CURRENT ISSUES IN SECURITIZATION

Adapted from an April 14, 2015
Educational Program by the

Committee on Structured Finance

OCTOBER 5, 2015

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CURRENT ISSUES IN SECURITIZATION

Committee on Structured Finance
of the
Association of the Bar of the City of New York

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Reporter: Mark Adelson

Securitization has been an efficient and effective financing technique for more than four decades in the U.S. For much of that time, the legal and regulatory framework did not specifically address securitization transactions and structures. In structuring and documenting securitizations, lawyers had to extrapolate from laws and regulations developed for other areas. The securitization sector started to get its own regulations in the mid-2000s, with the introduction of the original Regulation AB.[1] More recently, however, the sector has received a flood of new laws and regulations. This paper surveys many of the new legal and regulatory developments that securitization lawyers and their clients are now facing.

This paper is based on the "Current Issues in Securitization" program held on April 14, 2015. The program was sponsored by the Committee on Structured Finance of the Association of the Bar of the City of New York. The program featured presentations on recent regulatory developments affecting securitization as well as recent developments relating to specific sectors of the securitization market. The speakers at the event included Jack Costello (Sidley & Austin), Chris DiAngelo (Katten Muchin), Jason Kravitt (Mayer Brown), Steve Levitan (Morgan Lewis), Jerry Marlatt (Morrison & Foerster), Lauris Rall (Dentons), Jeffrey Rotblat (Cadwalader), Craig Stein (Schulte Roth

[1] Securities and Exchange Commission (SEC), *Asset-Backed Securities*, Release Nos. 33-8518, 34-50905, (70 Fed. Reg. 1506 (7 Jan 2005), available at http://www.gpo.gov/fdsys/pkg/FR-2005-01-07/pdf/05-53.pdf.

& Zabel), Jeffrey Stern (Winston & Strawn), Greg Walker (Credit Suisse), and Jordan Yarett (Paul Weiss). Jeffrey Stern's participation was limited to the risk retention material in the presentation on CLOs. Patrick Dolan (Dechert) was the moderator. The paper is a summary of the panelists' remarks. The views expressed are those of the individual panelists and not necessarily those of the Committee.

The paper is organized in 10 parts. The first is this short introduction. The second part is a discussion of various regulatory developments that affect securitization activities broadly. That part examines developments in the areas of risk-based capital regulations, so-called "high quality securitizations," liquidity ratios for banks, required risk retention by securitizers, the Volker Rule, and the SEC's update to Regulation AB. The remaining parts of the paper cover eight specific asset classes. Those parts primarily address developments that are special or unique to the covered asset classes. The eight covered asset classes are: auto loans, collateralized loan obligations, whole business securitizations, commercial mortgage-backed securities, covered bonds, student loans, peer-to-peer loans, and derivatives.

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Regulatory Developments

Risk-based Capital: It is useful to compare items in the U.S. regulatory capital rules for banks[2] to their corresponding items in the Basel III international capital guidelines[3] and to consider whether the U.S. rules are likely to change in order to conform to the Basel III approach. The U.S. rules no longer use rating agency credit ratings, while the Basel III guidelines still do. It is unlikely that the U.S. rules will change in that respect because the Dodd-Frank Act (DFA) specifically calls for removing rating agency credit ratings from federal regulations.[4]

The U.S. rules include a 20% minimum risk-weight for securitization exposures.[5] By contrast, the minimum risk weighting under Basel III is 15%.[6] The U.S. rule is likely to change to adopt the lower minimum risk-weight of the Basel III guidelines.

The U.S. risk-based capital regulations impose elaborate due diligence obligations in order for a bank to apply any risk weight other than 1,250% to a

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[2] 12 C.F.R. Parts 3, 167, 217, 325, and 390 (2015).

[3] Basel Committee on Banking Supervision (BCBS), *International Convergence of Capital Measurement and Capital Standards* (Jun 2006) http://www.bis.org/publ/bcbs128.pdf; *cf*. BCBS, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Dec 2010, rev. Jun 2011) http://www.bis.org/publ/bcbs189.pdf; BCBS, *Revisions to the Standardised Approach for Credit Risk – Consultative Document* (Dec 2014) http://www.bis.org/bcbs/publ/d307.pdf; BCBS, *Revisions to the Securitisation Framework* (Dec 2014) http://www.bis.org/bcbs/publ/d303.pdf.

[4] Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 939, 939A, Pub. Law No. 111-203, 124 Stat. 1376 (2010) available at http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf; *see, e.g.*, Office of the Comptroller of the Currency (OCC) and Federal Reserve System, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 Fed. Reg. 62018 (11 Oct 2013), available at http://www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf (removing references to credit ratings from regulatory capital guidelines for banks).

[5] *See, e.g.*, 12 C.F.R. § 3.43(f) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec3-43.pdf.

[6] BCBS, *Revisions to the Securitisation Framework* ¶¶ 64, 70, 87, 89 (Dec 2014) http://www.bis.org/bcbs/publ/d303.pdf.

securitization exposure.[7] There is no parallel requirement under the Basel III guidelines. The U.S. regulations are likely to stand unchanged.

The U.S. regulations and the Basel III guidelines define securitization differently.[8] The U.S. definition is likely to stand unchanged.

Exhibit 1: Acronyms Used in This Report	
ABCP	asset-backed commercial paper
ABS	asset-backed security
BCBS	Basel Committee on Banking Supervision
CDO	collateralized debt obligation
CEO	chief executive officer
CFPB	Consumer Financial Protection Bureau
CFTC	Commodities Futures Trading Commission
CLO	collateralized loan obligation
CMBS	commercial mortgage-backed security
CRE	commercial real estate
DFA	Dodd-Frank Act
EDGAR	Electronic Data Gathering Analysis and Retrieval system
FDIC	Federal Deposit Insurance Corporation
FFELP	Federal Family Education Loan Program
FHFA	Federal Housing Finance Agency
FICO®	Fair Isaac Corporation credit score
FTC	Federal Trade Commission
GAAP	generally accepted accounting principles
HUD	Dept. of Housing and Urban Development
HQS	high quality securitization
MBS	residential mortgage-backed security
MSR	mortgage servicing rights
NYDFS	New York Dept. of Financial Services

[7] *See, e.g.*, 12 C.F.R. § 3.41(c)(1) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec3-41.pdf.

[8] *Compare* 12 C.F.R. § 3.2 (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec3-2.pdf, *with* BCBS, *Revisions to the Securitisation Framework* ¶¶ 1-6 (Dec 2014) http://www.bis.org/bcbs/publ/d303.pdf.

Exhibit 1: Acronyms Used in This Report	
OCC	Office of the Comptroller of the Currency
QM	qualified mortgage
QRM	qualified residential mortgage
SEC	Securities and Exchange Commission
SFA	supervisory formula approach
SFIG	Structured Finance Industry Group
SPV	special purpose vehicle
SSFA	simplified supervisory formula approach

U.S. regulators have the discretion to require banks to hold capital above the amount required under the quantitative regulatory standards.[9] That is not likely to change.

The securitization industry asked U.S. regulators to allow a deal to include up to 5% underlying securitization exposures without being classified as a resecuritization. U.S. regulators rejected the request.[10] No change is likely on that result.

The U.S. regulations impose "operational requirements" for a bank to remove assets from its balance sheet in connection with a securitization. The requirements include transferring credit risk. Similar requirements apply to synthetic securitizations.[11] Those requirements are likely to stand.

