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Winter 2020

Structured Finance Bulletin

Legal Insights and Trends in the Structured Finance Markets

NOTES FROM THE EDITORS

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In this Winter 2020 edition of our Structured Finance Bulletin, we provide updates on recent legal and regulatory developments in the consumer loan space as well as the latest on the transition from LIBOR.

We also analyze the Federal Housing Agencies and GSE updates to COVID-19 relief measures for mortgage loan borrowers and US M&A considerations for Fintech Businesses during the COVID-19 pandemic.

Finally, we review recent Volcker Rule revisions and developments in the EU Securitisation Regulation and the EU securitization market as a whole and address legal issues in cross-border trade receivable securitizations and the CFPB QM proposal for the GSE Patch.

Please visit Mayer Brown's structured finance blog, Retained Interest, designed to provide clients updates and analysis on legal and regulatory developments impacting the structured finance industry. Our lawyers provide insights related to developments and innovations in the structured finance industry and concise and timely briefings on current issues affecting financial asset transactions. retainedinterest.com

The Consumer Financial Services Review blog provides insights from an industry-leading group of lawyers within Mayer Brown's global Financial Services Regulatory & Enforcement practice. For more than 20 years, the Consumer Financial Services group has been recognized for its thought leadership and for providing high-caliber regulatory counseling, enforcement defense and transactional advice to a broad range of consumer financial services providers, including mortgage and auto lenders, consumer finance companies, payment companies, credit card issuers and investment banks. cfsreview.com

Additionally, we recently launched an IBOR transition blog, Eye on IBOR Transition, designed to enable our global, cross-practice IBOR Task Force to keep to keep market participants abreast, in real time, of continuing regulatory and legislative announcements, trade group tools, and the status of market transition. eyeonibor.com

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What a Biden Presidency Will Mean for Structured Finance

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The implications of the 2020 election for structured finance are coming into focus. Informed by our discussions in Washington, we can anticipate the likely direction of federal policy over the next two years that will impact the structured finance markets.

Although former Vice President Joe Biden has won the U.S. Presidency, the predicted "Blue Wave" that would have given Democrats control of both the White House and Congress did not materialize. Republicans will likely retain the Senate and unexpectedly gained seats in the House of Representatives, substantially reducing the Democratic House majority.

If Republicans retain their Senate majority following the two runoff elections in Georgia set for January 5th, the absence of unified Democratic control will mean that while financial policy will shift in a Biden Administration, that shift will be muted, though not insignificant, and will primarily be effected through presidential and regulatory actions rather than legislation. **However, it is important to note that if Democrats do win both of the runoff elections in Georgia (or later events occur that shift the Senate majority to the Democrats), then it is very likely that Democrats would aggressively use their narrow majorities in Congress, including to pass substantial tax legislation and far-reaching regulatory reforms. The course of financial policy over the next two years largely hinges on which party controls the Senate.**

From a macroeconomic perspective, if the Republicans hold the Senate, the U.S. would likely continue its current accommodative monetary and fiscal policies, since significant tax increases would be unlikely. The open question is the degree to which fiscal policy will be accommodative going forward.

With respect to interest rates, a critical factor for structured finance, yields on Treasuries fell when the predicted "Blue Wave" failed to materialize, which reduced expectations of the amount of future borrowing by the federal government, including for a new COVID-19-related stimulus package. Indications are that interest rates will remain low for the foreseeable future, which is generally positive for the demand for consumer

loans and ABS/MBS but potentially decreases the demand for some consumer receivables such as auto leases.

A Threshold Matter: Personnel is Policy

The likelihood that the Republicans will retain their majority in the Senate increases the importance of the Biden Administration's financial regulatory appointments. The Biden transition team has indicated that President-elect Biden's senior economic team will likely be rolled out in December. We expect to see first an announcement of the nominee for Treasury Secretary, followed by announcements of the nominees for Chair of the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Comptroller of the Currency.

How a Biden Administration will handle the Consumer Financial Protection Bureau ("CFPB") and the Federal Housing Finance Agency ("FHFA") is unclear at this time. Those agencies are led by Trump-appointed directors whose terms have not expired, but who, in the case of the CFPB, can be removed at will by the President, or, in the case of the FHFA, will be subject to removal at will by the President if, in a Supreme Court case to be decided early next year, the high Court follows its recent precedent permitting at-will removal of the CFPB director. Expectations that the Biden Administration would promptly terminate those directors may now be tempered by the likely need for the Biden Administration to work with a Republican-controlled Senate to confirm its nominees. Nevertheless, expectations are that the Biden Administration will seek to have a new director of the CFPB in place as soon as possible.

With respect to appointments to the Federal Reserve Board, President-elect Biden may open up a seat if he nominates Fed Governor Lael Brainard to be Treasury Secretary. Another seat is expected to open up in October of next year, when Randy Quarles's term as Vice Chair ends. The Senate is currently considering nominees for the two open seats at the Fed. If those nominees are not confirmed before the end of this Congress, the Biden Administration will immediately be able to nominate two individuals to the Fed Board.

Federal Deposit Insurance Corporation ("FDIC") Chair Jelena McWilliams's term lasts until 2023, but because the director of the CFPB and the Comptroller of the Currency are members of the FDIC Board, once President Biden appoints new leadership to those agencies, a majority of the FDIC board will consist of Democratic appointees.

Lame Duck Session: Prospects for Stimulus Bill

The most immediate impact of the election in terms of economic policy, with implications for structured finance, will be on the ongoing negotiations for another stimulus bill to address the continuing impact of the COVID-19 pandemic. During the lame-duck period (the period between the election and the swearing-in of the new Congress in January), Congress will likely seek to pass another stimulus bill. Senate Majority Leader Mitch McConnell has said that he would like to pass a bill by the end of the year. Such legislation would still need to secure House Speaker Nancy Pelosi's support, and she has so far insisted that the price tag be north of $2 trillion. Senate Republicans voted in favor of a package with a $650 billion price tag in September, but a deal would likely be above that figure, as the White House has voiced support for

a package above $1 trillion. It is possible that Congress passes another stimulus bill in the lame-duck, but it is not guaranteed.

Another stimulus bill would likely build on the programs established by the CARES Act and include:

- Reauthorization of the Paycheck Protection Program for small businesses (with additional restrictions on eligibility and new requirements for participating banks); and
- Extension of enhanced unemployment benefits at a rate below the $600 per week provided in the CARES Act.

The bill could also include:

- A new foreclosure moratorium and payment forbearance for federally-backed mortgages, which would impact mortgage servicers, the value of MBS, and the residential mortgage space more generally;
- A possible eviction moratorium; an eviction moratorium could adversely affect Single-Family Rental securitizations;
- An extension of funding for Federal Reserve emergency lending facilities (see below);
- Funding for state and local government, though in a far smaller amount than the $1 trillion sought by Speaker Pelosi; and
- A liability shield for COVID-19 pandemic-related lawsuits.

The Future of TALF and Other Federal Reserve Emergency Credit Facilities

The funding authorized by the CARES Act for the Federal Reserve's emergency lending facilities expires at the end of the year. Likely incoming Senate Banking Committee Chair Pat Toomey (R-PA) has already publicly stated that the Fed's emergency lending facilities should terminate at the end of the year. If the CARES Act funding for the emergency lending facilities is not reauthorized, the Fed would be prevented from making new loans through its emergency lending facilities, though it would not have to terminate existing loans. The Term Asset-Backed Securities Loan Facility ("TALF") that supports structured finance utilizes funds appropriated in the CARES Act, and would likely be prevented from making new loans if the CARES Act funding is not reauthorized.

If the CARES Act funding is extended and the economy displays weakness next year, the Biden Administration will likely encourage the Fed to modify its underwriting criteria for its Main Street Lending Program to increase eligibility and participation.

GSE Reform

In the immediate term, the most significant reform on the horizon for structured finance is the Trump Administration's current effort to end the decades-old conservatorships of Fannie Mae and Freddie Mac (the "GSEs"). The Biden team has not indicated its policy views on the future of the GSEs. However, FHFA Director Mark Calabria has signaled his intention to finalize a new capital rule for the GSEs before the end of the year. Once that rule is finalized, or possibly beforehand, he is expected to announce how he intends to proceed with terminating the conservatorships. Director Calabria has indicated that the conservatorships could be terminated with an interim step being that the GSEs would operate under a consent order while raising capital.

It is important to note that the Supreme Court is hearing a case next month about the validity of

the Third Amendment to the Preferred Stock Purchase Agreement between Treasury and FHFA, through which Treasury provides fiscal support for the GSEs. If the Supreme Court signals at its oral argument next month that it may invalidate the Third Amendment when it issues its decision, likely in March or April, it may compel the FHFA and the Treasury Department to proceed more quickly with reform. Alternatively, it is possible that the Biden Treasury Department will seek to halt the reform efforts upon taking office.

Legislative Possibilities Limited – IF Republicans Keep the Majority in the Senate

While significant legislation is always a possibility if there is a major event that galvanizes public support for a legislative response (such as the 2001-2002 accounting scandals that prompted Congress to pass the Sarbanes-Oxley Act), we anticipate that the votes will not exist for dramatic financial regulatory reform if the Republicans retain the Senate majority.

That said, we would still expect Congress to be active next year, as is the case during the first year of any presidency. Legislation could include the following areas affecting structured finance at least indirectly:

- Infrastructure legislation, as the Highway Trust Fund expires in September of 2021, requiring reauthorization and providing a vehicle for a substantial infrastructure bill;
- Additional funding for renewable energy research and production (including solar, which could increase the supply of solar-loan-backed ABS); and
- Additional subsidies for electrical vehicle purchases and charging stations.

A Republican-controlled Senate and a closely divided House would very likely prevent the passage of legislation that would:

- Enact major housing finance reform impacting the residential mortgage space and related securitization products;
- Use the Congressional Review Act to invalidate regulations adopted by the Trump Administration since May of 2020 (the statutory timeframe in which the CRA can be used with respect to a regulation); the regulations exposed to reversal under the CRA include the recent revisions to the Volcker Rule, including changes paving the way for liberalization of certain investment restrictions in CLOs that bank investors in many such vehicles had required in order to comply with the previous version of the Volcker Rule;
- Impose substantial tax increases;
- Establish interest rate caps on non-residential consumer lending; or
- Enact the "Green New Deal" or other environmental legislation that greatly expands corporate legal liability.

Again, it is important to emphasize that if Democrats win both of the Georgia Senate seats on January 5th (or other unanticipated events flip control to the Democrats), we would expect that Democrats would then aggressively use their legislative majorities - as narrow as they would be - to potentially pass some of the above items, in particular substantial tax reform and far-reaching environmental legislation, and a Senate rule change to eliminate the filibuster. Again - a lot of financial policy that could impact structured finance hinges on the narrow margin of control in the Senate.

Given the substantial federal deficit and soaring debt-to-GDP ratio, the Biden Administration also is likely to examine how to place the federal government's finances on a more sustainable footing, including by reversing the Trump tax cuts. It will be extremely difficult to adopt substantial budget reforms on both the revenue and spending sides given the likely divided control of Congress and sharp divides in the Democratic caucus in Congress. Nevertheless, we expect that the Biden Administration will seek to include targeted tax increases (including raising the corporate and capital gains rates and treating carried interest as ordinary income) as part of future budget deals with Senate Republicans.

Executive Branch Regulatory Reforms

An inability to pass significant financial services legislation if Republicans retain the Senate majority will likely force the Biden Administration to implement its financial service policy agenda through existing presidential and regulatory authorities. President-elect Biden is expected to revoke many of the Trump Administration's executive orders and issue a series of new orders that set policy for his Administration. Although the president does not have substantial authority to change financial regulatory policy through executive orders, the issuance of executive orders will signal the direction of policy under a Biden Administration.

The groundwork for reform by financial regulators that could impact structured finance has already begun. Federal Reserve Vice Chair for Supervision and current Chair of the Financial Stability Board Randy Quarles and SEC Chair Jay Clayton have signaled that reforms are likely needed to address regulatory weaknesses in the non-bank sector that have surfaced in the wake of the COVID-19 economic shock. They have focused on the need to re-examine the regulation of securities dealers, in particular primary dealers, and non-bank mortgage lenders and servicers due to the continued movement of the mortgage credit market away from banks. This push for reform is likely to extend beyond the Trump Administration and set the stage for the Biden Administration to pursue new regulation that could have a substantial impact on structured finance.

One option for reforming non-bank finance would be for the Financial Stability Oversight Council ("FSOC") to designate large non-bank companies for enhanced prudential supervision by the Federal Reserve and/or to determine that lending or other activities by non-bank companies should be subject to additional regulation or a new statutory regime.

Biden appointees to financial regulatory agencies are likely to consider implementing a wide range of other rules that would impact structured finance, including:

- Reforms to the Volcker Rule to limit bank exposures to structured finance risks, either through supervision or modifications to the recently finalized rules (Fed Governor Brainard voted against the recently finalized Volcker changes, signaling that she may want to revisit the rules at a later date);
- New capital and liquidity requirements for non-bank mortgage companies;
- Reforms of the Treasury market, including potentially creating a central clearinghouse for Treasury securities;
- Relief with respect to Federal Direct Student Loans and FFELP student loans, including forbearance and forgiveness with respect

to loans owned or guaranteed by the Department of Education;

- Reversal of the True Lender/Valid-When-Made regulations issued by the Comptroller of the Currency and the FDIC;
- Stronger oversight of consumer lending (including credit cards);
- Credit score and credit bureau reforms;
- Environmental, social and governance ("ESG") requirements for public companies and government contractors; and
- Capital charges or other supervisory restrictions on banks financing carbon-energy-intensive businesses or carbon-energy-producing businesses.

Enforcement

The Biden Administration will also likely use enforcement to advance its policy agenda due to both the difficulty of passing legislation and the discretion afforded to craft remedies. The Department of Justice and financial regulators (including in coordination with state regulators and attorneys general) will likely focus enforcement actions on the following areas of relevance to structured finance markets:

- Fair lending;
- Student loan and mortgage servicing violations;
- Unfair, deceptive, or abusive consumer lending (especially auto loans, non-bank lending, student loans, and credit cards);
- Debt collection practices;
- Consumer and investor protections, with larger penalties and less credit for self-reporting and cooperating with regulators upon the discovery of a violation; and
- Stricter application of antitrust laws, especially with respect to larger financial institutions.

For more information, please do not hesitate to contact us or any of the other listed Mayer Brown contacts. Mayer Brown continues to monitor developments relevant to structured finance as the Biden transition team identifies senior personnel, and as the incoming Biden Administration and Congress signal their policy priorities for the coming weeks and next year.

SEC Report Underscores the Interconnectedness of the US Residential Mortgage Credit Markets

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When John Donne wrote the famous book, *No Man is an Island*, he most certainly wasn't thinking about residential mortgage credit. But the idea of interconnectedness has universal applicability and lies at the heart of the SEC's newly released report titled "U.S. Credit Markets Interconnectedness and the Effects of the Covid-19 Economic Shock." This report, issued on October 14, 2020, describes in detail the stresses experienced by the credit markets immediately following the shutdown of the US economy in early March 2020 in response to COVID-19. The report is thorough and data driven. It identifies a cohort of approximately $54 trillion of credit issued and outstanding in the US financial system at the end of 2019 and traces the flow of that credit through various intermediaries during the period of time studied by the report. The data in the report supports a widely-held view that credit markets are interdependent, directly linked through a myriad of complex, interconnected transactions.

