Asset Securitization:
Impact of Regulation AB II, the Credit Risk Retention Rules and the Volcker Rule
Navigating the Complexities of Federal Laws and Rules
Governing the Offer and Sale of Asset-Backed Securities

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ASSET SECURITIZATION: The Impact of Regulation AB II, The Credit Risk Retention Rules, and The Volcker Rule

November 25, 2014
State of the ABS/RMBS Markets

- The combined ABS and MBS markets hit a high before the credit crisis, with total issuance of $2.708 trillion.
- After the credit crisis, ABS issuance dropped precipitously, but private-label RMBS issuance fell off a cliff.
  - Between 2007 and 2010, ABS issuance declined 63 percent, from $289 billion to $106.5 billion.
  - From 2007 to 2008, private label RMBS issuance declined 98 percent, from $507 billion to under $9 billion, and in 2009 private label RMBS issuance was $0.
  - Agency MBS and CMO issuance took up the slack, increasing 38 percent, from $1.466 trillion in 2007 to $2.029 trillion in 2009.
• ABS began a strong recovery in 2011, with issuance of $124 billion.
  • Recovery continues today, with ABS issuance for the first three quarters of 2014 already equal to $179 billion
• Private label RMBS issuance began a weak recovery in 2010 with issuance of $1.1 billion, increasing to $16.8 billion in 2013
  • The overall RMBS market is still heavily weighted towards agency issuance, with agency MBS/CMO issuance totaling $1.858 trillion in 2013
Regulation AB II: What are the asset-level data requirements?

• Asset-level data requirements apply only to:
  • Residential mortgages
  • Commercial mortgages
  • Automobile loans and leases
  • Debt securities
  • Resecuritizations

• Each asset class has specific requirements
  • 270 data points for RMBS
  • Resecuritizations require asset-level data for underlying securities if they are in one of the covered asset classes

• Privacy concerns and implications
Regulation AB II: How will the registration process change?

- Forms SF-1 and SF-3
- New shelf eligibility requirements
  - CEO certification
    - Familiar with pool assets, structure of the securitization, and material transaction documents
    - No material misstatements or omissions
    - Fairly presents in all material respects the characteristics of the securitized assets and the risks of ownership of the offered ABS, including risks that would affect the cash flows
    - Reasonable basis to conclude that the securitization is structured (but not guaranteed) to produce expected cash flows to service scheduled payments of interest and the ultimate repayment of principal
Regulation AB II: How will the registration process change? (cont.)

- New shelf eligibility requirements (cont.)
  - “Asset representations manager”
    - Two-pronged trigger (delinquency + vote)
    - After trigger, must review all assets 60+ days delinquent
  - Dispute resolution
    - Arbitration or mediation, requesting party chooses
  - Investor communications
    - Investor requests included in Form 10-D
  - Annual compliance check
    - May lose shelf access for up to a year
Regulation AB II: How will the registration process change? (cont.)

- New filing and delivery requirements
  - Preliminary prospectus must be filed three business days before pricing
  - If any material changes, must file prospectus supplement at least 48 hours before pricing
  - Preliminary prospectus must be delivered 48 hours before delivery of confirmation
  - Final transaction documents must be filed by filing deadline for final prospectus
- Integrated prospectus
- Single asset class/single depositor
- Pay-as-you-go
Regulation AB II: Are any other new disclosures required?

- Static pool information
  - Narrative description of the information, methodology, differences from pool
  - For amortizing asset pools, delinquencies and losses presented in 30-31 day increments through no less than 120 days
  - Graphical presentation of delinquency, loss and prepayment data

- Transaction parties
  - If the sponsor or 20 percent originator is required to repurchase or replace any asset for breach of a representation or warranty, financial disclosures are generally required
  - Less than 10 percent originators identified if assets originated by nonaffiliates are 10 percent or more of the pool
Regulation AB II: Are any other new disclosures required? (cont.)

- Risk retention
  - Nature and amount of the risk retained
  - Amount and nature of any interest retained to comply with legal requirements (e.g., credit risk retention rules)
  - Hedge that is materially related to the credit risk of the securities and was entered into to offset retained risk
- Document provisions governing asset modifications, effect on cash flows
- Enhanced prospectus summary
Regulation AB II: What did we avoid, and how long do we have?

- What was not adopted:
  - Required disclosure in Rule 144A offerings
  - Filing transaction documents by preliminary prospectus deadline
  - Cash flow waterfall program
- Compliance dates and transition procedures
  - Published: September 24, 2014
  - Effective: November 24, 2014
  - Compliance date (other than asset-level data): November 23, 2015
  - Compliance date (asset-level data): November 23, 2016
Credit Risk Retention: Who must retain credit risk?