The U.S. regulations provide that an eligible clean-up call must not be a disguised form of credit enhancement.[12]

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[9] *See, e.g.*, 12 C.F.R. § 3.1(d)(1) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec3-1.pdf.

[10] OCC and Federal Reserve System, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 Fed. Reg. 62018, 62113 (11 Oct 2013), available at http://www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf.

[11] *See, e.g.*, 12 C.F.R. § 3.41(a), (b) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec3-41.pdf.

[12] *See, e.g.*, 12 C.F.R. § 3.2 (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec3-41.pdf (definition of "eligible clean-up call).

The U.S. regulations include an approach called the "simplified supervisory formula approach" or SSFA, for figuring the capital charge on a securitization exposure, K_{SSFA} (before the effect of the 20% minimum risk weight):[13]

$$K_{SSFA} = \frac{e^{a \times u} - e^{a \times l}}{a(u - l)}$$

where:

e = 2.71828, the base of natural logarithms

$a = \frac{1}{p \times K_A}$

$l = \max(A - K_A, 0)$

$u = D - K_A$

p = 0.5 for securitization exposures and 1.5 for resecuritization exposures

$K_A = (1 - W) \times K_G + (0.5 \times W)$

A = the attachment point for the exposure

D = the detachment point for the exposure

W = is the proportion of the exposure that has a status of 90-days delinquent or worse

K_G = the weighed-average capital requirement for the exposure using the regulatory risk weight factors.

However, if $A<K_A$ and $D>K_A$, the risk weight (RW) for the exposure is a blend of 1250% and 1250% time K_{SSFA}, calculated as follows:

$$RW = \left[\left(\frac{K_A - A}{D - A}\right) \times 1250\%\right] + \left[\left(\frac{D - K_A}{D - A}\right) \times 1250\% \times K_{SSFA}\right]$$

The SSFA is likely to change. The change is expected to require twice as much capital.

The U.S. "supervisory formula approach" (SFA) is also likely to change.[14] Changes are likely in the parts of the formula that address the maturity of an exposure. The anticipated effect will be an increase in required levels of risk-based capital.

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[13] *See, e.g.*, 12 C.F.R. § 3.43 (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec3-43.pdf.

Other elements of the U.S. risk-based capital regulations that are not likely to change include the following:

- 100% risk weight for non-credit-enhancing, interest-only mortgage-backed securities,[15]
- treatment of liquidity facility for any off-balance sheet asset-backed commercial paper (ABCP) conduits,
- elimination of the "internal assessment approach" because of the elimination of reliance on rating agency credit ratings,
- avoidance of double counting of capital,
- treatment of mortgage servicing rights (MSRs),
- treatment of credit risk mitigation, and
- enhanced disclosure requirements.

High Quality Securitizations: European securitization activity has slowed. There is a new initiative for "high quality securitization" (HQS) which emphasizes structure and transparency. No standard for HQS has been adopted, but the idea is receiving substantial attention.[16] Basel III is likely to be modified to offer lower capital on securitizations that meet the HQS standard. This will reverse some of the increase in Basel III capital requirements that came from the financial crisis. The Europeans want to have a third party responsible for designating HQS status, while the Americans favor

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[14] *See, e.g.*, 12 C.F.R. § 3.143 (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec3-143.pdf.

[15] *See, e.g.*, 12 C.F.R. § 3.42(g) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec3-42.pdf.

[16] European Central Bank and Bank of England, *The Impaired EU Securitisation Market: Causes, Roadblocks and How to Deal with Them* (11 Apr 2014) http://www.bankofengland.co.uk/publications/Documents/news/2014/paper070.pdf;
European Banking Authority, *EBA Discussion Paper on Simple Standard and Transparent Securitisations*, EBA/DP/2014/02 (14 Oct 2014) https://www.eba.europa.eu/documents/10180/846157/EBA-DP-2014-02+Discussion+Paper+on+simple+standard+and+transparent+securitisations.pdf;
BCBS and Board of the International Organization of Securities Commissions, *Consultative Document – Criteria for Identifying Simple, Transparent and Comparable Securitisations* (11 Dec 2014) http://www.iosco.org/library/pubdocs/pdf/IOSCOPD467.pdf;
Segoviano, M., Jones, B., Lindner, P., and Blankenheim, J., *Securitization: The Road Ahead*, IMF Staff Discussion Note, SDN/15/01 (29 Jan 2015) http://www.imf.org/external/pubs/ft/sdn/2015/sdn1501.pdf.

allowing issuers to self-designate. The Structured Finance Industry Group (SFIG) has lobbied the Treasury Department and the bank regulators about HQS. The FDIC opposes the idea of HQS.

Liquidity Ratios: Both Basel III[17] and the U.S. regulations[18] include liquidity ratio requirements. From a lender's perspective, an objective should be to include the smallest possible portion of a loan commitment in the denominator of a ratio. If an ABCP conduit is controlled by a bank and the bank issues a commitment to the conduit, then the bank can use the conversion factor that would apply to a loan commitment made to the ultimate borrower from the conduit. Asset-backed securities (ABS) and private-label residential mortgage-backed securities (MBS) do not count as liquid securities in the numerator of the ratio. By contrast, agency MBS[19] do count as liquid securities in the numerator. However, MBS from Fannie Mae and Freddie Mac are subject to a 15% haircut and to a limit on the proportion of the total numerator that they can be. The securitization industry argued unsuccessfully against the haircuts and composition limits.[20]

Risk Retention:[21] The regulations require 5% risk retention through a "horizontal slice" (*i.e.*, a subordinate tranche), a "vertical slice" (*i.e.*, an equal portion of all tranches), or a combination of the two. The basic risk retention requirement is 5%. In the case of a horizontal slice, the fair value of the retained piece must be at least 5% of the fair value

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[17] BCBS, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (Jan 2013) http://www.bis.org/publ/bcbs238.pdf; BCBS, *Basel III: The Net Stable Funding Ratio* (Oct 2014) http://www.bis.org/bcbs/publ/d295.pdf.

[18] *See, e.g.*, 12 C.F.R. Part 50 (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-part50.pdf; OCC, Federal Reserve System, and Federal Deposit Insurance Corporation (FDIC), *Liquidity Coverage Ratio: Liquidity Risk Measurement Standards*, 79 Fed. Reg. 61440 (10 Oct 2014), available at http://www.gpo.gov/fdsys/pkg/FR-2014-10-10/pdf/2014-22520.pdf.

[19] Agency MBS refers to mortgage-backed securities issued or guaranteed by Ginnie Mae, Fannie Mae, or Freddie Mac.

[20] 79 Fed. Reg. at 61457-59, available at http://www.gpo.gov/fdsys/pkg/FR-2014-10-10/pdf/2014-22520.pdf.

[21] *See, e.g.*, 12 C.F.R. Part 43 (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-part43.pdf; OCC, Federal Reserve System, FDIC, Federal Housing Finance Agency (FHFA), SEC, and Dept. of Housing and Urban Development (HUD), *Credit Risk Retention*, 79 Fed. Reg. 77602 (24 Dec 2014) available at http://www.gpo.gov/fdsys/pkg/FR-2014-12-24/pdf/2014-29256.pdf.

of the entire deal, based on GAAP.[22] There is no provision for risk retention through a representative sample or through a participation interest. Unfunded risk retention is not allowed, which differs from the European risk retention rule.[23] The risk retention rule becomes effective for mortgage securitizations in Decembere 2015 and for securitizations of other asset types in December 2016. The final rule eliminated the need for projected cash flows on a deal's closing date. Reg AB II calls for disclosure of the fair value of retained tranches, including key valuation assumptions.