The report studies several different markets to illustrate their level of interconnectedness, namely, (i) short-term funding markets, (ii) corporate bond markets, (iii) leveraged loans and CLO markets, (iv) municipal securities markets, (v) residential mortgage markets and other consumer lending markets and (vi) the commercial mortgage markets. With respect to each of these markets, the report examines COVID-19-induced stresses of different types, which fall into three categories.

- *Short-term funding stresses:* These are stresses caused by a sudden and immediate demand for liquidity in the short-term funding markets.
- *Markets structure/liquidity-driven stresses:* These are stresses caused by an elevated demand for financial intermediation in the context of constrained capital and risk limits. Liquidity constraints were a limiting factor in the volume of trades that regulated intermediaries (specifically broker-dealers) could undertake when trading volumes spiked during the initial COVID-19 shutdown hindering their ability to be a countercyclical force in the market.
- *Long-term credit stresses:* These are longer-term stresses from COVID-19, which may still be unfolding. Examples are building stress in the commercial real estate and leveraged loan markets. The health of financial intermediaries, which have significant holdings of these assets, will be highly correlated to the ultimate performance of these assets.

For this alert, we have chosen to focus on the aspects of the report that discuss the residential mortgage credit markets.

A. Changes in the Mortgage Credit Markets

As many of us who observe the residential mortgage credit markets know, the early days of the March 2020 COVID-19 lockdown produced tremendous challenges for non-bank entities that owned residential mortgage credit in the form of securities and loans and that depended on short-term funding to finance their assets. Mortgage REITs were impacted heavily by these market conditions, but so were non-bank mortgage originators and private credit funds, which originate and invest in residential mortgage credit.

The SEC report highlights the evolution of the non-bank mortgage intermediaries as a key reason for the COVID-19-related stress in the mortgage credit markets. Currently, 70% of mortgage loans are originated by non-bank mortgage originators. While banks have access to liquidity from deposits to fund their mortgage origination activities, non-bank mortgage originators do not have that source of liquidity and, therefore, must depend on the short-term repo markets for funding. Similarly, mortgage credit assets are increasingly held by mortgage REITs, which grew significantly after the 2008 subprime credit crisis from $168 billion in assets in 2009 to almost $700 billion in assets in 2019. The concentration of mortgage credit assets in the hands of mortgage REITs and other entities that depend on short-term repo funding to fund long-term assets exacerbated the impact of the COVID-19 shocks in the mortgage credit markets. The SEC report also points out that changes in the value of highly leveraged credit-linked securities, or "CRT," which are owned by many mortgage REITs, were directly correlated to the negative performance of the mortgage credit markets, potentially increasing the severity of the stress experienced by the mortgage credit markets in March 2020.

B. COVID-19 as a Triggering Event

In the early days of the COVID-19 crisis, the lack of certainty about future economic conditions and the scattered consumer payment relief policy initiatives among federal, state and local regulators that were often in conflict with one another drove severe and sharp declines in the value of mortgage credit assets. In an effort to deliver assistance to US consumers who were increasingly losing their jobs and being furloughed as employers scaled back or shut down operations, the federal government and state governments announced legally mandated forbearance periods for the enforcement of residential mortgage loans. These legislative initiatives and executive orders were intended to bring quick and immediate relief to affected borrowers, providing very few hurdles for borrowers seeking relief to qualify for the various forbearance programs. As a result, anticipated and actual mortgage delinquencies increased quickly, causing the mark-down of mortgage credit assets. At about the same time, the Federal Reserve restarted a quantitative easing program to deliver stimulus to the economy and increase liquidity to the credit markets during a time of sudden need. Many of the bond purchasing programs created in the 2008 subprime credit crisis were reactivated, increasing demand for credit securities and, therefore, rapidly raising prices for those securities, including

mortgage-backed securities issued or guaranteed by the Government Sponsored Enterprises ("GSEs") Fannie Mae and Freddie Mac, as well as by Ginnie Mae (collectively, "Agency MBS").

Along with mortgage REITs, the non-bank residential mortgage loan originators immediately felt the impact of these two events. Mortgage loans made and held in inventory by non-bank mortgage originators pending securitization or delivery to GSEs were marked down by the lenders that financed those loans on short-term repo facilities, triggering margin calls. When the Federal Reserve bond buying programs were resurrected causing prices of Agency MBS to rise rapidly, hedging arrangements used by these non-bank mortgage originators to hedge their pipeline of mortgage loans immediately dropped in value. This produced a separate set of margin calls that, when combined with the margin calls on the short-term warehouse facilities for mortgage loans, produced a sudden liquidity crisis for the non-bank mortgage originators.

Requests for relief, although reasonable, were difficult for repo lenders and hedge counterparties to grant, because they, too, were experiencing similar margin calls or write-downs of mortgage credit positions on their books, illustrating the interconnectedness of the mortgage credit markets. Although broker-dealers, for example, were sympathetic to non-bank mortgage originators' requests for more time to meet margin calls on hedging arrangements, they were unable to grant the requested extensions because of corresponding and interconnected transactions they had entered into. Similarly, mortgage REITs, facing margin calls, tried to convince their repo lenders to forego or reduce margin calls until the mortgage credit markets were able to reach more certainty on the true impact of the COVID-19-related forbearance initiatives. For margin calls made and enforced, the credit impact of the write-downs created a negative feedback loop; as holders of mortgage credit sold securities and loans into an illiquid market to meet margin calls, they drove prices lower, increasing the margin calls. The SEC report acknowledges this phenomenon and attributes additional stress to the lack of buyers in the Agency MBS market. Agency MBS buyers and market-makers are predominantly broker-dealers. However, the SEC report suggests that liquidity requirements, among other constraints, limited their trading capacity and their capacity to build inventories, which significantly undermined their ability to serve as market-makers at a time when large quantities of mortgage credit assets were being sold into the market. This is why the Federal Reserve's bond buying program was so important, even though it caused short-term stress on the non-bank mortgage originators that hedged their pipelines of mortgage loans.

Interestingly, the SEC report only gives passing mention to non-bank residential mortgage servicers, which have a unique role in the mortgage markets. Not only are they tasked with the responsibility of processing mortgage payments and working out COVID-19-related forbearance plans with borrowers, they are also mortgage credit holders to the extent that they own mortgage servicing rights and fund mortgage servicing advances. This is an interesting dynamic not replicated in other service industries. Mortgage servicers must not only be excellent operators, but they must also be astute financial managers. Mortgage servicing rights represent the right to a fixed payment on each mortgage loan in a pool of serviced mortgage loans. This right to payment

is in excess of the cost of servicing and, therefore, has value and trades in the market. Because mortgage servicers don't receive payment of this amount on delinquent loans but are still required to service them, the value of mortgage servicing rights can drop severely in anticipation of a long period of elevated mortgage delinquency. An expectation of elevated delinquencies that reduces the value of mortgage servicing rights can produce liquidity strains for servicers, many of which depend on short-term funding arrangements to finance their ownership of mortgage servicing rights.

Similarly, mortgage servicers are responsible for making advances of principal, interest, taxes, insurance and other payments on delinquent mortgage loans in order to keep MBS payments current and to protect the related mortgaged properties from losses and claims. These advancing obligations generally are first supported by prepayments on other mortgage loans in the pool of serviced mortgage loans for principal and interest advances, but, to the extent that prepayments are insufficient to fund the monthly payments on delinquent mortgage loans, the mortgage servicer must come out-of-pocket or turn to third-party financing sources to fund advances. Funding advances on Agency MBS with third-party lenders is especially complicated, requiring the cooperation of the GSEs.

C. Conclusions of the SEC Report and Possible Solutions

The SEC report does not propose solutions to these past, present and emerging problems. It was not written to do so. It was intended to demonstrate the interconnectivity of the financial markets and, as a result, the exponential impact that a shock like COVID-19 can have throughout the system. The credit markets are analogous to a collection of interconnected circuits that may individually function but can produce an overall system failure if one or more of the circuits in the system malfunction. This result is magnified from the 2008 subprime credit crisis because of changes in the size, structure and function of the US credit markets, which now depend more heavily on non-bank owners of credit and financial intermediaries. This is particularly true for the mortgage credit markets. The SEC report notes that, as of August 20, 2020, 7.4% of residential mortgage loans were in forbearance (although this percentage has been dropping recently) and concludes that, if mortgage delinquencies increase from that level going forward (which could happen as government support programs for small business, in particular, expire), it would escalate the financial stress for non-bank mortgage originators, owners of mortgage credit assets and non-bank mortgage servicers, and that stress would flow through the financial system given its interconnectivity.

The SEC report is rightly complementary of the bond buying programs restarted by the Federal Reserve to mute the impact of the stress in the credit markets, particularly the short-term funding markets. The report identifies securitization as a strength of the mortgage credit markets because it eliminates the mark-to-market and extension risk of short-term repo funding. This is an accurate observation, but it only holds true to the extent that those mortgage-backed securities ("MBS") are not themselves funded with short-term repo financing, which is how most non-bank holders of MBS, such as mortgage REITs and credit funds, finance their holdings of MBS.

Bond buying programs and other similar measures that add liquidity to the interconnected credit markets when it is most needed are an effective way to address temporary market dislocations of the type experienced shortly after the COVID-19 shutdown. Situational problems require situational solutions, such as the bond buying programs, that can be easily calibrated to the duration and severity of the problem. Unimaginative and inflexible solutions, like imposing leverage limits on mortgage REITs, for example, are attractive in theory but not ideal. They are blunt tools that may prevent future liquidity challenges, but, at the same time, they may unintentionally stunt the growth of the mortgage credit markets at a time when banks have exited the markets and non-bank capacity is needed to support consumer demand.

We think, however, the role the non-bank mortgage servicers play in the mortgage credit market was underplayed by this report. These are the entities tasked with the frontline work of collecting payments and working out forbearance plans with affected consumers, but, at the same time, they do not get paid for this work, because servicing fees are not paid on delinquent, non-remitting mortgage loans. Non-bank mortgage servicers now make up more than half of the mortgage servicing market, which is a significant change from the 2008 subprime mortgage crisis. Non-bank mortgage servicers use the mortgage credit markets to fund the financial obligations that go along with mortgage servicing, namely, owning mortgage servicing rights and making advances for delinquent loans. Creating and developing coordinated government crisis support programs to help non-bank mortgage servicers fund mortgage servicing rights and advances is necessary for the stable and proper functioning of the residential mortgage credit markets going forward, particularly following an economic shock similar to COVID-19. Expecting the banks to jump back in to pick up the slack, absent significant regulatory reforms, doesn't account for their regulatory capital impediments to holding mortgage servicing rights and their general hesitation to own them again as a result of the losses and reputation or harm they suffered from the asset during the 2008 subprime credit crisis.

We applaud the SEC's effort to put the data out in a comprehensive report and expect that this first step will lead to further action toward mitigating the effects of a future economic shock similar to COVID-19. The report intentionally leaves its readers with the open question of how contingency plans should be made for future events given the changing nature of the credit markets and the increasing participation by non-bank intermediaries. Over the coming weeks and months, we expect that market observers, regulators, including the Financial Stability Oversight Council, and participants will attempt to answer these and other questions posed by the report. ■

Eye On IBOR Transition

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With December 31, 2021, in plain sight, preparation for the transition from the London Interbank Offered Rate ("LIBOR") and similar interbank offered rates ("IBORs") to replacement benchmark interest rates is accelerating rapidly. In this article, we explore a number of recent core developments affecting structured finance products.

ISDA IBOR Fallbacks Protocol and Supplement

The International Swaps and Derivatives Association ("ISDA") launched the long-awaited IBOR Fallbacks Protocol and related IBOR Fallbacks Supplement on October 23, 2020.[1]

The IBOR Fallbacks Protocol[2] allows market participants that choose to adhere to it to incorporate fallback language into existing non-cleared derivatives with no further action. Derivatives contracts involving a counterparty that has not adhered to the Protocol will require a bilateral amendment to address IBOR cessation. The fallbacks in the Protocol apply upon a permanent cessation of an applicable IBOR. In addition, for LIBOR only, the fallback will become operative upon the occurrence of a pre-cessation trigger; that is, upon a determination by the UK Financial Conduct Authority ("FCA") that a particular LIBOR no longer is representative of its underlying market. ISDA reports that during the two-week period prior to official launch of the Protocol, 257 market participants elected to adhere to it.

Supplement No. 70 to the 2006 ISDA Definitions,[3] which also takes effect on January 25, 2021, amends ISDA's standard definitions to incorporate appropriate fallbacks for GBP (United Kingdom), CHF (Switzerland), USD (United States), EUR (Europe) and JPY (Japan) LIBOR, as well as EURIBOR (Europe), TIBOR (Japan), BBSW (Australia), CDOR (Canada), HIBOR (Hong Kong), SOR (Singapore) and THBFIX (Thailand). These fallback rates are deemed robust and follow the recommendations of applicable governmental working groups. They will apply to new cleared and non-cleared interest rate derivatives that reference the 2006 Definitions from the effective date. The Supplement also addresses the treatment of discontinued rate maturities.

ARRC Recommendations and Resources

The US Alternative Reference Rates Committee (the "ARRC"), convened by the Federal Reserve Board and New York Federal Reserve Bank, has

been very active in producing tools, across numerous product categories, to ease the transition from LIBOR to its recommended replacement: the Secured Overnight Financing Rate ("SOFR").

FALLBACK LANGUAGE AND SPREAD ADJUSTMENT

After conducting product-specific consultations, and refreshing its loan recommendations based on market evolution, the ARRC has produced final recommendations for key product categories that incorporate a "hardwired" approach to LIBOR fallback rate language. While the rate waterfall within the hardwired approach varies somewhat by product,[4] the essence of falling back to Term SOFR is constant.

Separately, the ARRC published its recommendation for a spread adjustment to recognize the difference between LIBOR and SOFR resulting from the fact that SOFR is a secured rate while LIBOR is not. In response to global market preference to align product fallbacks with potentially linked derivative product fallbacks, the ARRC's recommendation mirrors that of ISDA: a spread adjustment methodology based on a historical median over a five-year lookback period calculating the difference between USD LIBOR and SOFR.

It should be noted that many financial institutions still are considering whether SOFR is the appropriate fallback rate for them based on their funding models and loan activity structures, and specifically whether a more credit-sensitive rate might be more suitable. For the structured finance market, there would be obvious implications for securitization and hedged transactions that are SOFR-based. In a statement[5] released on November 6, 2020, US prudential banking regulators reiterated that banks should choose a robust replacement rate that is appropriate for their needs and include fallback language in their loan agreements providing for the use of such chosen rate if LIBOR were to be discontinued.

BEST PRACTICES

To assist market participants in preparing for LIBOR cessation, the ARRC released a set of recommended best practices in May 2020, which it updated in September.[6] Included in these best practices are timelines and intermediate steps that market participants should consider to accelerate their transition to a replacement benchmark interest rate. Key recommendations include:

- New USD LIBOR cash products should include ARRC-recommended (or substantially similar) fallback language as soon as possible;
- Institutions should implement clear and rigorous internal programs to assess and address their LIBOR exposure across all relevant activities;
- Third-party technology and operations vendors relevant to the transition should complete all necessary enhancements to support SOFR by the end of 2020;
- For contracts specifying that a party will select a replacement rate at their discretion following a LIBOR transition event, the determining party should disclose their planned selection to relevant parties at least six months prior to the date that a replacement rate would become effective; and
- New use of USD LIBOR should stop, with timing depending on specific circumstances in each cash product market.