• Rules generally impose risk retention requirements on sponsor
  • Any “person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer”
  • If there is more than one sponsor, each sponsor is responsible for ensuring that at least one retains the entire required credit risk
Credit Risk Retention: Who must retain credit risk? (cont.)

- Risk retention generally may be held by majority-owned affiliate
  - Entity other than the issuer that directly or indirectly majority controls, is majority controlled by, or is under common majority control with, sponsor
  - “Majority control” means ownership of more than 50 percent of equity or any other controlling financial interest under GAAP
Credit Risk Retention: Who must retain credit risk? (cont.)

- Under “standard” risk retention option, sponsor may allocate risk retention obligations to one or more originators
  - Only the original creditor
  - Must have contributed at least 20 percent of the assets to the asset pool and hold at least 20 percent of risk retention (but no more than the percentage of the pool assets it originated)
  - Acquired in same manner and proportion as originally by sponsor, for cash or reduction in asset purchase price
  - Sponsor remains responsible for compliance
- For CLOs, the agencies view the CLO manager as the sponsor, even though it does not transfer assets into the issuing entity
Credit Risk Retention: What is the base requirement?

- Rules apply to securitizers in issuances of Exchange Act ABS
  - Much broader than Reg. AB definition
  - Does not include synthetics
- Securitizer generally must retain an economic interest equal to at least 5 percent of the aggregate credit risk of the pool assets
- All asset classes may use “standard” risk retention option (vertical, horizontal or combined)
Credit Risk Retention: What is the vertical option?

• Sponsor retains (or causes majority-owned affiliate to retain) at least 5 percent of each class of ABS interests issued as part of the securitization transaction
  • Or an equivalent single vertical security
• “ABS interest” includes most types of interests issued by an issuing entity, whether or not certificated, if payments primarily depend on the cash flows from the collateral
  • Excluding non-economic REMIC residual interest, and uncertificated regular REMIC interest held by another REMIC where both REMICs are part of the same structure and a single REMIC issues investor ABS interests
• Fair value calculations are not required
Credit Risk Retention: What is the horizontal option?

- Sponsor retains (or causes majority-owned affiliate to retain) an “eligible horizontal residual interest” equal to at least 5 percent of the fair value of all ABS interests issued
  - Fair value is calculated under GAAP as of the closing date
  - Required pre- and post-closing disclosures of fair values and valuation methodologies
- “Eligible horizontal residual interest” is one or more ABS interests that:
  - Require P&I shortfalls to reduce amounts payable to the horizontal interest before reducing amounts payable to any other ABS interest
  - Have the most subordinated claim to P&I
  - No cash flow restrictions in final rules
Credit Risk Retention: What is the combined option?

- May fund “horizontal cash reserve account” in lieu of eligible horizontal residual interest
  - Amount equal to required fair value of eligible horizontal residual interest
  - Invested only in cash and cash equivalents
  - Amounts used only to satisfy payments on ABS interests if there are insufficient funds, or to pay critical trust expenses
- Sponsor (or majority-owned affiliate to retain) may retain any combination of eligible vertical and horizontal interests, as long as the total percentages add up to at least 5 percent
- No representative sample option
Credit Risk Retention: What other methods are available?

- Commercial mortgage-backed securities
  - Retention by up to two third-party B-piece buyers of a residual B-piece equal to at least 5 percent of the fair value of all ABS interests issued by the issuing entity
- Revolving pool securitizations
  - Retention by the sponsor of a seller’s interest equal to at least 5 percent of the total principal balance of the pool assets that shares the same risks as investors on a proportionate basis, or by combining a seller’s interest with certain other forms of retention
- Asset-backed commercial paper conduits:
  - Retention by each originator-seller of a residual interest equal to at least 5 percent of the fair value of all ABS interests backed by receivables of that originator-seller and certain of its affiliates
Credit Risk Retention: What other methods are available? (cont.)

- Securities guaranteed by Fannie Mae and Freddie Mac
  - Guarantee provided by Fannie Mae or Freddie Mac will satisfy the risk retention requirement

- Open market collateralized loan obligations
  - Retention of at least 5 percent of the face amount of each eligible loan tranche by the lead arranger of that loan

- Tender option bonds
  - Retention by the sponsor of an eligible horizontal interest that meets the requirements of an eligible vertical interest upon a tender option termination event, retention by the sponsor of at least 5 percent of the face value of the deposited munis
Credit Risk Retention: What is the QRM exemption?

- Qualified residential mortgages (QRM)s are exempt, if:
  - Pool consists solely of QRM s
  - Every loan in the pool currently is fewer than 30 days past due
  - Depositor certifies as to effectiveness of controls for ensuring that all assets are QRM s
- A QRM is a “qualified mortgage” (QM), as defined by the CFPB from time to time in ability to repay rules
- For a loan to be a QM, generally:
  - It must fully amortize over its term, which cannot exceed 30 years
  - Underwriting takes into account all mortgage-related obligations, is based on the maximum rate during the first five years and is on a fully amortized basis
Credit Risk Retention: What is the QRM exemption? (cont.)