Regulators decided to make the definition of "qualified residential mortgage" (QRM) be the same as the definition of the term "qualified mortgage" (QM).[24] That means that there is no minimum required level of borrower equity in a home for loan to be a QRM. That is important because securitizations of QRMs are exempt from the risk retention requirement.

The treatment of revolving pools (*e.g.*, credit card master trusts) under the risk retention rules will work. However, auto loan ABS issuer probably will not use the exemption for "eligible auto loans."

Volcker Rule:[25] The Federal Reserve has extended the "conformance period" to 7/21/2016 for compliance with the Volker Rule restrictions on pre-2014 bank investments in, and relationships with, "covered funds." The Fed also announced that it

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[22] *See, e.g.*, 12 C.F.R. § 43.4(a)(2) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec43-4.pdf.

[23] Commission Delegated Regulation (EU) No 625/2014, of 13 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council by way of Regulatory Technical Standards Specifying the Requirements for Investor, Sponsor, Original Lenders and Originator Institutions Relating to Exposures to Transferred Credit Risk, 2014 O.J. (L17416), available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_174_R_0006&from=EN.

[24] *See, e.g.*, 12 C.R.F. § 43.13(a), (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec43-13.pdf; 12 C.R.F. § 1026.43(e)(2) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol9/pdf/CFR-2015-title12-vol9-sec1026-43.pdf (definition of qualified mortgage).

[25] *See, e.g.*, 12 C.F.R. Part 44 (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-part44.pdf.

intends to extend the conformance period by at least another year (to 7/21/2017 or beyond).[26]

Reg AB II:[27] The new requirements under Reg AB II become effective in November 2015, except for the asset-level disclosure requirements, which become effective in November 2016. A key change under the new rules is the requirement that an offering must have a single, integrated prospectus.[28] The current practice of using a two-part disclosure document comprising a "base prospectus" and a "prospectus supplement" has been eliminated. Also, Reg AB II calls for loan-level disclosure on securitizations of certain types of assets.[29]

Reg AB II introduced new Form SF-3, which is the new SEC form for shelf registration of asset-backed securities. There is no credit rating requirement for using the form. However, there are several new eligibility requirements.[30] One new requirement is a certification by the CEO of a deal's depositor. The CEO must certify that (i) the prospectus is free of material misstatements and omissions; (ii) the prospectus "fairly presents" the characteristics of the subject securities, the structure of the transaction, and the risks of the securities; and (iii) there is reasonable basis to conclude that that securitization is structured to produce enough cash flow to pay the subject securities in accordance with their terms.[31] Some market participants view the CEO certification requirement as very onerous. Some issuers may limit their public offerings to bonds rated triple-A; they would sell lower-rated tranches in unregistered sales via Rule 144A. Issuers need to assess their due diligence procedures to make sure that they have covered the all the elements of the new certification requirement. Some

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[26] Federal Reserve System, Press Release (18 Dec 2014), http://www.federalreserve.gov/newsevents/press/bcreg/20141218a.htm

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

[28] General Instruction IV to Form SF-3, 79 Fed. Reg. at 57342., available at http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-21375.pdf.

[29] Regulation AB Item 1111(h)(1), 17 C.F.R.229.1111(h)(1) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title17-vol3/pdf/CFR-2015-title17-vol3-sec229-1111.pdf.

[30] 17 C.F.R. § 239.45 (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title17-vol3/pdf/CFR-2015-title17-vol3-sec239-45.pdf.

[31] 17 C.F.R. § 229.601(b)(36) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title17-vol3/pdf/CFR-2015-title17-vol3-sec229-601.pdf.

are likely to have layers of subordinate certifications (*i.e.*, below the level of the CEO) to push accountability downward.

Other new eligibility requirements include (i) an "asset review" provision, (ii) a "dispute resolution" provision, and (iii) an investor communication provision. In addition, the depositor must have made timely filings of all required 1934 Act reports on its prior deals.

The role of a deal's "asset representation reviewer" is to give a report about whether there has been non-compliance with a representation or warranty. The asset representation reviewer does not determine whether the non-compliance constitutes a breach. The trustee makes that determination. The issuer selects the asset representation reviewer. Reviews must be performed when two conditions are satisfied: delinquencies exceed a defined threshold and a specified proportion (max 5% by dollar holdings) of investors want a review.

Consumer privacy concerns are still an issue. Reg AB II attempts to address consumer privacy concerns by requiring only the first two digits of the zip code for the location of a mortgaged property.[32] In connection with designing Reg AB II, the SEC received guidance from the CFPB stating that the issuers would not violate the Fair Credit Reporting Act[33] by disclosing information that the SEC determines is necessary for investors to independently perform due diligence and that must be disclosed though the SEC's EDGAR system.[34] However, the CFPB guidance does not cover other, potentially relevant consumer privacy laws, such as the Graham-Leach-Bliley consumer privacy provisions.[35] Nor does the CFPB guidance cover deals that are not disclosed through EDGAR (*i.e.*, private transactions). The key issue is the risk of "re-identification" (using a combination of disclosed items – such as a loan's closing date, original balance, and zip code – to figure out the address of a mortgaged property, and from the address to then obtain the borrower's identity). The prior practice was to

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[32] 17 C.F.R. § 229.1125 Appendix, Item 1(d)(1)) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title17-vol3/pdf/CFR-2015-title17-vol3-sec229-1125.pdf.

[33] 15 U.S.C. § 1681 et seq. (2013), available at http://www.gpo.gov/fdsys/pkg/USCODE-2013-title15/pdf/USCODE-2013-title15-chap41-subchapIII.pdf.

[34] 79 Fed. Reg. at 57237, available at http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-21375.pdf.

[35] 15 U.S.C. §§ 6801-27 (2014), available at http://www.gpo.gov/fdsys/pkg/USCODE-2014-title15/pdf/USCODE-2014-title15-chap94-subchapI.pdf.

provide five-digit zip codes. Issuers appear willing to provide five-digit zip codes in unregistered offerings under Rule 144A, where investors accepted confidentiality obligations. This produces the ironic result of having disclosure with greater detail in unregistered offerings than in registered offerings.

Timing: Reg AB II and other regulations require changes to the timing of registered ABS offerings. The findings of any third-party due diligence report must be filed with the SEC at least five business days before the first sale of securities.[36] The prospectus for an offering must be filed with the SEC at least three days before the first sale.[37] Any material changes must be filed at least two days before the first sale. Brokers and dealers must deliver a prospectus at least 48 hours before the confirmation of a sale.[38] A preliminary prospectus must contain all information except pricing.

There is a chance that the SEC will extend the new disclosure requirements of Reg AB II to unregistered sales under Rule 144A. The outcome of the next Presidential election may influence the result.