The following table shows the ARRC's recommended target end dates by product:

Product	Hardwired Fallbacks Incorporated By	Tech / Ops Vendor Readiness By	Target For Cessation Of New Use Of Usd Libor	Anticipated Fallback Rates Chosen By
Floating Rate Notes	6/30/2020	6/30/2020	12/31/2020	6 months prior to reset after LIBOR's end
Business Loans	Syndicated: 9/30/2020 Bilateral: 10/31/2020	9/30/2020	6/30/2021	6 months prior to reset after LIBOR's end
Consumer Loans	Mortgages: 6/30/2020 Student Loans: 9/30/2020	Mortgages: 9/30/2020	Mortgages: 9/30/2020*	In accordance with relevant consumer regulations
Securitizations	6/30/2020	12/31/2020	CLOs: 9/30/2021 Other: 6/30/2021	6 months prior to reset after LIBOR's end
Derivatives	Not later than 3-4 months after the Amendments to ISDA 2006 Definitions are published	Dealers to take steps to provide liquid SOFR derivatives markets to clients	6/30/2021	

* The September 30, 2020, date for consumer loans refers to new applications for closed–end residential mortgages using USD LIBOR and maturing after 2021.

As this article is published, on November 30, ICE Benchmark Administration ("IBA") has announced that it will consult in early December on its intention to cease the publication of the one-week and two-month USD LIBOR settings after December 31, 2021, and to cease publishing the remaining USD LIBOR settings after June 30, 2023. The effect of this announcement (which has been well received by global regulators), if any, on the ARRC's Best Practices timeline summarized above has not been determined.

CONVENTIONS

Among the tools published by the ARRC are various recommended conventions for implementing LIBOR transition. The first of these was published in 2019 and related to floating rate notes ("FRNs"),[7] which present a particularly thorny transition issue because, with their widely held market (and like many structured finance products), they are so difficult to amend. These were followed by recommended cross-currency swaps conventions in January 2020,[8] syndicated loan "in arrears" conventions in July 2020,[9] and bilateral loan "in arrears" conventions in November 2020.[10]

The FRN conventions identify considerations for market participants interested in using SOFR in new issuances, including explanations of different SOFR variants, the possible use of a SOFR Index,[11] and the distinction among

lockout, lookback and payment delay interest payment conventions. The November 2019 appendix supplemented the conventions with sample key provision term sheets by interest payment convention, and recommended FRN fallback language.

The swaps conventions analyze potential technical specifications for interdealer trading of cross-currency basis swaps based on IBORs and replacement risk-free rates ("RFRs"), including IBOR-IBOR, RFR-RFR and RFR-IBOR swaps. The ARRC notes that these conventions may not be suitable for dealer-to-customer or customer-to-customer transactions.

The most recent ARRC conventions support bilateral loans, are substantially similar to the syndicated loan conventions, and focus on the ARRC's recommended "in arrears" structures: daily simple SOFR and daily compounded SOFR. The conventions address both new and legacy loans, and analyze structural issues, including simple versus compounded SOFR, interest payment conventions, day counts, rounding, interest rate floors, break funding and use of the SOFR Index. The bilateral loan conventions also note that market participants choosing to adopt the Hedged Loan Approach to the ARRC's recommended bilateral loan fallback language (which falls back to ISDA's successor rate and spread adjustment) should follow ISDA's related conventions. Both the bilateral loan conventions and the syndicated loan conventions rely on the ARRC's August 2020 technical reference appendix, which provides additional detailed discussion and spreadsheet calculations of the different lookback methodologies, calculations for daily simple SOFR and daily compounded SOFR for loans and the implementation of daily interest rate floors.

Sterling Working Group Recommendations and Resources

Another active working group on the global stage is the UK Working Group on Sterling Risk-Free Reference Rates ("Sterling Working Group"), which recently finalized its spread adjustment recommendations and has produced a wealth of transition tools for market participants.

SPREAD ADJUSTMENT RECOMMENDATION

Consistent with its global counterparts, in September the Sterling Working Group recommended[12] the use of the historical five-year median spread adjustment methodology when calculating the credit adjustment spread that should be applied to any relevant Sterling Overnight Index Average ("SONIA") rate chosen or recommended to replace GBP LIBOR pursuant to contractual fallback and replacement of screen rate provisions following a permanent cessation or pre-cessation trigger in relation to GBP LIBOR.

CONVENTIONS AND OTHER GUIDANCE

During September and October 2020 alone, the Sterling Working Group has produced over a half-dozen resources, including an updated list of "top level priorities," a paper describing how issuers might transition difficult-to-amend contracts, such as bonds and securitizations, from LIBOR to risk-free rates, and several resources relating to loan market conventions and transition.

In updating its top level priorities,[13] the Sterling Working Group emphasized the need to cease issuing LIBOR-referencing products not later than the end of the first calendar quarter of 2021, and to accelerate efforts to transition derivative

volumes from LIBOR to SONIA. Also updated were the roadmaps included in the priorities, as well as the product-specific target milestones, with active portfolio conversion still targeted to complete by the end of the third calendar quarter of 2021.

The guidance on transitioning difficult-to-amend bond and securitization transaction documents includes a discussion of the consent solicitation process, which already has been used successfully to transition these tough legacy contracts.[14]

Half of the recent resources relate to the loan market and the instruments that underlie many structured finance products. In publishing these resources, the Sterling Working Group has stated that it hoped to facilitate "the maximum possible degree of consistency across currencies, products and market,"[15] and that although some interim transition targets were adjusted to address the COVID-19 pandemic, the importance of transitioning product portfolios before the end of 2021 is unchanged.[16] The suite of resources includes detailed loans conventions[17] (intended to support the use of SONIA in loan markets for sterling bilateral and syndicated facilities, including multicurrency syndicated facilities where there is a sterling currency option) and a paper outlining practical steps that market participants can take to amend GBP LIBOR-referencing loans to SONIA.[18] The latter resource in particular emphasizes (i) the need to ensure that operating systems are updated to accommodate alternative reference rates, (ii) the importance of treating customers fairly and mitigating any transfer of value between the parties and (iii) the substantial time that will be required to amend all existing LIBOR-referencing loans.

The two most recent Sterling Working Group tools, released on October 16, 2020, are an overview of the key features of SONIA term rates[19] and a summary of the freely available independent RFR calculators (particularly addressing compounded rates) in the market.[20] The aim of these tools is to inform market participants about, and support, the use of SONIA variants, and to allow market participants to consider whether any amendments might be required to their operating systems or product offerings ahead of transition to such rates.

The UK Prudential Regulation Authority and FCA stated earlier this year[21] that firms should expect stepped up regulatory engagement with respect to LIBOR transition, which will be a "key input to [the Financial Policy Committee's] consideration … whether sufficient progress is being made to avoid seeking recourse to supervisory tools."

Progress in Europe

The transition to a new risk-free rate—the Euro Short-Term Rate, or €STR—has been slower in Europe than in the United States and United Kingdom. This may be because its interbank offered rate—EURIBOR—was reformed in 2019 to employ a "hybrid methodology" of rate quotation that relies on a three-level waterfall that prioritizes the use of real transaction data whenever available from a group of quoting banks that is larger than the LIBOR panel. The robustness of EURIBOR is reassessed annually, and currently is deemed to comply with the EU Benchmark Regulation ("BMR"). As a result of the 2019 reformation, the quotation and use of EURIBOR is not expected to cease as of January 1, 2022 (subject, of course, to ongoing robustness and BMR compliance).

Nonetheless, the European Central Bank ("ECB") is moving forward to establish €STR as a robust and appropriate replacement rate and in October 2020 released a summary of the responses[22] to its July 2020 consultation on compounded €STR term

rates.[23] The respondents supported the proposed calculation methodologies for compounded rates and index values, as well as proposed day-count conventions, selection of maturities and rate precision of four decimal places.

Most recently, on November 23, 2020, the ECB released two new consultations: one on EURIBOR Fallback Trigger Events[24] and one on €STR-based EURIBOR Fallback Rates.[25] The consultations seek market feedback with respect to a proposed set of potential permanent EURIBOR fallback trigger events, and to the most appropriate EURIBOR fallback provisions for cash products, including rate structure, spread adjustment, and market calculation conventions. Comments are due by January 15, 2021.

The National Working Group on Swiss Franc Reference Rates (the "Swiss Working Group") also has been making steady progress,[26] emphasizing that conventions for its replacement rate, the Swiss Average Rate Overnight, or SARON, be consistent with the international market. The Swiss Working Group has published recommended fallback language that tracks ISDA's implementation.

Singapore Working Group Recommendations and Resources

The most ample set of transition guidance in Asia has been published in Singapore. On October 27, 2020, the Steering Committee for SOR Transition to SORA ("SC-STS") published[27] a suite of IBOR transition guidance documents to lay the foundation for "a coordinated shift" from SOR to SORA.

Included in these resources were: recommended timelines[28] for discontinuing the issuance of SOR-linked products (following an approach consistent with the United States, United Kingdom and Europe, but not beginning until late in the first quarter of 2021); a report on customer segments and preferences,[29] which was compiled based on surveys of a range of market participants and provides guidance on adopting SORA for various types of loan products; a SORA market compendium[30] (intended to serve as a companion to the customer segments report, and which analyzes key issues by product type and provides fallback language and conventions); and an end-user checklist[31] providing practical steps that should be taken to effectively transition away from SOR.

These resources follow the publication by the Monetary Authority of Singapore, the administrator of SORA, of a SORA methodology document[32] and related User Guide[33] in September. SC-STS has stated that it will be publishing additional resources to assist corporate users and retail customers.

Legislative Solutions for Legacy Contracts

Perhaps the thorniest issue delaying transition from IBORs to applicable replacement benchmark rates is how to address so-called legacy contracts; that is, active contracts due to mature after 2021, that were entered into before fallback rates for a permanent discontinuance of LIBOR were contemplated, that are widely held by holders that are difficult or impossible to identify, and that require unanimous holder consent to amend essential provisions, such as the interest rate. The nature of these contracts has thwarted efforts to effectively transition them to a new benchmark interest rate. In response, governmental authorities in the

United States, UK, and Europe have introduced legislative solutions to effect a mandatory and automatic transition, under specified circumstances, for these contracts.

UNITED STATES

New York Senate Bill S9070,[34] introduced October 28, 2020, proposes to add a new Article 12 to New York's Uniform Commercial Code that substantially adopts the language from the proposed legislative solution[35] produced by the ARRC in March 2020. The ARRC's proposal establishes both mandatory (for contracts that either are silent as to LIBOR cessation or that default to the last quoted LIBOR in such event) and permissive (for contracts granting the parties discretion to choose a fallback rate) applications of the statutory language, sets forth an "opt-out" provision, applies to all product types and provides a safe harbor for "conforming changes" consisting of operational or administrative adjustments to implement the transition. We understand that a similar bill, applicable to all states, including New York, is under consideration at the federal level.

UNITED KINGDOM

On October 21, 2020, the UK government released its promised draft legislation[36] to assist the "tough legacy" issue for certain LIBOR-referencing contracts by providing the FCA with new and enhanced powers to oversee the orderly wind-down of critical benchmarks, such as LIBOR. The legislation includes the authority, subject to specified requirements, for the FCA to direct a change in the methodology of a critical benchmark and extend its publication for a limited time period.

Contemporaneously, HM Treasury issued a policy statement[37] supporting the proposed amendments to the UK Benchmark Regulation, encouraging firms to continue to prioritize active transition away from LIBOR to alternative benchmarks, and providing further detail on the framework for the FCA's enhanced powers.

Additional momentum was gained on November 18, 2020, when IBA announced its intention to cease the publication after December 31, 2021, of all tenors of GBP, EUR, CHF, and JPY LIBOR settings,[38] and again on November 30, when IBA announced its intention to continue to publish the most frequently used tenors of USD LIBOR through June 30, 2023.[39] Each of these proposals is subject to IBA consultations expected in December 2020. In connection with IBA's November 18 announcement, FCA stated[40] that it will consult on policies for implementing its proposed new powers under the Financial Services Bill and released two new consultations: one with respect to the designation of benchmarks[41] and one with respect to the exercise of its proposed new powers.[42] [43]

EUROPE

Earlier this summer, in July, the European Commission proposed an amendment to the EU Benchmark Regulation[44] to enable the amendment of specified financial instruments or contracts by way of a directly applicable regulation, to avoid a significant disruption in the functioning of the EU financial markets. A new Article 23(a) would empower the European Commission to designate a mandatory replacement benchmark and, by operation of law, replace all references to a benchmark that has ceased to be published with the replacement benchmark. This legislative solution would apply to financial instruments, financial contracts and measurements of the performance of an investment fund that are within the scope of the BMR; that is, in EU contracts involving EU

supervised entities.[45] The key components are consistent with the New York legislative approach, with the EU Benchmark Regulation amendment making the use of the statutory replacement mandatory in contracts with no fallback provision, fallbacks that only contemplate temporary benchmark suspension, and fallbacks that reference the last quoted benchmark (and operate to convert floating rate instruments into fixed rate instruments). For contracts that provide parties with a choice of fallback rates, as well as contracts involving non-supervised entities, the EU legislative solution is available as an option if the parties so choose.

Next Steps

Although December 31, 2021, is still more than a year away, multiple global regulators have targeted dates by which new originations of LIBOR-referencing products should cease, and the earliest of those dates are imminent.[46] Transition efforts are accelerating quickly, and wise market participants should be well advanced in assessing their product portfolios and related operating systems, choosing an appropriate replacement rate (by product, if necessary), and commencing a move to hardwired fallbacks and related contract amendments. The complexities of structured finance products and their underlying instruments and possible hedges make this effort all the more critical. ■

Endnotes

[1] ISDA Launches IBOR Fallbacks Supplement and Protocol, October 23, 2020.

[2] ISDA 2020 IBOR Fallbacks Protocol, published on October 23, 2020.

[3] Amendments to the 2006 ISDA Definitions to include new IBOR fallbacks - Supplement number 70 to the 2006 ISDA Definitions, Final on October 23, 2020, and published and effective on January 25, 2021.

[4] For example, the recommended waterfall of replacement benchmark rates for securitization transactions, set forth in the ARRC's May 2019 Recommendations, is (a) Term SOFR, (b) Compounded SOFR, (c) the rate recommended by the Relevant Governmental Body, (d) the ISDA Fallback Rate and, optionally, (e) the rate chosen by a party designated with that responsibility in the transaction documents. The ARRC Recommendations for Floating Rate Notes, issued in April 2019, are slightly different in that they recommend the calculation of an interpolated LIBOR rate before resorting to the waterfall (which is substantially identical to the securitization waterfall). In contrast, the refreshed Syndicated Loan Recommendations and Bilateral Loan Recommendations offer a simpler recommended hardwired waterfall that starts with Term SOFR but then prefers Daily Simple SOFR and ends with a rate selected by the administrative agent and borrower, for syndicated loans, or lender, for bilateral loans (i.e., an amendment approach, which was removed as an alternate first-step approach in the refreshed recommendations).