- For a loan to be a QM, generally (cont.):
  - Lender must verify current or reasonably expected income or assets and current debt obligations
  - Borrower must have a total (or “back-end”, i.e., reflecting all debts, not just housing-related debts) DTI ratio of no more than 43 percent (based on the highest payment in first five years)
  - No points or fees in excess of 3 percent (other than “bona fide discount points” on prime loans)
  - No LTV or down payment requirement
  - Also includes other special QM definitions as defined by applicable regulators
  - If any non-QRM makes it into the pool, exemption will not be lost if sponsor repurchases within 90 days of discovery and notifies investors
Credit Risk Retention: Are other qualified assets exempt?

- Other qualified assets include qualified commercial loans, qualified commercial real estate loans and qualified consumer auto loans
  - Commercial loan exemption will not help CLOs
  - Auto loan exemption does not cover leases, requires DTI ratio of no more than 36 percent and does not recognize credit scoring
- A pool consisting solely of qualified assets is exempt
- These assets also qualify for blended pool treatment
  - Qualified assets have a zero percent risk retention requirement, down to a minimum pool risk retention of 2.5 percent
- If non-qualified asset makes it into the pool, exemption will not be lost if sponsor repurchases or cures within 90 days of discovery and notifies investors
Credit Risk Retention: What other exemptions are there?

- Laundry list of securitization types with governmental guarantees or other governmental involvement
- Partial FFELP student loan exemption
  - Exempt if guaranteed as to 100 percent of defaulted principal and accrued interest
  - 2 percent if guaranteed as to at least 98 percent of defaulted principal and accrued interest
  - 3 percent if guaranteed as to at least 97 percent of defaulted principal and accrued interest
  - Blended pool uses highest risk retention requirement
Credit Risk Retention: What other exemptions are there? (cont.)

- Two limited resecuritization exemptions
  - Single class pass-through exemption
    - Underlying must comply with risk retention
    - Single class, full pass-through of P&I
  - Multiple class securitizations of first-pay classes of RMBS
    - “First-pay class” is entitled to the same priority of payment and entitled to P&I prior to or pro rata with all other classes (except for POs or IOs)
    - Underlying must comply with risk retention
    - No credit tranching, only reallocation of prepayment risk
Credit Risk Retention: What other exemptions are there? (cont.)

- Exemption for transactions collateralized solely by seasoned loans
  - Residential mortgage loan must have been outstanding and performing for the longer of five years, or until its outstanding principal balance has been reduced to 25 percent of the original principal balance, but no longer than seven years
  - Any other loan must have been outstanding and performing for the longer of two years, or until its outstanding principal balance has been reduced to 33 percent of the original principal balance
  - No loan may have been modified or delinquent for 30 days or more
Credit Risk Retention: Can you transfer, hedge or finance?

• Generally, sponsor may not transfer its retained risk, or hedge its retained risk if it would limit financial exposure

• There are some permitted hedges:
  • Tied to interest rates, currency exchange rates or home prices
  • Tied to other sponsors’ securities
  • Tied to an index, as long as the ABS in the deal represent no more than 10 percent of the dollar-weighted average of all instruments in the index (and ABS in all deals where the sponsor must retain risk represent no more than 20 percent)

• Prohibition includes hedges at the issuer level that benefit the retained interest

• Any financing of retained risk must be full recourse to the borrower
Credit Risk Retention: Can you transfer, hedge or finance? (cont.)

- For ABS other than RMBS, restrictions sunset on the latest of:
  - Unpaid principal balance ("UPB") of the pool assets is 33 percent of the cut-off date UPB
  - UPB of the ABS interests is 33 percent of the closing date UPB
  - Two years after the closing date
- For RMBS, restrictions sunset on the later of:
  - Five years after the closing date
  - UPB of the underlying mortgages has been reduced to 25 percent of the closing date UPB, but no later than seven years after closing date.
- For CMBS, a retained B-piece may be transferred to another qualified buyer five years after closing
- For revolving pool, no sunset for restrictions on seller’s interest
Credit Risk Retention: Foreign Transactions

• There is a limited safe harbor for foreign transactions, which applies only if:
  • securities are not registered under the Securities Act
  • no more than 10 percent of dollar value of ABS interests are sold or transferred to U.S. persons
  • neither sponsor nor issuing entity is organized under U.S. law
  • no more than 25 percent of UPB of pool assets were acquired from U.S. majority-owned affiliate

• Limited nature of safe harbor and incompatibility with EU risk retention regime are significant concerns
Credit Risk Retention: How long do we have?