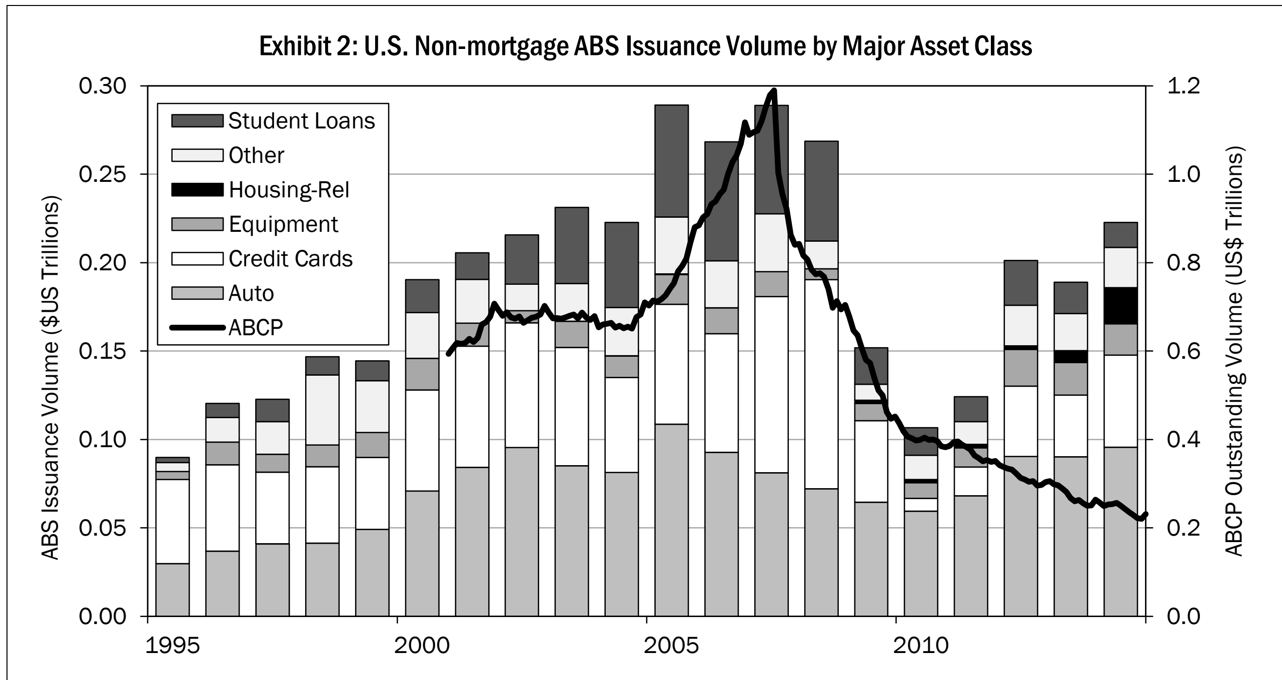
Auto Loans

The securitization industry got hammered starting in 2007, but auto loan ABS issuance has held up pretty well over the past couple of years. Auto ABS accounted for 47% of total non-mortgage ABS issuance in 2013 and 47% in 2014.

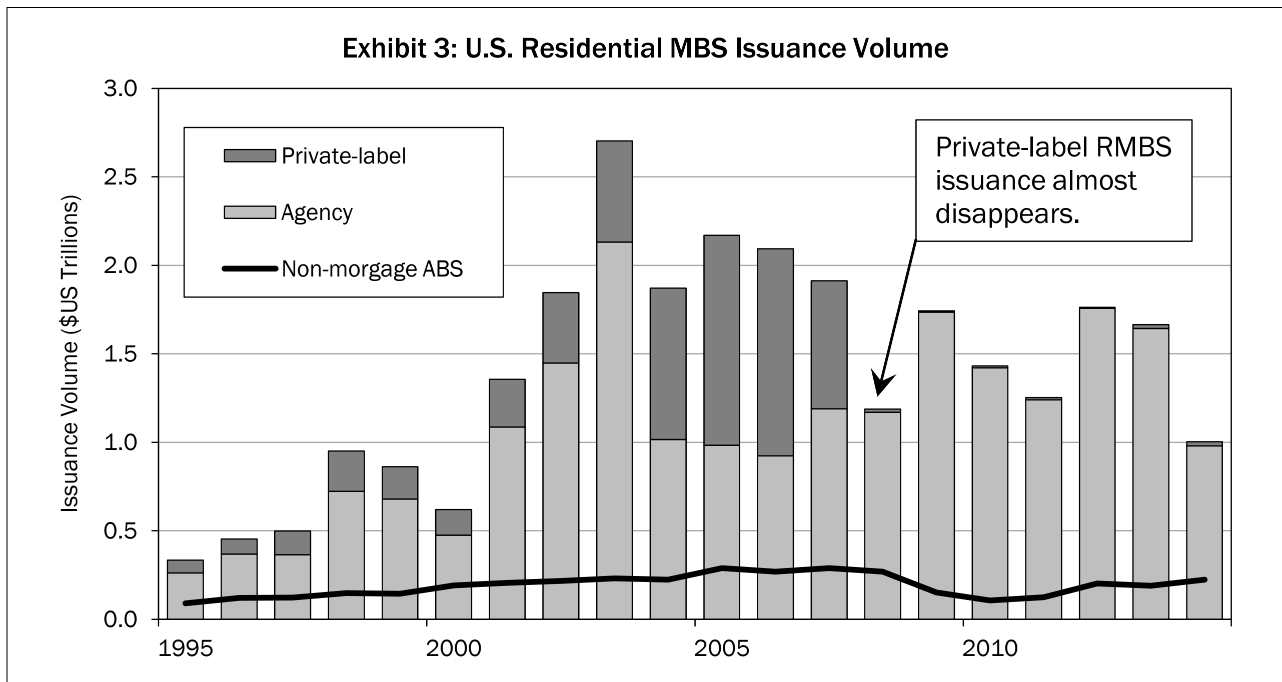
[36] 17 C.F.R. § 240.15Ga-2(a) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title17-vol4/pdf/CFR-2015-title17-vol4-sec240-15Ga-2.pdf.

[37] 17 C.F.R. § 230.424(h)(1) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title17-vol3/pdf/CFR-2015-title17-vol3-sec230-424.pdf.

[38] 17 C.F.R. § 240.15c2-8(b) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title17-vol4/pdf/CFR-2015-title17-vol4-sec240-15c2-8.pdf.



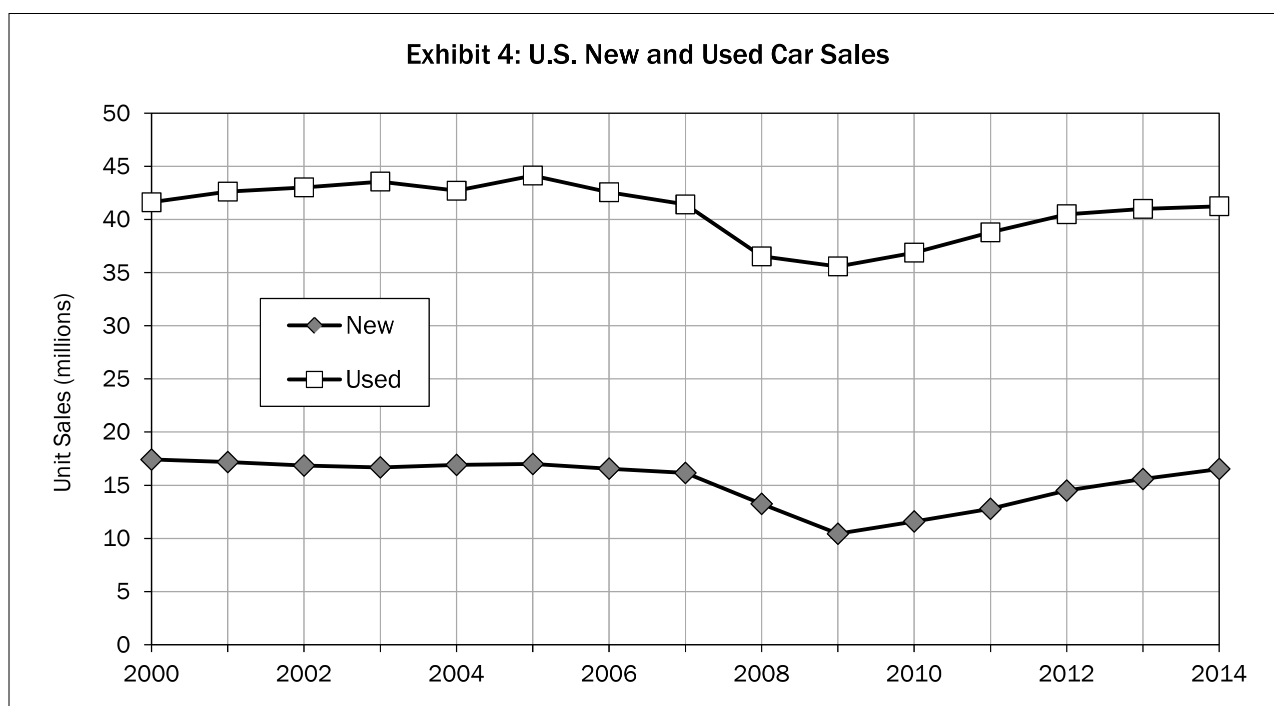
Sources: SIFMA and Federal Reserve. Note: Does not include CDOs or securitizations backed by subprime mortgage loans or loans secured by manufactured homes. Housing-related category includes transactions backed by servicing advances and rent-to-own contracts, and the credit risk transfer transactions by Fannie Mae and Freddie Mac.