[5] Statement on Reference Rates for Loans, Federal Reserve Board, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, November 6, 2020.

[6] ARRC Recommended Best Practices for Completing the Transition from LIBOR, Alternative Reference Rates Committee, September 3, 2020, which includes links to numerous additional tools.

[7] SOFR Floating Rate Note Conventions Matrix, Alternative Reference Rates Committee, August 1, 2019, and supplemented by an Appendix to SOFR FRN Conventions Matrix dated November 21, 2019.

[8] Recommendations for Interdealer Cross-Currency Swap Market Conventions, Alterative Reference Rates Committee, January 24, 2020.

[9] SOFR "In Arrears" Conventions for Syndicated Business Loans, Alternative Reference Rates Committee, July 22, 2020, and supplemented by a Technical Reference Appendix to Syndicated Loan Conventions dated August 27, 2020.

[10] SOFR "In Arrears" Conventions for Use in Bilateral Business Loans, Alternative Reference Rates Committee, November 25, 2020

[11] Further analyzed in the ARRC's Statement on the Use of the SOFR Index in FRNs, May 6, 2020, including transaction structuring considerations and sample key terms for a floating rate note referencing the SOFR Index.

[12] Statement on behalf of the Working Group on Sterling Risk-Free Reference Rates – Recommendation of Credit Adjustment Spread Methodology for fallbacks in cash market products referencing GBP LIBOR, Working Group on Sterling Risk-Free Reference Rates, September 10, 2020.

[13] UK Working Group 2020-21 Top Level Priorities, Working Group on Sterling Risk-Free Reference Rates, updated September 28, 2020.

[14] Active Transition of GBP LIBOR-Referencing Bonds, Working Group on Sterling Risk-Free Reference Rates, September 10, 2020.

[15] Statement on behalf of the Working Group on Sterling Risk-Free Reference Rates – Recommendations for SONIA Loan Market Conventions, Working Group on Sterling Risk-Free Reference Rates, September 1, 2020.

[16] Securing a SONIA-based sterling loan market, Working Group on Sterling Risk-Free Reference Rates, September 10, 2020.

[17] Detailed Loans Conventions, Working Group on Sterling Risk-Free Reference Rates, September 1, 2020. These conventions include a recommendation to employ compounded SONIA in arrears using a five banking days' lookback without observation shift.

[18] Active Transition of GBP LIBOR-Referencing Loans, Working Group on Sterling Risk-Free Reference Rates, September 10, 2020.

[19] Term SONIA Reference Rate Publication Summary, Working Group on Sterling Risk-Free Reference Rates, October 16, 2020.

[20] Freely Available Independent RFR Calculator Summary, Working Group on Sterling Risk-Free Reference Rates, October 16, 2020.

[21] Letter to Senior Managers re Next Steps on LIBOR Transition, Prudential Regulation Authority and Financial Conduct Authority, January 16, 2020.

[22] Summary of responses to the ECB's public consultation on the publication of compounded term rates using the €STR, European Central Bank, October 7, 2020.

[23] Public consultation on the publication by the ECB of compounded term rates using the €STR, European Central Bank, July 24, 2020.

[24] Public consultation on EURIBOR fallback trigger events, European Central Bank, November 23, 2020.

[25] Public consultation on €STR-based EURIBOR Fallback Rates, European Central Bank, November 23, 2020.

[26] Executive summary of the 29 September 2020 meeting of the National Working Group on Swiss Franc Reference Rates, October 22, 2020.

[27] Industry Steering Committee Announces Timelines to Cease Issuance of SOR-Linked Financial Products, and Publishes Market Guidance to Support Transition to SORA, SC-STS, October 27, 2020.

[28] Timelines to Cease Issuance of SGD Swap Offer Rate (SOR) Linked Financial Products, SC-STS, October 27, 2020.

[29] Overview on the Usage of SORA in Loans - Customer Segments and Preferences, SC-STS, October 27, 2020.

[30] SORA Market Compendium: Transition from SOR to SORA, SC-STS, October 27, 2020.

[31] SC-STS End-User Checklist on Benchmark Transition, October 27, 2020.

[32] Singapore Overnight Rate Average - Key Features and Calculation Methodology, Monetary Authority of Singapore, September 1, 2020.

[33] Compounded Singapore Overnight Rate Average Index, Compounded SORA and MAS Floating Rate Notes: A User Guide, Monetary Authority of Singapore, September 1, 2020.

[34] Senate Bill S9070 (2019-20 Legislative Session) – An act to amend the uniform commercial code, in relation to the effect of a LIBOR discontinuance event on contracts, securities and other agreements, New York State Senate, October 28, 2020.

[35] Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition, Alternative Reference Rates Committee, March 6, 2020.

[36] Financial Services Bill 200, House of Commons, October 21, 2020. Benchmarks are addressed in sections 8-21 and Schedule 5.

[37] Amendments to the Benchmarks Regulation to support LIBOR transition - Policy Statement, Her Majesty's Treasury, October 21, 2020.

[38] ICE Benchmark Administration to Consult On Its Intention to Cease the Publication of GBP, EUR, CHF and JPY LIBOR, Intercontinental Exchange, November 18, 2020.

[39] ICE Benchmark Administration to Consult on Its Intention to Cease the Publication of One Week and Two Month USD LIBOR Settings at End-December 2021, and the Remaining USD LIBOR Settings at End-June 2023, Intercontinental Exchange, November 30, 2020.

[40] FCA consults on new benchmarks powers, Financial Conduct Authority, November 18, 2020.

[41] Consultation on proposed policy with respect to the designation of benchmarks under new Article 23A, Financial Conduct Authority, November 18, 2020.

[42] Consultation on proposed policy with respect to the exercise of the FCA's powers under new Article 23D, Financial Conduct Authority, November 18, 2020.

[43] In response to the announcements of IBA and FCA, ISDA issued a statement clarifying that "neither of these statements constitute an index cessation event under the IBOR Fallbacks Supplement or the ISDA 2020 IBOR Fallbacks Protocol," nor do they trigger fallbacks under the 2018 ISDA Benchmarks Supplement or its related protocol. ISDA Statement on IBA and UK FCA Announcements on LIBOR Consultations, November 18, 2020.

[44] Proposal to amend EU Benchmark Regulation as regards the exemption of certain third country foreign exchange benchmarks and the designation of replacement benchmarks for certain benchmarks in cessation, European Commission, July 24, 2020.

[45] Defined in Regulation (EU) No 468/2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation), European Central Bank, April 16, 2014.

[46] The ARRC recommends a date of December 31, 2020, for USD LIBOR-linked floating rate notes and June 30, 2021, for most other products, including securitizations. The Sterling Working Group has targeted March 31, 2021, for the cessation of GBP LIBOR-linked loan products.

Federal Housing Agencies and GSEs Provide Relief Measures for Residential Mortgage Loan Borrowers Negatively Impacted by COVID-19

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Over the past eight months, the US federal housing agencies and government-sponsored enterprises (GSEs) that insure, guarantee or purchase "federally backed mortgage loans" covered by Section 4022 of the CARES Act (Act) have issued a significant number of guidelines, and updates to those guidelines, intended to implement the Act's provisions applicable to such loans. These actions aim to provide assistance to residential mortgage loan borrowers facing financial hardship in connection with the COVID-19 pandemic during and after the forbearance period set forth in the Act.

Section 4022 of the Act includes a moratorium on foreclosures and foreclosure-related evictions for "not less than the 60-day period beginning on March 18, 2020," on all "federally backed mortgage loans," which term includes loans insured by the US Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA), guaranteed by the US Department of Veterans Affairs (VA), made or guaranteed by the US Department of Agriculture's (USDA) Rural Housing Service (RHS), or purchased or securitized by Fannie Mae or Freddie Mac. Section 4022 also provides borrowers with "federally backed mortgage loans" who have experienced a financial hardship related to the COVID-19 pandemic up to 180 days of forbearance, which can be extended for an additional 180-day period at the request of the borrower. The GSEs and federal housing agencies promptly implemented these provisions into their single-family residential mortgage loan programs and have continued to routinely update guidance related to CARES Act requirements.

This Legal Update summarizes some of the significant guidance issued by the federal housing agencies and GSEs related to the Act's broad provisions covering federally backed mortgage loans, as well as guidance for servicers on how to manage such loans after expiration of the forbearance period provided for in the Act. Specifically, we provide details regarding: (1) updates to the federal housing agencies' and GSEs' foreclosure and eviction moratoria, (2) updates to the GSEs' and federal housing agencies' COVID-19 loss mitigation guidelines for borrowers exiting a CARES Act forbearance, and (3) guidance from the GSEs, VA and FHA regarding the eligibility of borrowers in forbearance for refinancing and new home purchases.

Extension of FHFA and Federal Housing Agency Foreclosure and Eviction Moratoria

While the CARES Act's foreclosure and eviction moratorium could have ended at any point after May 18, 2020, the GSEs and federal housing agencies have extended the foreclosure and eviction moratoria for "federally backed mortgage loans" multiple times since the Act was passed. Most recently, on August 27, 2020, an announcement from the Federal Housing Finance Agency (FHFA) and HUD's Mortgagee Letter 2020-27 extended the GSEs' and FHA's existing foreclosure and eviction moratoria for single-family mortgage loans through December 31, 2020. As with past extensions, these extensions do not apply to vacant or abandoned properties; FHA's extension continues to extend both the first legal action and reasonable diligence timelines applicable to foreclosure by 90 days from the expiration date of the moratorium. The RHS followed suit on August 28, 2020, suspending all foreclosures and related evictions, except for vacant and abandoned dwellings, for borrowers with USDA Single Family Housing Direct and Guaranteed loans through December 31, 2020. On September 9, 2020, the VA also issued an update extending its moratorium on foreclosures and evictions for VA-guaranteed loans through December 31, 2020. As we approach the end of 2020, it remains to be seen whether the GSEs and federal housing agencies will again extend these foreclosure and eviction moratoria in light of the ongoing COVID-19 pandemic.

Post-Forbearance COVID-19 Loss Mitigation Options

Determining how to establish loss mitigation options available to borrowers at the end of the CARES Act forbearance period, which could last up to 360 days, is one of the key unanswered questions raised under Section 4022 of the Act. In response, the GSEs and federal housing agencies have introduced specific loss mitigation options and waterfall requirements for borrowers impacted by COVID-19 and receiving mortgage payment forbearance. Within each loan program's parameters, the guidance demonstrates the GSEs and federal agencies' attempts to provide loss mitigation options tailored to the unique circumstances created by the COVID-19 pandemic. In addition to the guidance referenced below, the GSEs and federal housing agencies have issued Frequently Asked Questions (FAQ) documents and continue to update these FAQs with additional information on evaluating borrowers for, and the implementation of, relief options related to the COVID-19 pandemic.

GSE COVID-19 LOSS MITIGATION OPTIONS

One such loss mitigation tool to help servicers in assisting borrowers negatively impacted by the COVID-19 pandemic is the COVID-19 Payment Deferral announced by Fannie Mae and Freddie Mac in May of 2020 in Lender Letter LL-2020-07 and Bulletin 2020-15. The COVID-19 Payment Deferral is a retention workout option designed to assist borrowers who missed up to 12 months of forborne payments due to COVID-19 hardships that have been resolved and return their mortgage to a current status. To accomplish this workout option, the servicer

defers the following amounts as a non-interest bearing balance on the loan: (1) up to 12 months of past-due principal and interest payments, (2) out-of-pocket escrow advances paid to third parties and (3) servicing advances paid to third parties in the ordinary course of business and not retained by the servicer. The deferral balance is due and payable at maturity of the mortgage loan or earlier upon the sale or transfer of the property, refinance of the mortgage loan or payoff of the interest-bearing unpaid principal balance. All other terms of the mortgage loan must remain unchanged.

Since July 1, 2020, the GSEs have required servicers to evaluate a borrower's eligibility for a COVID-19 Payment Deferral by achieving Quality Right Party Contact (QRPC) (for Fannie Mae loans) or Limited QRPC as specified in Bulletin 2020-10 (for Freddie Mac loans).[1] After discussing reinstatement and repayment plan options with the borrower, the servicer must evaluate the borrower for the COVID-19 Payment Deferral by confirming that the borrower (1) has resolved the COVID-19 hardship, (2) is able to continue making the existing contractual mortgage payment and (3) is unable to afford a repayment plan or full reinstatement of the mortgage. Any late charges must be waived by the servicer upon completion of a COVID-19 Payment Deferral. Fannie Mae additionally provides that all penalties, stop payment fees or similar charges must be waived by the servicer. Servicers also have an obligation to confirm that borrowers meet certain additional requirements, such as verifying the borrower has not previously received a COVID-19 Payment Deferral, which are set forth in Fannie Mae's Lender Letter 2020-07 and Freddie Mac's Bulletins 2020-15, 2020-21 and 2020-28.

A servicer implementing the COVID-19 Payment Deferral option has an obligation to comply with GSE requirements relating to borrower eligibility, evaluation and solicitation practices, as well as documentation, timing and other aspects of program administration, all of which are detailed in Fannie Mae's Lender Letter 2020-07, as updated, and Freddie Mac Bulletins 2020-15 and 2020-21. Importantly, the servicer is required to evaluate the borrower according to the following hierarchy: COVID-19 Payment Deferral, Flex Modification[2] and then standard short sale or standard deed-in-lieu of foreclosure, as appropriate.

OVERVIEW OF FHA LOSS MITIGATION OPTIONS

Pursuant to Mortgagee Letters 2020-06 and 2020-22, HUD implemented a COVID-19-specific loss mitigation waterfall requiring servicers to evaluate FHA borrowers who have received a CARES Act forbearance at the end of the forbearance period, which includes requirements for servicers to evaluate FHA borrowers for COVID-19 Home Retention and Home Disposition Options according to the following hierarchy: COVID-19 Standalone Partial Claim, COVID-19 Owner-Occupant Loan Modification, COVID-19 Combination Partial Claim and Loan Modification, COVID-19 FHA-HAMP Combination Loan Modification and Partial Claim with Reduced Documentation, COVID-19 Pre-Foreclosure Sale (PFS), and COVID-19 Deed-in-Lieu of Foreclosure (DIL). A COVID-19 loan modification option is also available for non-occupant borrowers. Below is a brief description of each option:

- **COVID-19 Standalone Partial Claim.** This option is available to borrowers who indicate that they have the ability to resume making

on-time mortgage payments. The claim amount includes only arrearages, consisting of principal, interest, taxes and insurance (PITI), and may not exceed the 30-percent maximum statutory value of all partial claims for a FHA-insured mortgage.[3]

- **COVID-19 Owner-Occupant Loan Modification.** This option is available to borrowers who indicate they have the ability to make a modified mortgage payment.
- **COVID-19 Combination Partial Claim and Loan Modification.** This option is available to borrowers who have not exceed the 30-percent statutory maximum value of all partial claims for an FHA-insured mortgage and who indicate they have the ability to make a modified payment. The servicer is required to apply any remaining available partial claim amount toward the arrearage first and then capitalize the remaining arrearage into the modified mortgage.
- **COVID-19 FHA-HAMP Combination Loan Modification and Partial Claim with Reduced Documentation.** This option is available to borrowers who have not exceeded the 30-percent statutory maximum value of all partial claims for an FHA-insured mortgage and are ineligible for the other COVID-19 loss mitigation options because the borrowers are unable to resume existing or modified payments. The servicer must review the borrower for an affordable monthly payment using HUD's FHA-HAMP guidelines.[4]
- **COVID-19 Non-Occupant Loan Modification.** The servicer must evaluate a non-occupant borrower for this option, and a borrower is eligible if the mortgage was current or less than 30 days past due as of March 1, 2020, and the borrower indicates he or she has the ability to make the modified payments.
- **COVID-19 PFS.** Servicers are required to follow the FHA Streamlined PFS requirements,[5] with the following additional requirements, among others: the mortgage must have been current or less than 30 days past due as of March 1, 2020; the borrower must indicate a financial hardship affecting his or her ability to sustain the mortgage due, directly or indirectly, to the COVID-19 pandemic; the borrower does not qualify for the COVID-19 Home Retention Options; and the borrower and the mortgage must meet all PFS eligibility requirements.
- **COVID-19 DIL.** This option is available for borrowers experiencing a hardship affecting their ability to sustain the mortgage due to the COVID-19 pandemic and who are unable to complete a COVID-19 PFS transaction at the expiration of the PFS marketing period. To evaluate a borrower for this option, the servicer must follow the Streamlined DIL requirements.[6]

For all options involving a modification, the option must fully reinstate the mortgage at a fixed interest rate no greater than the Market Rate (as defined by HUD) for a period of 360 months or less. Under all of the COVID-19 loss mitigation options, the servicer must waive accumulated late charges, fees and penalties. A servicer implementing the options must comply with FHA requirements relating to borrower eligibility, evaluation and solicitation practices, as well as documentation, timing and other aspects of program administration, all of which are detailed in ML 2020-22 and ML 2020-06.