• Adoption and effective dates
  • Adopted October 21-22, 2014
  • For RMBS, effective one year after the date of publication in the Federal Register
  • For all other asset classes, effective two years after the date of publication in the Federal Register
The Volcker Rule: What are the covered fund restrictions?

• A “banking entity” generally may not “sponsor,” or own an “ownership interest” in, a “covered fund”
• A “banking entity” generally is:
  • An insured depository institution
  • A company that controls an insured depository institution
  • A bank holding company
  • Any affiliate or subsidiary of any of the foregoing
• Most securitization concerns have focused on the covered fund restrictions
The Volcker Rule: What is a covered fund?

- Generally, a “covered fund” is an issuer that would be an investment company, as defined in the Investment Company Act, but for Section 3(c)(1) (the “100 holder” exemption) or Section 3(c)(7) (the “qualified purchaser” exemption).
  - A securitization vehicle that can rely on any exemption from requirements of the Investment Company Act other than Section 3(c)(1) or 3(c)(7) generally is not a covered fund.
  - Therefore, a securitization vehicle that relies on Rule 3a-7 (for certain asset-backed securities) or Rule 3(c)(5) (certain sales financing and real estate financing funds) is not a covered fund.
  - CLOs generally do not qualify for Rule 3a-7 because of active pool management.
The Volcker Rule: What is an ownership interest?

- An “ownership interest” is any equity, partnership, or other similar interest
- An “other similar interest” has any of the following characteristics:
  - Right to participate in the selection or removal of general partner, managing member, member of board of directors or trustees, investment manager or investment adviser
  - Right to receive a share of the income, gains or profits (regardless of whether pro rata)
  - Right to receive the underlying assets after all other interests have paid (a “residual”)
  - Right to receive all or a portion of excess spread
  - May be reduced based on losses on underlying assets, such as allocation of losses, write-downs or charge-offs
The Volcker Rule: What is an ownership interest? (cont.)

• An “other similar interest” has any of the following characteristics (cont.):
  • Receives income on a pass-through basis or has a rate of return determined by reference to the performance of the underlying assets
  • Any synthetic right to any of the foregoing
• There are interpretive questions, but broadly interpreted, many of these could apply to most ABS interests
The Volcker Rule: What is a sponsor?

- A banking entity is a “sponsor” of a covered fund if the banking entity:
  - Serves as a general partner, managing member, trustee, or commodity pool operator of the fund
  - In any manner selects or controls a majority of the directors, trustees, or management
  - Shares the same name or a variant
  - Differs significantly from Reg. AB definition, but no special rules for securitization transactions analysis is fact-specific
The Volcker Rule: What is the loan securitization exemption?

- An issuer of Exchange Act ABS is not a covered fund if the asset pool consists solely of “loans” and certain related assets.
- A “loan” includes “any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.”
- Securities (including other ABS) and derivatives generally may not be included in the collateral pool.
  - This excludes resecuritizations and synthetics.
  - Most CLOs have included securities buckets. CLO 3.0 generally excludes the securities bucket in order to qualify for the loan securitization exemption.
- There also are exemptions for:
  - Qualifying asset-backed commercial paper conduits.
  - Qualifying covered bond structures.
The Volcker Rule: What are the rest of the covered fund restrictions?

- A banking entity generally must limit aggregate ownership interest in a covered fund to 3 percent of fair market value of the ownership interests (or any greater credit risk retention requirement), and in all covered funds to 3 percent of tier 1 capital.
- In limited circumstances, a banking entity may:
  - Sponsor a covered fund
  - Underwrite an offering by a covered fund
  - Make markets in ownership interests in a covered fund
  - Underwriting and market-maker inventory count toward limits on ownership interests
  - “Super 23A” could limit the ability to provide liquidity, servicing advances or other customary credit to, or repurchase assets from, a covered fund.
The Volcker Rule:
What are the proprietary trading restrictions?

- Banking entities generally will be prohibited from “proprietary trading,” which is broadly defined to include engaging as principal in the purchase or sale of any financial instrument (regardless of whether it is an ownership interest in a covered fund)
- Exemptions for repurchase financings and securities lending arrangements
- Limited exemption for underwriting and private placement activities, which prohibit a banking entity from purchasing more securities than necessary to meet reasonably expected near-term market demand
- Limited exemption for market-making, which requires inventory to be designed not to exceed reasonably expected near-term market demand
The Volcker Rule: How long do we have?

- Generally, a banking entity must bring its activities and investments into compliance with the Volcker Rule no later than July 21, 2015.

- Banking entities must engage in good-faith efforts that will result in their conformance to all requirements no later than the end of the conformance period.

- Good faith efforts include:
  - Evaluating the extent to which the banking entity is engaged in activities and investments covered by the Volcker Rule.
  - Developing and implementing a specific plan for full compliance by the end of the conformance period.
Questions?

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