Sources: SIFMA; 2007 Mortgage Market Statistical Annual (for private-label before 1996). Note: Agency includes MBS issued or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac, and excludes CMOs. Private-label includes transactions backed by prime, alt-A, sub-prime, and manufactured housing loans. Inclusion of subprime and manufactured housing starts in 1990. Private-label excludes resecuritization transactions.

There are three products in the auto finance ABS space: auto loans, auto leases, and dealer floorplan loans (for financing the dealers' inventories).

The retail auto finance space includes both prime and subprime segments. Sales of new vehicles contracted during the financial crisis but have since recovered to pre-crisis levels. The used vehicle market is actually much larger than the market for new vehicles.



Sources: Goodcarbadcar.net for annual new car sales. Usedcars.about.com for annual used car sales.

About 85% of new car purchases are financed. About 54% of used car purchases are financed. Although the percentage of homes purchased on credit has fluctuated markedly since the financial crisis, the proportion of cars financed has been more stable. Because a greater proportion of American households own cars than own homes, the auto finance industry reaches more "everyday Americans" than does the mortgage finance industry.

About 40% of all auto loans are "subprime." Subprime auto loans are those where the borrower has a FICO® score below 640,[39] though the average FICO® score of

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[39] Aliff, T. and O'Connor, M., *Credit Scores Don't Tell the Entire Story for Car Buyers* at 1, Equifax white paper (Jan 2013), http://www.equifax.com/pdfs/corp/EFX_CreditScores_WP.pdf.

subprime auto loans is around 595. A typical subprime auto loan has a loan-to-value ratio (LTV) of about 115%. That means that the amount of the loan is 115% of the value of the auto being financed. Ten percent of subprime auto borrowers have no FICO® score. The original term of the typical subprime auto loan has been lengthening and most new loans have terms longer than 60 months.

The subprime auto segment is facing increased scrutiny by the press and regulators. The government alleged "disparate impact" on minority borrowers in a December 2013 action against Ally Financial.[40] That enforcement action was notable because it largely concerned the conduct of the thousands of auto dealers that refer loan applications to Ally Financial and other lenders. However DFA § 1029 provides that the CFPB cannot regulate auto dealers.[41] In another case, the New York State Department of Financial Services (NYDFS) shut down Condor Capital in April 2014.[42] In a third notable action, the FTC settled with Consumer Portfolio Services (CPS) in June 2014.[43]

One enforcement technique is to install an outside third-party to monitor a lender's activities (at the lender's expense). There is enforcement focus on the frequency of underwriting exceptions.

Reg AB II:[44] A main goal of Reg AB II was to revive the residential loan market and to restore confidence in private-label MBS. Investors continue to express a complete loss of trust in the private-label MBS segment. The SEC approach to other asset classes

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[40] Consent Order, U.S. v. Ally Financial, No. 13-15180 (E.D.Mich. 23 Dec 2013), available at http://www.justice.gov/crt/about/hce/documents/allyco.pdf; Consent Order, In the Matter of Ally Financial, CFBP Administrative Proceeding No. 2013-CFPB-0010 (23 Dec 2013), available at http://files.consumerfinance.gov/f/201312_cfpb_consent-order_ally.pdf.

[41] 12 U.S.C. § 5519 (2014), available at http://www.gpo.gov/fdsys/pkg/USCODE-2014-title12/pdf/USCODE-2014-title12-chap53-subchapV-partB-sec5519.pdf.

[42] Lawsky v. Condor Capital, No. 14 Civ. 2863 (S.D.N.Y. 22 Dec 2014) (consent and final consent judgement), available at http://www.dfs.ny.gov/about/ea/ea141218a.pdf and http://www.dfs.ny.gov/about/ea/ea141218b.pdf

[43] Stipulated Order for Permanent Injunction and Civil Penalty Judgment, U.S. v. Consumer Portfolio Services, No. 14-cv-00819 (C.D. Cal. 11 Jun 2014), available at https://www.ftc.gov/system/files/documents/cases/140529cpsstiporder_0.pdf.

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

was generally to extend the disclosure rules for residential mortgages to those asset classes. Extending the residential mortgage rules might not have been the best approach. Post-crisis performance of the auto ABS sector has shown that auto ABS were not "broken" and did not need to be repaired. Some market participants assert that the pre-crisis rating agency standards were arguably correct and did not require material adjustment. The mortgage sector's problems with the enforcement of representations and warranties are not necessarily relevant in the auto finance sector. However, Reg AB II nonetheless imposes the asset reviewer requirements on auto ABS deals.[45] The large auto finance companies are likely to keep their representations and warranties unchanged unless the SEC requires otherwise. The impetus for standardization of representations and warranties is not present in the auto finance sector.

CLOs

CLOs generally performed very well through the financial crisis.[46] They have lower cumulative default rates than other structured products and even lower default rates than corporate bonds.

CLOs received comparatively favorable treatment under the Volcker Rule.[47] Regulators placed the CLOs within the ambit of the risk retention rule despite the fact that the sector suffered relatively few losses through the financial crisis. Those rules are already affecting CLO issuers and collateral managers even though the rules' effective date for non-mortgage securitizations is almost two years away (12/24/2016). The rules are affecting pricing, structures, and execution. Market participants are already working on "solutions."

Risk Retention:[48] The basic rule is that the sponsor or a majority-owned affiliate must retain an economic interest in the credit risk of securitized assets.[49] Some market

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[45] 17 C.F.R. § 239.45(b)(1)(ii) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title17-vol3/pdf/CFR-2015-title17-vol3-sec239-45.pdf.

[46] *See, e.g.*, Roy, D.D., *Default & Loss Rates of Structured Finance Securities: 1993-2013*, Moody's special comment, at 17-19 (30 Sep. 2014); Roy, D.D., *Structured Finance Rating Transitions: 1983-2013*, Moody's special comment, at 25-31 (23 Jun 2014).

[47] See infra, text accompanying note 57.

[48] *See, e.g.*, 12 C.F.R. Part 43 (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-part43.pdf;

participants argue that the rule should not apply to the CLO segment because, in contrast to the residential MBS segment (for example), it is not an "originate to distribute" market. Nevertheless, regulators were not persuaded by the argument and imposed risk retention on CLOs.[50] The risk retention requirement classifies a CLO's manager as the "sponsor" to which the requirement applies.