RHS FORBEARANCE OPTION

With regard to RHS-guaranteed loans, according to stakeholder announcements, at the end of the forbearance period, if a borrower is able to resume making regular contractual payments, the servicer has an obligation to offer the borrower a written re-payment plan to resolve any amount due or, at the borrower's request, extend the loan term for a period that is at least the length of the forbearance. If the servicer determines that the borrower is unable to resume making contractual payments, the servicer is required to evaluate the borrower for all available loss mitigation options as outlined in the RHS Technical Handbook.

VA FORBEARANCE AND DEFERRAL OPTIONS

Finally, with regard to VA-guaranteed loans, no later than 30 days before the forbearance period ends, servicers are required to consider all loss mitigation options described in Chapter 5 of the VA Servicer Handbook M26-4 in determining how to account for payments that were subject to forbearance. If no loss mitigation options are possible, in cases where the home has equity, a servicer has an obligation to refer the file to the relevant Regional Loan Center for VA's consideration of a loan refunding. When such a refunding is not possible, servicers are required to consider alternatives to foreclosure, including short sale and DILs.

The VA also offered deferment as a loss mitigation option in VA Circular 26-20-33, issued on September 14, 2020. Under the VA's deferral option, when the borrower is able to resume making monthly payments, the servicer may defer payment of the total amount of forborne payments to the loan maturity date or until the borrower refinances the loan, transfers the property or otherwise pays off the loan, at no additional cost, fee or interest to the borrower, including no penalty for early payment of the deferred amount. Deferment is not permitted in cases where the borrower will need a post-forbearance payment reduction. Unlike the FHA's partial claim, however, the VA's deferral option does not authorize the VA to reimburse the servicer at the time the payments are deferred. Without further guidance on this important issue, it is unclear how much assistance will be available under the VA deferral option.

Refinance and Home Purchase Eligibility for Borrowers Impacted by COVID-19 Forbearance

Another question at the center of the Act's implementation is whether loans that are in a forbearance plan are eligible for refinance as an alternative to the loss mitigation options provided by the GSEs and federal housing agencies. This is particularly important in this national emergency, given the low interest rates available to mortgage borrowers and the high percentage of loans that are in a forbearance plan but remain contractually current as borrowers continue to make timely mortgage payments. Given the importance of providing borrowers impacted by COVID-19 with as much flexibility as possible to resolve their hardships and return to current mortgage payments, the GSEs and most of the federal housing agencies have provided lenders with guidance in this area.

With regard to GSE loans, days after announcing the COVID-19 Payment Deferral program, FHFA announced on May 19, 2020, that borrowers in, or recently out of, forbearance will be eligible to refinance their existing loan or purchase a new home. Fannie Mae and Freddie Mac issued guidance setting out the requirements for borrower eligibility and seller due diligence. The GSE guidance sets forth eligibility requirements for borrowers impacted by the COVID-19 pandemic who have either reinstated their existing loan, or are resolving a delinquency through a loss mitigation solution. Specifically, if the borrower resolved any missed payments through a reinstatement, the borrower will be eligible for a new mortgage loan.[7] If outstanding payments have been or will be resolved through loss mitigation, the borrower is eligible for a new mortgage loan if they have, as of the note date, made at least three qualifying timely payments as provided below:

- **Repayment Plan.** A borrower subject to a repayment plan must either have (1) completed the repayment plan or (2) have completed at least three payments.[8]
- **Payment Deferral.** A borrower subject to a payment deferral must have made at least three consecutive payments after the deferral took effect.
- **Loan Modification Trial Period Plan.** A borrower subject to a modification must have completed the trial payment period.
- **Other Loss Mitigation Solution.** A borrower subject to any other loss mitigation program must either have (1) successfully completed the program or (2) completed at least three consecutive full monthly payments.[9]

With regard to VA-guaranteed loans, on June 30, 2020, the VA issued Circular 26-20-25 to address the availability of VA-guaranteed purchase and cash-out refinance loans for borrowers who received a CARES Act forbearance by announcing that it is temporarily relaxing certain credit underwriting policies for such borrowers. While lenders have an obligation to continue to follow the VA's general underwriting standards, lenders should not use a COVID-19 forbearance or deferral as a reason to deny a borrower a VA-guaranteed loan. In such cases, borrowers, through the lender, must provide reasons for the loan deficiency and information to establish that the cause of the delinquency has been corrected. Although deferred payments may not be considered for credit risk purposes, the lender should consider the monthly obligation if the debt remains active after closing the new loan. The VA also waived certain prior approval requirements for its interest rate reduction refinance loans (IRRRLs), provided certain conditions are met.[10]

For FHA-insured loans, on September 10, 2020, HUD issued Mortgagee Letter 2020-30, in which it announced an expansion of underwriting guidelines for mortgages involving borrowers who previously were granted a forbearance. Generally, such borrowers are eligible for a new FHA-insured mortgage under the following circumstances:

- **Continued Payments.** The borrower continued to make regularly scheduled payments and the forbearance plan is terminated.
- **Cash-Out Refinances**. The borrower has completed the forbearance plan and made at least 12 consecutive monthly payments post forbearance.

- **Purchase and No Cash-Out Refinances.** The borrower has completed the forbearance plan and made at least three consecutive monthly payments post forbearance.
- **Credit Qualifying Streamline Refinances.** The borrower has completed the forbearance plan and made less than three consecutive monthly payments post forbearance.[11]

As the COVID-19 pandemic continues to disrupt the residential mortgage market, we can expect the GSEs and federal housing agencies to continue to update the programs and guidance discussed above, as well as announce new requirements designed to address the unique circumstances presented by the pandemic as it continues to evolve. ■

Endnotes

[1] QRPC is a defined term that generally means creating a uniform standard for communicating with the borrower or his or her representative to determine the reason for delinquency, the occupancy status of the property, whether the borrower has the willingness and ability to repay and to discuss available workout options. For complete definitions of QRPC and Limited QRPC, please refer to Section D2-2-01 of the Fannie Mæ Servicing Guide, Section 9102.3(b) of the Freddie Mac Seller/Servicer Guide and Freddie Mac's Bulletin 2020-10.

[2] In general, a Flex Modification targets a 20-percent payment reduction while bringing the loan current by adding to the unpaid loan balance any past due amounts, including unpaid interest, real estate taxes, insurance premiums, certain assessments paid on the borrower's behalf to a third party and extending the loan term and/or reducing the loan's interest rate.

[3] The Statutory Maximum for Partial Claims can be found in the HUD Single Family Handbook at III.A.2.k.v(D)(2)(a).

[4] The Loss Mitigation Home Retention Waterfall Options can be found in the HUD Single Family Handbook at III.A.2.j.iii.

[5] The Streamlined PFS Requirements can be found in the HUD Single Family Handbook at III.A.2.l.ii.

[6] The Streamlined DIL Requirements can be found in the HUD Single Family Handbook at III.A.2.l.iii. In addition, for the COVID-19 DIL, among other things, the borrower must meet the requirements for COVID-19 PFS transactions; the borrower eligibility Streamline DIL standards are not required; the mortgagee is not required to submit a request for National Servicing Center approval; and the Mortgagee DIL Compensation dœs not apply.

[7] In this circumstance, if the reinstatement was completed after the application date of the new transaction, the lender is required to document and confirm the eligibility of the source of funds used for reinstatement, and such source must meet the GSEs' eligibility requirements for sources of funds. Both Fannie Mæ and Freddie Mac expressly state that proceeds of the new transaction may not be used to reinstate any mortgage.

[8] Freddie Mac's guidance additionally provides that the borrower must be performing under the repayment plan (i.e., no missed payments) and that the three payments must have been consecutive.

[9] Freddie Mac's guidance additionally provides that the borrower must be performing under the loss mitigation plan (i.e., no missed payments).

[10] VA regulations normally require lenders to obtain prior approval from the VA if the loan being refinanced is delinquent. The VA announced that it is temporarily waiving the prior approval requirement if the VA has already approved the lender to close loans on an automatic basis, the borrower has invoked a COVID-19 forbearance relating to the loan being refinanced, the borrower has provided information to establish that the borrower is no longer experiencing a financial hardship caused by COVID-19, and the borrower qualifies for the IRRRL under the credit standards set forth by 38 C.F.R. § 36.4340 (c) through (j). In addition, if the loan being refinanced is not more than 30 days past due, VA approval and underwriting are not required in advance of the loan.

[11] For all Streamline Refinances, the borrower must have made at least six payments on the FHA-insured mortgage being refinanced; where the FHA-insured mortgage has been modified after forbearance, the borrower must have made at least six payments under the modification.

US M&A During the COVID-19 Pandemic — Considerations for Fintech Businesses

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Fintech businesses started 2020 on an optimistic note with several large M&A deals announced and an environment that indicated that other deals were sure to follow. This momentum has paused and may have come to a screeching halt with the COVID-19 pandemic raising a host of new issues for fintechs. Many had predicted that fintechs were overvalued and had never weathered an economic downturn. On the other hand, as the global workplace deals with the need to work remotely, fintech online solutions become increasingly relevant. Deals relating to software and software-related businesses may be less negatively affected by the pandemic. Large financial institutions enter this crisis in a much stronger position than in 2008 and may be willing to assist or acquire fintechs, including fintechs that they may have viewed as uncertain in value in the recent past. Similarly, private equity funds retain massive amounts of uninvested capital and, if not overwhelmed by COVID-19-related concerns with their existing portfolio companies, may seek to capitalize on current opportunities. As with past economic downturns, winners and losers among fintechs will emerge.

Factors Driving M&A Upswing Preceding the Crisis

The fintech sector started 2020 strong coming off a very active 2019. For example, according to CB Insights, corporate venture capital deals for financial services companies hit new records with 368 deals worth $9.6 billion in 2019.[1] Bank investors in fintechs were more active in 2019 than in 2018 while insurance company investors in insurtechs in 2019 remained steady with 2018.[2] In general, there were fewer early stage fintech start-up investments with a greater focus on later stage and larger investments in more mature fintechs, including investments in more unicorns (companies worth more than $1 billion). Investors such as American Express, Citi Ventures and Goldman Sachs led the charge with multiple minority investments in unicorns and other later stage fintechs. A growing trend saw financial institutions entering into bank/fintech platform transactions whereby the fintech provides technology-related services or customer-facing white label services to the financial institution to, for example, originate unsecured personal or small business loans.[3] These bank/fintech

partnerships might or might not include a minority investment by the bank in the fintech.

Early 2020 also saw more full M&A acquisitions of mature fintechs than in the past, reflecting greater confidence by financial institution investors that they could properly value and execute these transactions. Large acquisitions of Credit Karma, Inc. by Intuit Inc., Plaid, Inc. by Visa Inc. and Cardworks by Ally Financial highlighted this new acquisition trend. Because the IPO market for fintechs was lukewarm in 2019 following some noteworthy missteps (e.g., the WeWork saga), private fintechs achieved liquidity through an M&A sale as opposed to an IPO.

- **Credit Karma/Intuit:** In February 2020, Intuit announced that it would acquire Credit Karma, with a closing reported as likely to occur in the second half of 2020. A mature and successful fintech, Credit Karma was founded in 2007, employs approximately 1,300 employees and reported approximately $1 billion in unaudited revenue for 2019 (up 20% year-over-year). Total consideration for the transaction equals approximately $7.1 billion (subject to adjustment) with approximately 50% Intuit stock and 50% cash. Demonstrating the importance of human capital to fintech businesses, total consideration included approximately $1 billion of equity awards, with an additional $300 million of retention equity to be granted to Credit Karma employees upon closing. Through this acquisition, Intuit will acquire Credit Karma's sizable customer base and suite of products. For example, Intuit will benefit by purchasing Credit Karma's tax preparation services business and consolidating it with its own TurboTax.[4] The acquisition of Credit Karma's products also allows Intuit to significantly increase the number and depth of interconnected products it offers with a view to address all of its customers' financial needs in one platform.
- **Plaid/Visa:** In January 2020, Visa announced it would acquire data aggregator Plaid, with a closing reported as likely to occur in the next three to six months. The consideration for the transaction totals $5.3 billion, consisting of approximately $4.9 billion of cash and $400 million of retention equity and deferred equity consideration. This acquisition will allow Visa to expand from its core credit and debit network business into an emerging fintech ecosystem. Prior to the acquisition, Plaid successfully worked to connect customers with numerous successful fintech businesses (e.g., the popular "Venmo" application). The acquisition of Plaid presents an opportunity for Visa to use its reputation and recognition in the marketplace to grow Plaid's prevalence and further develop Visa's relationships with fintech companies in the future. The Plaid transaction was regarded as one of the most successful fintech exits to date.
- **CardWorks/Ally:** In February 2020, Ally announced it would acquire Cardworks, with a closing likely to occur in the third quarter of 2020. Another mature and successful fintech, Cardworks is a credit card issuer founded in 1987 with approximately $4.7 billion in assets and $2.9 billion in deposits. The consideration for the transaction totals approximately $2.65 billion, consisting of approximately $1.35 billion of cash and $1.30 billion of Ally common stock. The CardWorks acquisition will allow Ally to expand its consumer finance offerings,

expanding into a mature subprime credit card business that is synergistic with its existing online banking and prime and subprime auto loan finance businesses.

Prior to the COVID-19 crisis, many viewed these deals as likely to start a new boom of fintech M&A with the M&A exit route often being viewed as more predictable and value enhancing than an IPO. Time will tell whether these pre-COVID-19 transactions are viewed as overvalued in the current environment and whether transaction parties may seek (if they have the contractual ability to seek) to terminate or re-negotiate their deal terms.

