictive. In CMBS deals, the risk retention requirement can be satisfied by having up to two outside, third-parties (B-piece buyers) hold the required risk position. However, a deal that uses B-piece buyers must have an "operating advisor."

18. The rule makes CLO managers "securitizers" under Exchange Act § 15G.

19. The topic of revolving pool securitizations had the most changes relative to the 2013 proposal. There are important changes in the definition of the term "seller's interest." A seller's interest can be *pari passu* or subordinated. The rule allows offsetting some of the seller's interest with a subordinated interest in excess spread.

20. The treatment of student loans is the same as in the 2013 proposal. The treatment of asset-backed commercial paper (ABCP) programs is substantially the same as in the 2013 proposal, with some small accommodations. The rule includes safe harbor provisions for foreign transactions substantially along the lines of the 2013 proposal. The securitization industry wanted an exemption for transactions under Regulation S, but the final rules do not have one. There is no accommodation for complying with

foreign risk-retention rules or for fair value determinations made under foreign accounting regimes.

VIII. China

Xiaowei Luan, GE Capital

21. The China Securitization Forum is modelled after SFIG. China wants to establish a securitization market. The CSF has asset-type subcommittees and subject matter subcommittees, as well as subcommittees for education and advocacy. Meetings are scheduled between representatives of the CSF and U.S. securitization professionals to share knowledge.

IX. RMBS 3.0

Mary Robinson, SFIG

22. Last October, SFIC held a roundtable meeting to address structural impediments to the revival of a vibrant market for PLS (private-label securities). SFIG has published its first batch of "Green Papers"[9] and it is about to put out a second batch. The work is on issues like due diligence and representations and warranties.

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[9] Structured Finance Industry Group, *RMBS 3.0 – A Comprehensive Set of Proposed Industry Standards to Promote Growth in the Private Label Securities Market* (6 Aug 2014) http://www.sfindustry.org/images/uploads/pdfs/RMBS_3.0_First_Edition_Green_Paper.pdf.