The regulations require 5% risk retention through an eligible vertical interest, an eligible horizontal residual interest, or a combination of the two.[51] The rule generally prohibits hedging the retained risk.[52] The rule permits pledging a retained interest as collateral for a financing, but only if the financing is with full recourse to the sponsor or a majority-owned affiliate.[53] The risk retention requirement for a deal applies until the latest of (i) the assets in the deal have amortized to 33% of their original balance, (ii) the securities issued in the deal have amortized to 33% of their original balance, and (iii) two years after the deal's closing date.[54]

Vertical risk retention amounts to a 5% piece of each tranche. Horizontal risk retention calls for holding 5% in the most subordinate tranche where the fair value of the position must be at least 5% of the fair value of all the securities issued at the deal's closing.[55]

OCC, Federal Reserve System, FDIC, FHFA, SEC, and HUD, *Credit Risk Retention*, 79 Fed. Reg. 77602 (24 Dec 2014), available at http://www.gpo.gov/fdsys/pkg/FR-2014-12-24/pdf/2014-29256.pdf.

[49] *See, e.g.*, 12 C.F.R. § 43.3(a) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec43-3.pdf.

[50] 79 Fed. Reg. at 77650-59, available at http://www.gpo.gov/fdsys/pkg/FR-2014-12-24/pdf/2014-29256.pdf.

[51] *See, e.g.*, 12 C.F.R. § 43.2 (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec43-2.pdf (definition of "eligible vertical interest" and "eligible horizontal interest").

[52] *See, e.g.*, 12 C.F.R. § 43.12(b), (c) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec43-12.pdf.

[53] *See, e.g.*, 12 C.F.R. § 43.12(e) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec43-12.pdf.

[54] *See, e.g.*, 12 C.F.R. § 43.12(f)(1) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec43-12.pdf.

[55] *See, e.g.*, 12 C.F.R. § 43.2 (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec43-2.pdf (definition of "eligible vertical interest" and "eligible horizontal interest").

The risk retention rule includes a broad definition of "majority-owned affiliate." For a CLO manager it means any entity (other than CLO issuer) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, the manager. "Majority control" means ownership of either (i) more than 50% of the affiliate's equity or (ii) any other controlling financial interest as determined under GAAP.[56] The second leg of the definition of majority control is prompting some CLO managers to explore structures for having a controlling interest under GAAP with less than 50% equity ownership. Warehouses for open market CLOs may require some type of risk retention.

Several questions remain unanswered. One such question, for example, relates to "legacy CLOs" (*i.e.*, a CLO issued before the effective date of the risk retention rule): What happens if a legacy CLO is amended, or effects a standard refinancing or repricing after the rule becomes effective? Could it lose its "grandfathered" status because of those actions? Other unresolved questions: If a collateral manager resigns, what does it mean for risk retention? Does the collateral manager have to sell its risk retention piece to the successor? What happens if a manager finances its retained piece and the lender ultimately forecloses on it?

Volcker Rule:[57] The Volcker Rule is ultimately simple. A banking entity cannot engage in (i) proprietary trading or (ii) sponsoring or investing in "covered funds." The "conformance date" for the prohibition on proprietary trading is 7/21/2015. The conformance date for other prohibitions will likely be in 2017.

Under the Volcker Rule, a bank will be allowed to invest in a CLO tranche only if either (i) the CLO is not a "covered fund" or (ii) the tranche is not an "ownership interest." In practical terms, those limitations are quite restrictive. Most CLOs created before the release of the rules are covered funds. In addition, most of their securities that are attractive to banks constitute ownership interests.

…Covered Funds: Most legacy CLOs are covered funds because (i) they rely on the exemption under § 3(c)(7) of the Investment Company Act and (ii) they allow for underlying assets that are bonds (in addition to loans). The Volker Rule prohibits a

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[56] Id.

[57] *See, e.g.*, 12 C.F.R. Part 44 (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-part44.pdf.

bank from owning, investing in, or sponsoring to a covered fund. It also prohibits a bank from extending credit to a covered fund that it sponsors or advises.

The definition of covered fund excludes entities that rely on an exclusion or exemption from the definition of "investment company" *other than* the exclusions in § 3(c)(1) and § 3(c)(7) of the Investment Company Act.[58] This means that securitizations that rely on the exclusions under § 3(c)(5) or Rule 3a-7 are not covered funds. The definition also excludes securitizations backed entirely by loans and certain incidental assets.[59] New CLOs in the U.S. can avoid being covered funds by being limited to loans (*i.e.*, not allowing bonds in the underlying assets). Legacy CLOs can be amended to become loan-only, but that solution will not work for CLOs that already have non-loan assets. Additionally, the loan-only solution is not workable for future European CLOs because a substantial share of the potential assets are in the form of bonds.

A CLO manager can potentially take a CLO outside the definition of covered fund by amending the deal to rely on the exemption under Rule 3a-7.

A commodity pool can be a covered fund.[60] A static pool deal outside the U.S. with no U.S. investors would not be a covered fund. A foreign bank conducting activities outside the U.S. also would not be investing in a covered fund in violationof the rule.

…Ownership Interests: A bank can own a security from a CLO that is a covered fund as long as the security is not an "ownership interest." A bank is prohibited from owning any ownership interest in a covered fund.[61] A CLO tranche would be an

[58] *See, e.g.*, 12 C.F.R. § 44.10(c)(12) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec44-10.pdf.

[59] *See, e.g.*, 12 C.F.R. § 44.10(c)(8) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec44-10.pdf.

[60] *See, e.g.*, 12 C.F.R. § 44.10(b) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec44-10.pdf.

[61] *See, e.g.*, 12 C.F.R. § 44.10(a)(1) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec44-10.pdf.

ownership interest if it includes the right to remove a CLO's manager or the right to receive excess spread.[62]

A bank is not allowed to enter into "covered transactions" with a covered fund that it (or an affiliate) sponsors or advises.[63] Covered transactions include extensions of credit.[64] This restriction may hamper a CLO's ability to obtain warehouse funding from bank lenders. A bank is not allowed to be the sponsor of a covered fund. However "sponsor" is defined narrowly.[65] It is generally possible to structure a CLO so that the arranging bank will not be a sponsor.

A bank can be a market maker in CLO ownership interests, including the equity classes of a CLO.[66] However, making a market in ownership interests that include the right to remove the manager (including senior interests) will attract a 100% capital charge and must be limited to 3% of capital.[67]

Margin Rules:[68] By classifying CLOs as "financial end users,"[69] the margin rules for swaps put CLOs within the requirements for posting daily variation margin. But, deals are not set up to be able to do so. CLO market participants argue that the margin rules should not apply to CLOs because swap payments in a CLO are at the top of

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[62] *See, e.g.*, 12 C.F.R. § 44.10(d)(6)(i)(A), (D) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec44-10.pdf.

[63] *See, e.g.*, 12 C.F.R. § 44.14(a) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec44-14.pdf.

[64] 12 U.S.C. § 371c(b)(7) (2014), available at http://www.gpo.gov/fdsys/pkg/USCODE-2014-title12/pdf/USCODE-2014-title12-chap3-subchapX-sec371c.pdf.

[65] *See, e.g.*, 12 C.F.R. § 44.10(d)(10) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec44-10.pdf.

[66] *See, e.g.*, 12 C.F.R. § 44.11(c)(3) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec44-11.pdf.