Perhaps the most interesting transaction of early 2020, however, received the least attention – Lending Club's purchase of Radius Bank, an online bank with approximately $1.4 billion in assets, for cash and stock valued at $185 million. In February 2020, Lending Club was the first US fintech business to acquire a bank, with a closing likely to occur in the next 12 to 15 months. Marketplace lender fintechs have struggled for years with how to efficiently fund their personal consumer lending businesses with access to bank deposit funding and the ability to export interest rates being the holy grail. Many fintechs have spent years trying to apply for their own bank charters with little progress made in light of the extensive requirements to obtain a bank charter. Many fintechs have partnered with smaller banks to support their lending programs and benefit from national preemption of state usury laws (e.g., Square/Celtic and Avant/WebBank), but pending litigation presents uncertainty as to whether the partner bank is the "true lender" in these relationships. Lending Club potentially solves these issues with its acquisition of Radius. In a related significant development that received little attention during the COVID-19 crisis, on March 17, 2020, the FDIC approved Square Financial Services's application to become a Utah-chartered industrial bank with access to federal deposit insurance.[5] At the same time, the FDIC proposed for comment a new rule codifying its approach to approve new insured industrial banks and industrial loan companies.[6] These new developments for fintech marketplace lenders have been overshadowed by recent events but will undoubtedly prove to be of lasting significance.

Short-Term Issues for Fintech Businesses

Fintechs, and particularly marketplace lenders providing online unsecured personal loans, have not benefited from federal relief legislation as of the date of this alert, except for loans originated by fintechs in accordance with the Paycheck Protection Program under the CARES Act. The CARES Act additionally provides forbearance and other relief for agency mortgage loans. In addition, programs such as the proposed Term Asset-Backed Securities Loan Facility to date have failed to include unsecured personal loans and non-SBA small business loans in the list of eligible assets and asset-backed securities.[7] Many marketplace lending securitizations also do not have the "AAA" ratings currently required to meet TALF standards. All of this added up to a liquidity crisis for marketplace lenders and other fintechs that rely on capital markets, but this trend is reversing as the markets again become active. It should be noted, however, that many market participants expect the markets to slow following the 2020 presidential election.

Venture capital investments are also expected to take an abrupt downward plunge. CB Insights's data indicates that global startup funding in the

first quarter of 2020 will likely be 17% lower than the fourth quarter of 2019 (which reflects a healthy January and February and a dramatic drop off in March) and predicts that these challenges to private company financing are likely to be even more dramatic in the second quarter of 2020.[8]

Time will tell how severely fintechs will be affected by COVID-19. Some segments may benefit from the situation. For example, digital-payment services will benefit from a surge in demand from stay-at-home shoppers stocking up on groceries, prescription drugs, basic household items and movies online. AI-driven businesses may need to assess how effectively their AI functions when it has not been trained on historical data from a downturn. A general lack of liquidity will likely challenge fintechs regardless of segment. On the other hand, private credit and private equity funds may view the current situation as an opportunity to make investments in the fintech sector, which ultimately will grow and thrive in an increasingly digital economy. ■

Endnotes

1 *The Global Financial Services CVC Report,* CB Insights, (information as of December 11, 2019).

2 *Id.*

3 *Contracting for Digital Platform Relationships,* Mayer Brown LLP, November 5, 2019, https://www.mayerbrown.com/-/media/files/perspectives-events/events/2019/11/contractingfordigitalplatformrelationships.pdf

4 *What the Recent Wave of Fintech M&A Tells Us About the Future of Financial Services, CB Insights,* March 11, 2020.

5 Order of the Federal Deposit Insurance Corporation Re: Square Financial Services, Inc., March 17, 2020, https://www.fdic.gov/news/news/press/2020/pr20033a.pdf?source=govdelivery&utm_medium=email&utm_source=govdelivery

6 Proposed Rule of the Federal Deposit Insurance Corporation Re: Parent Companies of Industrial Banks and Industrial Loan Companies, https://www.fdic.gov/news/news/press/2020/pr20031a.pdf?source=govdelivery&utm_medium=email&utm_source=govdelivery

7 *Market Participants Request Expansion of TALF 2.0*, Mayer Brown LLP, March 23, 2020, https://www.retainedinterest.com/2020/03/market-participants-request-expansion-of-talf-2/

8 CB Insights, March 26, 2020.

Cross-Border Trade Receivables Securitisation – Opportunity Awaits

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Trade receivables securitisation is one of the primary means through which middle market and investment grade companies alike are able to obtain more efficient and cost-effective financing, manage their balance sheets and diversify their financing sources. While it may not be as simple or straightforward as a trade receivables securitisation in a single jurisdiction, the opportunity and potential for growth for a cross-border trade receivables securitisation can often outweigh the time and cost of structuring it. While the inclusion of each jurisdiction will mean that the parties will have to take additional considerations into account, by partnering with experienced deal counsel and local counsel, the parties can be flexible and creative in order to achieve their operational and financial goals.

This article presents an overview of key considerations when structuring a cross-border trade receivables securitisation, including insight from some of our leading partners in England, France, Germany, Mexico and the United States.

Structural Considerations

CHOICE OF LAW

A typical trade receivables securitisation involves the sale by an originator or originators (each, an "Originator") of trade receivables (the "Receivables") owed by certain account debtors (each, an "Obligor") to a newly-formed, insolvency-re mote, special purpose entity (the "SPV"), with the purchase of the Receivables by the SPY being financed by one or more banks or conduits (the "Financing Parties").

A cross-border trade receivables transaction will require an in-depth review of all relevant jurisdictions, including (a) the location of the SPY, (b) the location of the Originators and the governing law of the sale agreement between each Originator and the SPY (each, a "Sale Agreement"), (c) the location of the Obligors, (d) the governing law of the Receivables, and (e) the location of any bank accounts, particularly where a security interest will be granted in favour of the SPY or the Financing Parties in those bank accounts. Each additional jurisdiction will raise local law and choice of law questions, which will need to be analysed and considered in light of the objectives which the

Originators and the Financing Parties wish to achieve in structuring the securitisation.

Key questions include:

- which law will apply to determine:
  a) whether there has been a "true sale" of the Receivables between each Originator and the SPY; and
  b) whether a Receivable is permitted to be assigned by the applicable Originator to the SPY in the event of a restriction on, or prohibition of, assignment in the underlying contract between such Originator and the Obligor (the "Underlying Contract");
- whether payment by an Obligor to the applicable Originator (rather than the SPY) will discharge such Obligor's payment obligation;
- whether the Financing Parties or the SPY can enforce against and sue an Obligor directly for its failure to pay the applicable Receivable; and
- whether a third-party creditor or insolvency trustee may assert its interest in or rights over the applicable Receivables. Determining the answers to these questions and the impact those answers have on the structure and implementation of a trade receivables securitisation are critical both for protecting the Financing Parties' rights in the Receivables and for achieving the Originators' balance sheet and liquidity management objectives. Once all applicable local laws have been determined, further analysis should be performed in each relevant jurisdiction, with the assistance of local counsel, to ensure that all jurisdiction-specific legal formalities are satisfied.

THE ROME I REGULATION

In securitisation transactions with Originators and/or Obligors located in European Union ("EU") countries (other than Denmark) and/or the United Kingdom (the "UK"), the Rome I Regulation (Regulation (EC) No 593/2008 of June 17. 2008 on the law applicable to contractual obligations) ("Rome I") will be relevant. Rome I provides that the relationship between the assignor (i.e., the applicable Originator) and the assignee (i.e., the SPY) is governed by the law of the contract between them (i.e., the Sale Agreement) (Article 14(1)). For matters concerning the assignability of any Receivable, the relationship between the SPY and the Financing Parties, as assignees, and the Obligor, enforceability against the Obligor and whether the Obligor's payment obligations have been discharged, it is necessary to look at the governing law of the applicable Receivable (i.e., the law of the Underlying Contract).

In addition, there is a draft regulation (Proposal for a regulation of the European Parliament and of the Council on the law applicable to the third-party effects of assignments of claims) aimed at addressing the effectiveness of the transfer of Receivables as against third parties. This regulation is yet to be finalised but the effect of it could make this legal analysis more complicated. This is because, while the parties are generally free under Rome I to choose the law of a contract, such as a Sale Agreement, the new regulation could make it necessary to comply with the law where the Originator has its habitual residence in assessing whether a valid transfer has been achieved as against third parties (including a liquidator or other insolvency official).

THE SECURITISATION REGULATION

In transactions where the relevant entities are located in the EU or the UK, it will also be important to consider the requirements of Regulation (EU) 2017/2402 (the "Securitisation Regulation") and the related technical standards and guidance. The Securitisation Regulation sets out certain obligations with respect to originators, sponsors, securitisation special purpose entities and institutional investors (each as defined therein) with respect to securitisations (as defined therein) entered into from 1 January 2019 or which are no longer grandfathered. These obligations include the following:

- due diligence and ongoing monitoring obligations for institutional investors;
- risk retention requirements; and
- transparency requirements including the requirement to provide certain information using specified reporting templates.

The Securitisation Regulation also includes a set of requirements which will need to be met in order for a securitisation to be considered "simple, transparent and standardised" or "STS", which among other things, and provided any other relevant regulatory requirements are met, will allow the Financing Parties to benefit from favourable regulatory capital treatment.

During the Brexit "transition period" (which is expected to end on December 31, 2020, unless it is extended), UK entities will be treated as if they are located in an EU Member State and will therefore be subject to the applicable requirements under the Securitisation Regulation. Following the end of that period, UK entities are expected to be subject to a parallel regime under which a modified version of the Securitisation Regulation will apply as adopted in the UK.

SPV LOCATION

In the case of multi-jurisdictional securitisations that include EU and/or UK Originators, the SPY is typically located in a European jurisdiction, such as Ireland, Luxembourg or the Netherlands. The choice of jurisdiction for the SPY is often driven by the availability of preferential tax treatment, such as double taxation treaties and/or beneficial tax regimes, as well as other factors such as the relevant legal system, the cost of establishing and maintaining the SPY and the location of the parties and the Receivables. For securitisations with EU and/or UK Originators and no US Originators, the SPY is usually an orphan company, in order to enhance its insolvency remoteness and as a matter of market practice. For transactions with US Originators only, it is typical to establish the SPY as a Delaware limited liability company that is a wholly-owned subsidiary of one or more of the Originators. This enables the over-collateralisation in the transaction to be achieved through equity capital rather than a subordinated loan, which is preferable for US bankruptcy remoteness principles. Also, the tax issues that apply to cross-border distributions are generally not an issue for distributions by US SPYs to US parent entities. Regardless of where the SPY is organised, its liabilities are typically limited by way of certain provisions in its organisational documents and/or under the securitisation documents, such as restrictions on its activities to those required under or ancillary to the securitisation and requirements to keep separate books, records and accounts and to have no employees, as well as the inclusion of limited recourse and non-petition clauses by which the other parties agree to be bound. In some cases, such as in Luxembourg, the SPY may be deemed to be insolvency remote by virtue of compliance with a specific statutory securitisation regime.

DILIGENCE IN RELATION TO THE RECEIVABLES AND RESTRICTIONS ON ASSIGNMENT

It is common for the Financing Parties or the Originator (in consultation with the relevant legal counsel) to review and perform diligence with respect to the Underlying Contracts. One important purpose of such diligence is to determine the extent to which there are any restrictions or prohibitions on assignment in the Underlying Contracts.

In our experience, most jurisdictions outside the US will enforce a restriction or prohibition on assignment which is included in the Underlying Contract. If there is such a restriction with respect to certain Receivables and the Originator desires to sell those Receivables to the SPY, in most cases the Obligor's consent will be required. However, the Originator typically does not want to request that Obligors consent to the sale of the Originator's Receivables for fear of disruption of the business relationship (or providing leverage to Obligors for other concessions). The Originators and the Financing Parties will need to determine whether certain Obligors should be excluded from the securitisation and consider whether their economic and commercial goals in entering into the transaction will still be achieved in the event of such exclusions, taking into account the aggregate amount of Obligors and Receivables that will be excluded.

In some cases, it may be possible to benefit from some structural alternatives (such as trusts in England, depending on the wording of the Underlying Contract and whether this is acceptable to the parties) or exceptions such as in Germany under 354a(1) of the German Commercial Code (Handelsgesetzbuch) that, as long as the requirements are met in order for such exception to apply, provides for the assignability of commercial receivables even if the parties to the underlying contract have agreed on a ban on assignment, but still leaving the Obligor certain defences or the possibility to pay the assignor with discharging effect. In Germany, assignability as an eligibility criterion usually includes assignability by way of 354a(1) of the German Commercial Code (Handelsgesetzbuch). However, banks are closely considering the potentially increased dilution risk because of the above-mentioned defences and the payment choice of the Obligor.

In transactions that are done in the US, the parties typically ignore any contractual restrictions on assignment in the Underlying Contracts. That is because the Uniform Commercial Code (the "UCC") renders such provisions unenforceable generally. However, as per Section 9-406(a) of the UCC, obligors may continue to discharge their Receivables by payment to the assignor until notified of the assignment. Obligors also will enjoy greater offset rights as to their assigned Receivables until such notice of assignment is received. Consequently, Financing Parties normally will require notice of assignment following certain performance triggers in the transaction.

In France, the French commercial code clearly stated that any outright ban on assignment was considered to be ineffective under French law. However, a recent reform in relation to commercial transparency (enacted in April 2019) repealed that provision. At this stage, given the uncertainties raised by this new legislation, in the presence of an outright ban on assignment clause in an Underlying Contract, the legal position of the Originator would therefore be less robust than under the previous regime and consequently the Financing Parties would be exposed to a higher risk of challenge to the extent the relevant parties to the Underlying Contract do not comply with such ban on assignment provisions of the

Underlying Contract. Note that a further reform of the French commercial code is in the process of being prepared in order to clarify the position, revert back to the previous position and end the uncertainties raised by this new legislation.

TRUE SALE

One of the key aspects of structuring a securitisation transaction is considering whether the transfer of the Receivables from the Originator to the SPY will be construed as a "true sale", with the Receivables no longer considered to be part of the assets of the Originator, including during any insolvency proceedings of the Originator, or whether it could be recharacterised as a secured loan. Achieving a legal true sale is an essential component of the structure for the Financing Parties in a cross-border trade receivables transaction, and this will require careful review and discussion with the relevant local counsel.

Not all jurisdictions have years of case law or history surrounding what constitutes a "true sale". Indeed, in many jurisdictions, the concept does not even exist. Therefore, it is important to discuss the true sale analysis and obtain and review legal opinions and memoranda early in the process of structuring the transaction, to obtain a full understanding of the legal framework in the applicable jurisdiction. In some jurisdictions, there is such limited case law that the legal opinion may simply assume "economic risk has been transferred" (in other words, the legal standard for a true sale). This is not particularly helpful from a legal perspective, as the opinion has been essentially assumed; however, the parties may be comfortable with such coverage to the extent the applicable local law Receivables do not represent a large portion of the Receivables portfolio, or if there are certain trigger events incorporated into the securitisation documents that would result in the removal of such Receivables from the securitisation. Legal opinion custom in local jurisdictions varies greatly, and what is typical or customary in one jurisdiction is often not the case in other jurisdictions. Working with local counsel and deal counsel together to reach a common ground is imperative for both the Financing Parties and the Originators in a cross-border trade receivables securitisation.

It is also important to consider whether there are any grounds under which the sale could be "clawed back" in the event of an insolvency of the Originator, such as whether there is a transaction at an undervalue, a preference or a transaction defrauding creditors, depending on the local insolvency laws. Steps should be taken to confirm that the Originator is solvent, which may include searches and a requirement for solvency certificates from the Originator.

It is worth keeping in mind that no two jurisdictions are exactly alike. Each jurisdiction's legal system has its own nuances and complexities that need to be considered closely with transaction counsel and local counsel. It may not be practical to include some jurisdictions depending on the Originators' commercial or operational requirements. For example, in order to achieve a true sale certain jurisdictions require (a) notice to Obligors of the assignment of their Receivables, (b) the execution of daily assignment or transfer agreements, (c) the deposit by the Obligor of all collections into a bank account owned by the SPY or (d) the ability to replace the servicer of the Receivables without cause (including prior to a servicer default). While these formalities fall on the cumbersome end of the true sale spectrum, if they are required under local law, the Originator

group may determine that it is not in its best interest to include that jurisdiction or those Receivables in the securitisation. Note, however, that these are not common requirements, and in our experience most jurisdictions are able to be included in cross-border trade receivable securitisations with some modifications.

In Germany, a crucial point for true sale is risk retention by the seller as insolvency courts in Germany tend to draw the line between true sale and secured lending (i.e. separation and segregation) rather than from a commercial perspective. In the past, most law firms took the view that risk retention lower than 9% of the purchase price was a clear indication of a true sale because in a secured lending transaction the insolvency administrator would already deduct 9% for its fees and secured lending with only 9% overcollateralisation would be rather unusual. Based on this view, the 9% rule was only critical for direct risk retention such as, for example, deferred purchase price payments. It was generally not seen as an issue if the Originator participated in the credit risk of the transaction through participation in subordinated tranches of the refinancing side of the SPY. More recently, law firms have taken the view in their legal opinions that based on a court decision of the Federal Tax Court it cannot be excluded that insolvency courts will follow more of an accounting-based approach which could then easily conflict with risk retention requirements.

In order to mitigate eventual clawback risks, the sale of receivables is usually structured as a cash transaction in Germany. For a cash transaction an adequate purchase price needs to be paid immediately to the Originator. If the sale qualifies as a cash transaction, clawback risk is generally very remote.

In the US, legal true sale is determined primarily based on the intent of the parties and whether the economic consequences of the transaction are consistent with the intent of the parties. There is a significant amount of case law in the US that informs this analysis and lawyers will generally study the details of the economic relationship of the transaction in order to provide a strong legal true sale opinion. Such details will normally include an evaluation of the extent to which the risks (in particular credit risks) and rewards (in particular excess spread) associated with the sold Receivables have truly been conveyed to the purchaser. In order to provide the Financing Parties with the level of credit protection they desire while also providing the Originators with a fair purchase price for their Receivables, a typical US trade receivables securitisation is structured as a two-step transaction in which the Originator transfers the Receivables to the SPY, which is a wholly-owned subsidiary of the Originator, and the SPY obtains financing for the purchase from the Financing Parties. Many such transactions have been structured to achieve derecognition under US Generally Accepted Accounting Principles.

In the case of French securitisations, there is a legal "true sale" if (a) the sale to the SPY is unconditionally and immediately valid, final and enforceable against local and/or foreign third parties (including, where applicable, the Obligors), whether or not such third parties or the Originator's creditors are formally notified of the sale, and (b) the transfer cannot be challenged by a court in the event that the Originator becomes insolvent (the "bankruptcy remoteness" test).

Where a French Originator is subject to a bankruptcy or insolvency proceeding (such as safeguard (*sauvegarde*), judicial reorganisation (*redressement judiciaire*) or liquidation

proceedings (*liquidation judiciaire*)), under French law, assignments of assets by the Originator which occurred between (a) the "payment stop date" (*date de cessation des paiements*), and (b) the judgment opening the insolvency proceeding may be challenged by the appointed bankruptcy administrator. In most cases, the payment stop date coincides with the date of the opening judgment, but the insolvency court may backdate the payment stop date by up to 18 months prior to this date. The period between the payment stop date and the date of the opening judgment is called the "hardening period" (*période suspecte*).

Article L. 632-1 of the French Commercial Code enumerates the transactions which are void per se (*nullités de droit*) if they occurred during the hardening period. These include, notably, gratuitous transfers, transactions entered into unreasonably below market value, payments of debts not yet due, security/guarantee granted for previous debts; or transfers of assets into a French *fiducie* (trust). In addition, payments of debts which are due or transactions for consideration which occur after the payment stop date may potentially be voided (*nullités relatives*) if the counterparty of the insolvent party was aware of the insolvency at the time of the transaction (Article L. 632-2 of the French Commercial Code).

Please note that to mitigate such clawback issues for French securitisation transactions, French securitisation law (as codified in Articles L. 214-169 to L. 214-190 and Articles D. 214-216-1 to D. 214-240 of the French Monetary and Financial Code) provides for specific exemptions to applicable bankruptcy laws applying to securitisations and therefore offers a strong and legally effective protection to French securitisation vehicles for assignments of Receivables carried out in the context of a securitisation involving such French securitisation vehicles.

CASH MANAGEMENT AND SERVICING

In many transactions, the Financing Parties will allow the Originators to commingle collections on the Receivables for a specific period of time (typically intra-month), with settlement occurring on a monthly basis. While the purchase price for Receivables is due and payable on a daily basis, and Receivables are in fact sold on a daily basis, it is customary for settlement of the purchase price actually to occur periodically (such as once a month) for administrative ease. Furthermore, the Servicer will continue to service the Receivables and manage the relationship with its Obligors, including collection activities.

In a cross-border transaction, it may not be possible to achieve a true sale in a certain jurisdiction unless the collections on the Receivables are deposited into the SPY's account. This adds a layer of complexity, as new accounts will need to be established, and the Obligors will need to be notified of the change in their payment instructions. This often can be included in the Obligor's invoice but that is not always an option for every jurisdiction. The Financing Parties may also want to consider whether account control agreements should be in place over the SPY's accounts.

While it may be feasible for settlement to occur on a monthly basis, in jurisdictions such as Germany, the payment of the purchase price cannot be delayed and ideally should be made on a daily basis immediately or at least on the same day as the transfer of the Receivables. These daily cash flows could create an administrative and operational burden for the Originator or, at a minimum, a restructure of the Originator's operations, especially if purchase price payments are netted against collections of the Originator. As a matter of German tax law the servicing should generally remain with the

Originator and thus no direct payments to the account of the SPY will be made (except in the case of redirection).

Whether settlement occurs on a daily or less frequent basis, however, given the characteristically short-term nature of most trade receivables, the Financing Parties normally will require transfers by the Originators to the SPY on a daily basis immediately upon origination until all obligations owing by the SPY to the Financing Parties have been paid in full. The daily transfer of the Receivables by the Originator to the SPY helps to offset the risk to the Financing Parties of losing all of their collateral as the Receivables turn over quickly.

As mentioned above, the local law true sale analysis may in some cases require the ability to replace the servicer of the Receivables (typically the Originator or its parent company) without cause. For the relevant Originator, this may be a "deal-breaker" as it would effectively result in the Financing Partieshaving the ability to take control of the Originator's relationship with its Obligors, even when the servicer has not defaulted and no events of default or other trigger events under the securitisation documents have occurred. Of course, it is in the Financing Parties' best interest if the Originator continues to maintain its own relationships with its Obligors, but the Originator's concern with such a replacement requirement nonetheless is understandable. If a jurisdiction with this requirement represents a small portion of the securitisation portfolio as a whole, or if such requirement is limited only to that jurisdiction, the parties will need to determine whether the relevant Receivables should be included in the securitisation.

OBLIGOR NOTICE AND CONSENT

Obligor notice and consent is perhaps one of the most sensitive and negotiated points in a trade receivables transaction. Understandably, the Originator does not want to disturb or change its sometimes long-standing relationship with its Obligors. Sending notices or obtaining consents from Obligors regarding the transfer of their Receivables to the SPY could confuse the Obligors or tarnish the Originator's relationship with them. From the Financing Parties' perspective, provided that the Originator has not defaulted and the Originator is complying with the securitisation documents, it is in the Financing Parties' best interest for the Originator to maintain these relationships. In many cases, the Financing Parties are only able to notify Obligors of the assignment of Receivables after certain trigger events, usually events of default or servicer defaults. While Obligor notice would cut off the Obligor's right to discharge its debt to the Originator as well as other defences and set-off rights, the Financing Parties are typically comfortable taking this risk until such trigger events occur, at which time notices may be sent.

However, some jurisdictions may require notice to or consent from Obligors not only for the SPY to exercise rights or remedies *vis-à-vis* the Obligor, but in order to achieve a true sale. Furthermore, notice may be required only once to the Obligor, but in some cases, it must be provided for the sale of each Receivable, which could easily annoy the Obligor and strain its relationship with the Originator. If the Originator is uncomfortable providing notice to its Obligors, which is particularly understandable if such notices are happening frequently, the applicable jurisdiction may not be feasible for the cross-border transaction.

Certain formalities may be required for the notice. For example, in Mexico, although notice is not required to achieve a true sale, the effect of the notice is to cut off the Obligor's right to discharge its debt to the Originator as well as other defences and set-off rights. Depending on the type of transfer agreement, notice may be made in one of the following ways: (a) notice to the Obligor made by a public broker or notary public (in this case, the written acknowledgment of receipt by the Obligor is not necessary); or (b) two witnesses. Further, pursuant to Mexican law, factoring agreements (*contrato de factoraje*) allow for notice to be made in the following additional ways: (a) delivery of the Receivable with a legend of the sale and an acknowledgment of receipt by the Obligor; (b) communication by certified mail with an acknowledgment of receipt, including telegram, telex or fax, with a password, along with evidence of the receipt by the Obligor; or (c) through "data message" sent pursuant to the Mexican Commercial Code (*Código de Comercio*), which requires the prior designation by the receiver (i.e., the Obligor) of a "system" or "means" to receive data messages (e.g., the prior written designation of a certain email address by the Obligorto receive notifications of assignment via email, or pdf email, encrypted email, data room or electronic member website, etc.). Given the lack of precedent for electronic communications, the market standard has been for notice to be made through a public broker or notary in order to limit the potential for challenges that notice had not been properly provided. Nevertheless, electronic communications have started to become more popular where Receivables are purchased through the use of technology-managed platforms.

It is common for the Obligor to be located outside of Mexico, in which case the notification of assignment may be done by any of the aforementioned means, by courier, with an acknowledgment of receipt or by using any methods established in accordance with the provisions of treaties or international agreements signed by Mexico which relate to the Obligor's jurisdiction.

However, where the parties to the Sale Agreement agree that the Originator will remain as servicer of the Receivables *vis-à-vis* the Obligors, then the question arises whether the notice of assignment discussed above is necessary. A conservative approach suggests that the Obligor should be notified of the existence of the Sale Agreement and provided with payment instructions (which usually state that payments shall continue to be made as usual unless otherwise instructed). In this case, identification of the SPY in the notification would not be necessary. Where the Originator remains as servicer of the Receivables, it will be deemed to hold the collections from the Receivables in trust (*depositario*) on behalf of the SPY. To mitigate the risk that collections could be diverted, it is highly advisable to implement an account control agreement over the account into which such proceeds are deposited. The first option for an account control agreement under Mexican law is to create a Mexican trust *(contrato de fideicomiso*). A second option is the use of an irrevocable mandate agreement whereby the Originator opens a bank account and acts as principal providing instructions to the bank who acts as attorney-in-fact, and the SPY acts as beneficiary. In addition, it is common to obtain and perfect a pledge (*prenda sin transmisión de posesión*) in favour of the SPY or Financing Parties over all of the Originator's rights related to the collection account, in order for the SPY or the Financing Parties to have a registered security interest in the event of a bankruptcy scenario

(which would be enforceable *vis-à-vis* other creditors of the Originator). Such pledge would need to be formalised by a public broker or notary and filed with the RUG.

As discussed above, in many jurisdictions the consent of the Obligor may also be required to the extent that there are restrictions or prohibitions on assignment in the Underlying Contracts.

OPERATION OF TRANSFERS

For cross-border trade receivables securitisations with multiple jurisdictions, English law is often used as the governing law for the Sale Agreements (including, in some cases, with respect to Receivables governed by a different governing law or sold by an Originator located in a different jurisdiction). However, in some cases it will be preferable to use the law of the Originator's jurisdiction as the governing law of the Sale Agreement with respect to the transfer of that Originator's Receivables.

Under English law, there is a distinction between a legal assignment and an equitable assignment. In order to be a legal assignment, the assignment must be in writing and signed by the assignor, absolute and unconditional (and not by way of charge only), of the whole of the debt and notified in writing to the debtor. Given that, in the majority of cases, the Obligors are not notified of the sale of the Receivables at the outset of the securitisation, most English law sales of Receivables will be equitable assignments, which will be capable of becoming a legal assignment upon notice being given to the Obligor if the relevant trigger event occurs. Until notice is given to the Obligor, (a) the legal title will remain with the Originator, (b) the SPY or the Financing Parties may need to join the Originator in legal proceedings against the Obligor, (c) the Obligor can discharge its payment obligation by paying the Originator, (d) the Obligor can exercise set-off rights against the Originator, and (e) a subsequent assignee who does not know of the prior sale and who gives notice to the Obligor may obtain priority over the SPY and the Financing Parties. However, it is important to note that equitable assignments will still be capable of being a true sale under English law.

In some jurisdictions/transactions, including the US, it is typical to sell all Receivables of the Originator automatically upon origination, other than specific Receivables designated in the securitisation documents as excluded Receivables (which usually relate to certain Obligors). This is an important feature to ensure that the Financing Parties continue having replenishing collateral as collections on prior Receivables are held and commingled by the Originator pending settlement. However, in other jurisdictions, automatic sales are unusual, and it is more common to sell Receivables periodically, with such Receivables being specified in a list in order to identify which Receivables are being sold. Providing such a list can mean an additional administrative or operational burden for the Originator. For example, even in Germany, when a global assignment is used, the assignment needs to meet the criteria of determining exactly which claims are being assigned and should also ensure the immediate and adequate payment of purchase price, which is why some transactions provide for a list of Obligors, to be updated from time to time (each time a new Obligor is added or removed from the list), to ensure a certain process of determining assigned receivables and corresponding

purchase prices. If the purchase price is not determined on a daily basis but netted against collections, the transaction must provide for a mechanism to determine which receivables are being assigned in which order against available collections (e.g., by date). Furthermore, certain jurisdictions may require specific details for the identification of the Receivables, such as invoice numbers, descriptions of the Underlying Contract, Obligor addresses and other information. Other jurisdictions (such as Mexico) may require the filing of frequent registrations or the execution and delivery of assignment agreements for each sale of Receivables. To the extent it is not possible for the Originator to perform these daily administrative tasks, the parties may want to consider a structure that involves less frequent transfers of Receivables (such as weekly or monthly) for the relevant jurisdiction. Alternatively, the Financing Parties may require daily transfers nonetheless with the additional steps necessary to perfect such transfers occurring on a less frequent basis. In such case, the Financing Parties may take some additional risk that the transfers are not perfected prior to completion of all the requisite steps but may be in a better position by being able to control those additional perfection steps in the event of enforcement against the Originators.