[67] *See, e.g.*, 12 C.F.R. §§ 44.12(a)(2)(iii), (d) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec44-12.pdf.

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

[69] Id. at 59926-27 (definition of "financial end user," item (1)(xi).)

deal's cash-flow waterfall. The margin rule would effectively prevent CLOs from hedging interest rate and currency risks.

Whole Business Securitization

Securitizations of intellectual property and of franchise fees are sometimes executed as "whole business securitizations" because the owner of the intellectual property or the franchisor may have no other material assets. Dunkin Donuts recently securitized its franchise royalties for more than $2 billion. The deal included foreign franchise rights and had to address legal issues in many jurisdictions.[70]

In contrast, there are also intellectual property securitizations that do not involve substantially all the assets of the issuer. Those are not whole business securitizations. Intellectual property securitizations should be viewed as a type of corporate finance for the issuer. Rating agency methodologies discourage the presence of creditors "above" the securitization who might interfere with the business operations on which securitization depends.[71] One way to accommodate corporate finance concerns is to allow expanding a closed securitization when the issuer obtains more eligible assets.

Franchise deals create a bankruptcy issue because the SPE becomes the franchisor for future franchisees, although the operating company actually runs everything as manager/servicer. Lawyers give opinions that transfer of the franchise contracts to the SPE is a true sale and that the SPE would not be substantively consolidated with the operating company.

CMBS

CMBS was one of the first securitization sectors to recover following the financial crisis. Market participants introduced a set of reforms and improvements called "CMBS 2.0."[72] The new CMBS market has a high proportion of deals backed by mortgage loans

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[70] Davis, C.R., *DB Master Finance LLC $2.60 Billion Notes Series 2015-1 Assigned Ratings*, Standard & Poor's press release (26 Jan 2015); Kothari, V., *Dunkin' Brands Completes $2.6Billion Securitization Refinancing*, blog entry (undated), http://vinodkothari.com/dunkin-brands-completes-2-6billion-securitization-refinancing/.

[71] Wang, X., Lambotte, B., Black, W., Wang, Z., and Faynzilberg, I., *Moody's Approach to Rating Intellectual Property ABS*, Moody's methodology report (12 Dec 2013).

[72] CRE Finance Council, *CMBS 2.0*, PowerPoint presentation (15 Aug 2011), http://www.appraisalinstitute.org/assets/1/7/RebuildingCapMrktsandCMBS.pdf; *CMBS University: What*

on single properties. The properties in such deals are usually "trophy assets," worth more than $200 million. Another kind of single-asset deal has multiple properties all of the same type (*e.g.*, health care facilities or cold storage units).

One structuring issue for securitizing certain large assets is a mortgage's compliance with the REMIC tax rules.[73] The issue arises when a property generates significant non-real estate income, such as from entertainment, food, and beverages.

Sometimes bankers divide a very large loan into smaller pieces that are included in separate securitizations. That practice raises the issue of disclosure in the follow-on securitizations about the servicer that is servicing such a loan. Will investors in the follow-on securitizations receive the same level of information on the servicer?

Recent CMBS deals include a greater proportion of "mezzanine loans" than in the past. However, deals that include such loans are not eligible for REMIC treatment. CRE CLOs (*i.e.*, CLOs backed by commercial real estate assets) are a variation on the basic CMBS theme. Both CMBS and CRE CLOs are securitizations of commercial real estate loans. However, they use different structures, rely on different tax exemptions, and allow different degrees of flexibility. For example, an ordinary CMBS transaction would not normally include a loan secured by a transitional property (*e.g.*, a property that is not fully leased). However, such a loan might be eligible for a CRE CLO. CRE CLOs are perfect for risk retention because the users are actually trying to retain risk (as well as the potential upside). CRE CLOs are sometimes done as qualified REIT subsidiaries.

CMBS generally rely on the exemption under § 3(c)(5)(C) of the Investment Company Act. That provides an automatic exemption from Volcker Rule restrictions. The exemption under § 3(c)(5)(C) may not work for CRE CLOs and, therefore, they may have Volcker issues.

CMBS receive special treatment under the risk retention rule. There is a provision to allow for risk "retention" by a third party ("B piece buyer").[74] A given deal can have

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is the Difference Amongst CMBS 1.0, 2.0 and 3.0?, blog entry (9 Jun 2014), http://thecrereview.blogspot.com/2014/06/cmbs-university-what-is-difference.html.

[73] I.R.C. §§ 860A-860G (2013), available at http://www.gpo.gov/fdsys/pkg/USCODE-2013-title26/pdf/USCODE-2013-title26-subtitleA-chap1-subchapM-partIV.pdf; Treas. Reg. §§ 1.860A-0 to 1.860G-3 (2014), available at https://www.law.cornell.edu/cfr/text/26/1.860A-0.

no more than two B piece buyers. The other features of the risk retention rule apply to the B piece buyer. A key point, though, is that the risk retention rule places the compliance obligation on the sponsor of a deal. The sponsor is on the hook for any violation by the B piece buyer.

Covered Bonds

Covered bonds are originally a European product. A covered bond is senior, secured debt obligation of a bank. The collateral is usually a pool of mortgage loans, public sector assets, or ship loans. The special feature of covered bonds is that if the issuing bank becomes insolvent, the debt is not accelerated and it becomes, in effect, a securitization similar to a credit card trust. The bonds have bullet maturities and there is a master pool of collateral that secures all the bank's covered bonds. The bank is responsible for maintaining the level of the collateral pool on a daily basis. The assets and liability remain on the bank's balance sheet.

Many jurisdictions have specific laws about covered bonds. The laws detail the treatment of covered bonds if an issuing bank becomes insolvent. There is a widely held view in certain jurisdictions that the government would provide support for covered bonds because banks and central banks are the main buyers of covered bonds.[75]

Today's European covered bond market is €3 trillion. There has never been a default on covered bonds in 250 years.

Some investors view covered bonds as alternatives to sovereign bonds. Covered bonds have simple structures. There is 100% transparency. An issuing bank has 100% skin in the game. One of the reasons why covered bonds are so important and ubiquitous in Europe is that Europe does not have its own GSEs comparable to Ginnie Mae, Fannie Mae, and Freddie Mac. One reason why the U.S. does not have covered bond legislation (or a substantial covered bond market) is that the U.S. has the GSEs.

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[74] *See, e.g.*, 12 C.F.R. § 43.7(b) (2015) available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec43-7.pdf.

[75] *But see*, Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, 2014 O.J. (L173/190), available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN.

The GSEs are absorbing the great bulk of U.S. mortgage production, so the impetus for covered bond legislation in the U.S. is less.

There has been good proposed legislation for covered bonds in the U.S., but it never gained traction.[76] The proposals would have made covered bond financing available for at least seven different asset classes.

There is about $150 billion of U.S. dollar-denominated covered bonds outstanding in the U.S. market. So far in 2015, covered bond issuance in the U.S. has been about $10 billion. Washington Mutual and Bank of America did U.S. covered bond deals in 2006 and 2007. Since then, foreign banks have done all the U.S. covered bond deals. Movements in cross-currency swap costs have been the key driver in issuance volume fluctuations over time.

The SEC has agreed that covered bonds are not asset-backed securities. Nonetheless, the SEC wants disclosures for covered bonds to look similar to residential mortgage securitization disclosure. In a recent SEC-registered covered bond deal from a Canadian bank (backed by Canadian loans), the SEC focused on corporate disclosures about the issuer plus disclosures on the mortgage loans and the bank's mortgage loan programs.[77]

About 50% of U.S. covered bond issuance comes from Canadian banks. The transactions tend to be large, often over $1 billion.

Student Loans

There are two sub-asset-classes in the student loan sector. The first is federally-guaranteed loans from the Federal Family Education Loan Program (FFELP). The second is private student loans, which have no federal guarantee. Also, there are two main populations of issuers: not-for-profit lenders and for-profit lenders. The for-profit side includes both major banks and small, specialty lenders. The student loan ABS

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[76] *See, e.g.*, United States Covered Bond Act of 2011, H.R. 940, 112th Cong. (2011), available at http://www.gpo.gov/fdsys/pkg/BILLS-112hr940rh/pdf/BILLS-112hr940rh.pdf; United States Covered Bond Act, S.1835, 112th Cong. (2011), available at http://www.gpo.gov/fdsys/pkg/BILLS-112s1835is/pdf/BILLS-112s1835is.pdf.

[77] Royal Bank of Canada, Prospectus Supplement for U.S.$2,000,000,000 1.875% Covered Bonds Due 2020 (29 Jan 2015), http://www.rbc.com/investorrelations/_assets-custom/pdf/transactions/CB18-Prospectus-Supplement.pdf.

market has both publicly registered deals and deals executed under Rule 144A. Some recent deals have been backed by private student loans and others have been backed by FFELP loans. The latter are refinancings of older arrangements for funding FFELP loans.

Action is brisk in the area of private student loans. There are both "in-school" loans made to current students and "consolidation" loans made to students who have graduated. Private, in-school loans help students cover the gap between the amount that they can borrow from the government and the actual cost of their education.

In-school student loan origination has moved away from "direct to consumer" and toward "school certification" loans. In the latter, a school certifies the student's needs and receives the money directly from the lender.

A key term is "deferment," which refers to permitted deferrals of payment while a student is in school or after returning to school. Another key term is "forbearance." The idea is to help a borrower avoid default by temporarily reducing his or her payments. Many private loans have a parent co-signer.

Investors look at the quality of origination and underwriting practices. Today there is more focus on schools and degree types. Another key feature is servicing capabilities. Private student loans require a greater degree of hands-on servicing than federally-guaranteed loans. Some securitizations of private student loans include special servicers that step-in at the first hint of trouble. An additional consideration is general oversight by an issuer. Investors want to have meaningful recourse for breaches of representations and warranties. The inclusion of a back-up servicer is becoming more common in deals by new issuers.

Most student loan ABS use a senior-subordinated structure. The deals have substantial overcollateralization and triggers for diverting cash flows to senior tranches if defaults exceed specified levels. There is often a reserve account to cover shortfalls that might otherwise happen because of deferments or forbearances. Some deals allow "recycling" of principal (reinvesting principal collections in new loans) and some allow prefunding.

Private student loan defaults have declined for the fifth straight year.[78]

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[78] *Moody's: Private Student Loan Defaults Will Continue to Fall Towards Pre-Recession Levels*, Moody's press release (17 Mar 2015).

Many student loan ABS deals are done via Rule 144A. The loan-level disclosure requirements of Reg AB II do not apply to deals sold under Rule 144A (though there is a chance that the SEC could extend Reg AB II to cover such deals). However, third-party due diligence reports will need to be filed with the SEC. Student loan ABS are subject to risk retention, even on 97% federally-guaranteed FFELP loans. The student loan industry operates under close scrutiny of the CFPB because of its monitoring of and reactions to consumer and borrower complaints about student loan marketing, originations, and servicing.

Whole-loan trading of student loans has been brisk. Rehab loans have been the subject of recent whole-loan sales. Hedge funds are new entrants to the area of trading student loans in whole-loan format. There is an ongoing dialog about whether there can be a public-private partnership to revive private sector involvement in originating federally-guaranteed loans. Finally, nobody believes that education lending is not worthwhile because America needs an educated workforce.

Peer-to-peer Loans

Peer-to-peer lending started with the idea of a "platform operator" connecting a specific lender with a specific borrower. Later it evolved into a system where an investor could invest in a lending pool. Today, the term "peer-to-peer lending" broadly refers to almost any type of online lending system. The new term is "marketplace lending." Currently, the largest companies in the area are (i) LendingClub Corporation, (ii) Prosper Marketplace, and (iii) Social Finance (SoFi). The source of funds has been steadily changing from individuals to institutions. Hedge funds and banks finance the lending activities by the marketplace lenders. Major financial firms, including Capital One, Credit Suisse, Citigroup, Goldman Sachs, Deutsche Bank, and Morgan Stanley, are leaders in supplying funds to the sector.

Rating agencies have stressed marketplace lending deals very harshly in their analyses. The stresses have been out of proportion to the FICO® scores on the underlying borrowers. Unrated execution is competitive with execution on a recent deal that got a triple-B rating. A concern is that the asset class has no credit performance history during a downturn.

Regulation is a challenge for marketplace lenders. Most marketplace lenders have not obtained licenses in all 50 states. However, they do not make loans with usurious interest rates and they do not make themselves magnets for regulation and enforcement. As the market expands, there is the potential for the lenders to engage in a race to the bottom, which could attract scrutiny from states or the CFPB.

Lending Club did an initial public offering and has made substantial disclosures. Prosper sells public notes, which also include substantial disclosures.

Derivatives

A key part of Dodd-Frank was the regulation of derivatives.[79] Is a securitization a commodity pool? Does the manager of a securitization have to register as a commodity pool operator? The DFA expanded the definition of commodity to include all swaps, which raises the potential for any deal that includes a swap to be a commodity pool. The CFTC has issued an interpretation that most traditional asset securitizations (but not CDOs) are not commodity pools.[80] The CFTC then issued a second interpretation that broadened the exemption to cover ABCP conduits and CDOs that have only basic interest rate or currency swaps.[81]

Another issue for derivatives is clearing of swaps. Today there is clearing of two main categories of swaps: interest rate swaps and credit index swaps. However, interest rate swaps included in securitizations are non-standard and, therefore, outside of the clearing requirement. The issue of margin requirements might be tougher, though, because the requirements cover "uncleared swaps" (*i.e.*, swaps not subject to the clearing requirement). There is a proposed rule that would require securitization vehicles to post margin, but SFIG has submitted a comment letter seeking to get the opposite result in the final rule.[82]

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[79] Dodd-Frank Wall Street Reform and Consumer Protection Act, Title VII, Pub. Law No. 111-203, 124 Stat. 1376 (2010) available at http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf;

[80] CFTC Letter No. 12-14 (11 Oct 2012), available at http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-14.pdf.

[81] CFTC Letter No. 12-45 (7 Dec 2012), available at http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-45.pdf.

[82] Structured Finance Industry Group, Comment Letter regarding Proposed Rules re: Margin and Capital Requirements for Covered Swap Entities (OCC Docket ID OCC-2011-0008, Federal Reserve Docket No. R-1415 and RIN 7100 AD74, FDIC RIN 3064-AE21, FHFA RIN 2590-AA45) and Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (CFTC RIN 3038-AC97), (24 Nov 2014), available at http://www.sfindustry.org/images/uploads/pdfs/SFIG_Comment_Letter_Margin_Requirements.pdf.

SFIG recently got a no-action letter from the CFTC covering legacy SPVs. An amendment to a legacy deal forced by a downgrade of a swap provider will not cause the old deal to become subject to the new requirements solely because of an amendment or replacement of a swap.[83]

— END —

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[83] CFTC Letter No. 15-21 (31 Mar 2015), available at http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/15-21.pdf.