While a simple transfer of Receivables between the Originator and the SPY is ideal, in some jurisdictions a new structure needs to be set up for that jurisdiction to ensure the Receivables can be included in the securitisation. When including these jurisdictions, structural changes may need to be made not only in the Sale Agreement, but also to the securitisation documents generally, which may not contemplate an intermediate sale or a subrogation structure. If the Receivables in that jurisdiction represent a meaningful portion of the Receivables portfolio as a whole, such structural changes are usually worth the time and expense and will provide the securitisation programme with additional flexibility for the inclusion of future jurisdictions.

For example, in France, there are banking monopoly rules which, in principle, disallow the performance of credit transactions (i.e., lending or ongoing purchases of French unmatured Receivables) in France by anyone other than a French-licensed or EU-passported financial institution, or any French investment fund specifically authorised to lend.

For cross-border securitisation transactions involving French Originators, this implies that the SPY will not be authorised to purchase Receivables directly from such French Originators. Depending on the terms and conditions of the envisaged securitisation, the French Originators will only be able to sell their Receivables either: (a) to a French securitisation vehicle (such as a *fonds commun de titrisation* or "FCT"), which will then issue units or notes to be subscribed by the SPY; (b) to an intermediate banking purchaser located outside of France and benefitting from a EU passport to trade in France, which in turn will on-sell them to the SPY; or (c) on the basis of an exemption under the French banking monopoly rules, to a foreign group affiliate thereof (which affiliate will then on-sell those Receivables to the SPY). Note that, for each of the sale options mentioned above, there are sale mechanics available under French law which provide for strong protections in terms of legal true sale and enforceability.

FILINGS AND REGISTRATIONS

In some jurisdictions it may be necessary to make a filing or registration with respect to the sale. For example, in the US, the UCC requires the filing of a financing statement to provide notice of a sale of accounts receivable. That is because Section 1-201(b)(35) of the UCC defines the term security interest to expressly include the interests of a buyer of accounts in addition to the interests of a lender secured by accounts. Section 9-109(a) (3) of the UCC also expressly states that Article 9 of the UCC (*Secured Transactions*) applies to the sale of accounts. While some may view the need to file a UCC-1 as unnecessarily conservative for a legal true sale, it actually provides US Financing Parties with protection against Originator fraud and mistake risk that is not otherwise mitigated without such an objective notice filing system. Furthermore, in the United States, the Sale Agreement will typically contain a back-up grant of a security interest in the Receivables to mitigate the potential risk of the transfer of the Receivables not being treated as an absolute sale, transfer and assignment of the Receivables notwithstanding the express intent of the parties. This is important and beneficial for the Financing Parties because, without a perfected security interest under the UCC, the Financing Parties would be unsecured creditors in the event the sale of Receivables was not deemed a true sale. While the inclusion of a back-up grant of a security interest in the Receivables under a Sale Agreement may seem contrary to the express intent of the parties, it does not typically cause stress on the true sale analysis for securitisation transactions in the United States because US case law regarding true sale tends to hinge on commercial substance over form.

In Mexico, the granting of a back-up security interest is generally viewed as inconsistent and potentially harmful to the expressly stated intention of a sale. However, in order to ensure that the sale will be effective against third parties, particularly against creditors of the Originator if it becomes subject to an insolvency proceeding, a filing under the Sole Registry of Security Interests in Movable Assets (*Registro Único de Garantías Mobiliarias* or "RUG") is required. Recording in the RUG serves as a notice to third parties that the sale took place and, accordingly, gives the SPY priority over (a) any future creditors of or purchasers from the Originator, and (b) prior creditors that have not filed their security interest or assignment of rights with the RUG. RUG filings should be made for each sale on each sale date in order to protect the SPY from the Originator's creditors who could challenge a specific unregistered assignment of Receivables. While the filing protects Financing Parties from fraud or mistake risk similar to the UCC, it is not required in order to achieve a true sale of the Receivables under Mexican law. Thus, the parties may wish to structure the transaction such that RUG filings are made on a less frequent basis, rather than daily, in order to balance the Financing Parties' risk of third-party claims against the administrative burden on and expense for the Originator. Furthermore, when filing with the RUG, it is highly advisable to (a) perform a previous search for the Receivables that are intended to be purchased to confirm that they are free and clear of any security interests and that they have not been transferred in favour of a third party, and (b) request the public broker or notary to describe, in as much detail as possible, the purchased Receivables, including, for example, the relevant invoice numbers.

LEGAL OPINIONS

A discussion of cross-border trade receivables securitisations would be incomplete without mentioning legal opinions, which provide both the Financing Parties and the Originator with legal comfort regarding enforceability, true sale, choice of law and tax matters (among other things). For the law governing the applicable Sale Agreement, it is customary to receive a true sale and enforceability opinion from counsel in that jurisdiction, particularly if the Originator wishes to receive off-balance sheet treatment. For each Originator jurisdiction, customary corporate opinions are typically provided, as well as no conflict opinions and tax opinions. An opinion from the SPY's jurisdiction is likewise customary. Opinions will also be required in relation to security. While these opinion practices are typical, each transaction should be discussed and reviewed carefully among the parties to determine the appropriate opinion coverage for the relevant transaction.

When looking at issues such as enforcement against Obligors and set-off rights and defences, a minority approach is to obtain opinions from each Obligor jurisdiction, as well as the jurisdiction that governs the law of the applicable Receivable. This request may be limited to all such jurisdictions, or only those that make up a sizeable portion of the pool of Receivables. A more common approach is to obtain a legal memorandum from local counsel detailing the practical steps that need to be taken in such jurisdiction to remove such defences and rights (such as providing notice to the Obligors). A legal memorandum may also briefly discuss tax questions and enforcement mechanics for bringing foreign judgments into a local court in the relevant jurisdiction. Benefits of legal memoranda, particularly in Obligor jurisdictions, include the following: (a) memoranda are usually less expensive than legal opinions; and (b) memoranda will address factual matters that may not be included in a legal opinion, such as the detailed process of enforcement and bringing judgments into local legal systems.

Conclusion

A multi-jurisdictional trade receivables transaction will involve a detailed consideration of legal and tax issues in a range of countries. Selecting a law firm that is very familiar with analysing such issues and has helped implement and structure transactions that include jurisdictions across the globe is a valuable initial step for navigating through complex multi-jurisdictional legal questions and finding the best solutions for the particular transaction. ■

CFPB Hatches QM Proposals for the GSE Patch and a Seasoned QM

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The Consumer Financial Protection Bureau ("CFPB") has issued proposed rules to address Qualified Mortgages ("QMs"). In the first of the batch, in June 2020, the CFPB proposed to revise its general QM definition by adopting a loan pricing test. Specifically, under the proposal, a residential mortgage loan would not constitute a QM if its annual percentage rate ("APR") exceeds the average prime offer rate ("APOR") by 2 percentage points or more. The CFPB also proposed to eliminate its QM debt-to-income ("DTI") threshold of 43%, recognizing that the ceiling may have unduly restrained the ability of creditworthy borrowers to obtain affordable home financing. That would also mean the demise of Appendix Q, the agency's much-maligned instructions for considering and documenting an applicant's income and liabilities when calculating the DTI ratio.

The CFPB intends to extend the effectiveness of the temporary QM status for loans eligible for purchase by government-sponsored enterprises ("GSEs") Fannie Mae or Freddie Mac (the "GSE Patch") until the effective date of those revisions to the general QM loan definition (unless of course those entities exit conservatorship before that date). That schedule will, the CFPB hopes, allow for the "smooth and orderly transition" away from the mortgage market's persistent reliance on government support.

Along the way, in August 2020, the CFPB also proposed a concept for a seasoned QM—a loan that would gain safe harbor status if the borrower makes timely payments and the creditor retains the loan in its portfolio for 36 months.

The GSE Patch

In July 2019, the CFPB started its rulemaking process to eliminate the GSE Patch (scheduled to expire in January 2021) and address other QM revisions. For the past 5 years, that patch has solidified the post-financial crisis presence by Fannie Mae and Freddie Mac in the market for mortgage loans with DTIs over 43%. The GSE Patch was necessary, the CFPB determined, to cover that portion of the mortgage market until private capital could return. The agency estimates that if the GSE Patch were to expire without revisions to the general QM definition, many loans either would not be made or would be made at a higher price. The CFPB expects that the amendments in its current proposal to the general QM criteria will capture some portion of loans currently covered by the GSE Patch and will help ensure that responsible, affordable mortgage credit remains available to those consumers.

ADOPTING A QM PRICING THRESHOLD

Although several factors may influence a loan's APR, the CFPB has determined that the APR remains a "strong indicator of a consumer's ability to repay," including across a "range of datasets, time periods, loan types, measures of rate spread, and measures of delinquency." The concept of a pricing threshold has been on the CFPB's white board for some time, although it was unclear where the agency would set it. Many had guessed the threshold would be 150 basis points, while some suggested it should be as high as 250 basis points. While the CFPB proposed to set the threshold at 200 basis points for most first-lien transactions, the agency proposed higher thresholds for loans with smaller loan amounts and for subordinate-lien transactions.

In addition, the CFPB proposed a special APR calculation for short-reset adjustable-rate mortgage loans ("ARMs"). Since those ARMs have enhanced potential to become unaffordable following consummation, for a loan for which the interest rate may change within the first 5 years after the date on which the first regular periodic payment will be due, the creditor would have to determine the loan's APR, for QM rate spread purposes, by considering the maximum interest rate that may apply during that 5-year period (as opposed to using the fully indexed rate).

ELIMINATING THE 43% DTI CEILING

Presently, for conventional loans, a QM may be based on the GSE Patch or, for non-conforming loans, it must not exceed a 43% DTI calculated in accordance with Appendix Q. Many commenters on the CFPB's advanced notice of proposed rulemaking urged the agency to eliminate a DTI threshold, providing evidence that the metric is not predictive of default. In addition, the difficulty of determining what constitutes income available for mortgage payments is fraught with questions (particularly for borrowers who are self-employed or otherwise have nonstandard income streams). While the CFPB intended that Appendix Q would provide standards for considering and calculating income in a manner that provided compliance certainty both to originators and investors, the agency learned from "extensive stakeholder feedback and its own experience" that Appendix Q often is unworkable.

While the CFPB proposed to eliminate a DTI threshold for QMs, the agency indicated that rate spread combined with DTI would better predict early delinquency rates than either factor on its own. Accordingly, the CFPB requested comments on certain hybrid approaches, such as retaining a higher DTI limit but injecting more flexibility in verifying debt and income, or imposing a DTI limit only for loans above a certain pricing threshold.

Although under the proposed rule the general QM parameters would not include a DTI limit, creditors still would be required to consider DTI (or residual income) in making a general QM. In fact, in order to achieve QM status, the creditor would have to retain documentation of its consideration of one or both of those factors, such as by documenting that the creditor followed its standard procedures for considering the factors in connection with a specific loan, and/or by including an underwriter worksheet or final automated underwriting system certification.

The CFPB also proposed to retain requirements for the verification of income, and is considering providing a safe harbor to creditors using specified standards, such as those required by Fannie Mae or Freddie Mac, or under one of the

government insurance/guarantee programs. The CFPB stated that those external standards appear reasonable and would provide greater compliance certainty—particularly with respect to verifying income for self-employed consumers.

The CFPB also is taking the opportunity to address unidentified deposits in the consumer's bank account. The rule would require that the creditor generally must confirm that an inflow of funds into the consumer's account is in fact income, and not, for example, the distribution of loan proceeds. However, the rule does not otherwise propose any standards for relying on bank statements or other types of documentation for borrowers with self-employment or nontraditional income sources.

RETENTION OF OTHER QM CRITERIA

The proposal would retain many current elements of the general QM criteria. The existing limitations on QM product features and on points and fees would remain. The proposal also would preserve the current threshold separating safe harbor from rebuttable presumption QMs. Accordingly, a loan that otherwise meets the general QM loan definition would be a safe harbor QM if its APR exceeds the APOR for a comparable transaction by less than 1.5 percentage points (for first-lien transactions); all other QM loans (those with a rate spread at or above 1.5 but less than 2 percentage points) would be considered rebuttable presumption QMs.

OTHER CONSIDERATIONS

Some commenters argued that the CFPB should trim back its QM definition, and rely only on the definition in the Dodd Frank Act (e.g., prohibitions on certain loan features and a limitation on points and fees). However, the CFPB insists that some direct or indirect measure of the consumer's finances is needed to ensure that consumers have a reasonable ability to repay. Others had suggested retaining a DTI limit but allowing for exemptions when compensating factors were present. However, the CFPB stated that such exemptions would undermine the goal of compliance certainty, which is of particular importance to purchasers of mortgage loans concerned about potential assignee liability for violations of the statutory ability-to-repay requirements.

There also had been a suggestion that the CFPB would institute some type of results-oriented approach to gaining QM status by providing that loans that do, in fact, experience timely payments would be deemed to comply with the ability-to-repay requirement. However, the CFPB did not include that approach in this proposal.

As we previously noted, changes to the QM parameters also will likely affect the types of loans that are exempt from credit risk retention in securitizations (qualified residential mortgages, or "QRMs"). Although the purposes of the ability-to-repay rule and the credit risk retention rule are different, the multiple agencies responsible for defining QRMs are likely to continue prioritizing the conformity between the two sets of safe harbor loans.

TIMING

While this proposal was expected earlier, surely the agency's rule drafters were working diligently from home, weighing the input received from industry and housing advocates as the mortgage market shifted into pandemic, CARES Act relief mode. While low interest rates have kept loan applications pouring in, and default and forbearance rates are not as high as one might have predicted, the CFPB stated that

the pandemic has resulted in a contraction of mortgage credit availability for those who may be dependent on the GSE Patch or non-QMs for financing. It is undeniable that economic uncertainties will persist for those and other borrowers, and for creditors and investors.

The CFPB accepted comments on the QM revisions described above for 60 days. The proposed rule indicated that the CFPB will recognize a 6-month delayed effective date after publication of the final rule. As to the expiration of the GSE Patch, the CFPB accepted comments on that proposal for 30 days. As indicated above, the expiration is proposed to take effect at the same time as the general QM revisions. For planning purposes, the CFPB indicated that it does not intend for that effective date to be prior to April 1, 2021, taking it well past the election in November.

Seasoned QMs

In August 2020, the CFPB issued a proposal to amend the agency's Ability-to-Repay ("ATR") Rule to provide that a first-lien, fixed-rate loan meeting certain criteria, that the lender has held in its portfolio, could become a QM after 36 months of timely payments. Figuring that if a borrower has made payments on a loan, the lender must have made a reasonable determination of ability-to-repay, the proposal would open the safe harbor door to non-QMs (including those originated as such intentionally or inadvertently) and higher-priced QMs that otherwise receive only a rebuttable presumption of compliance with the ATR Rule. The proposal also would, consequently, close the door on those borrowers' ability to challenge the lender's underwriting determination in a foreclosure, which otherwise would last far beyond the 3-year period.

CRITERIA

Specifically, the CFPB proposed that a covered loan for which an application is received on or after this rule becomes effective could become a "seasoned QM" and earn a conclusive safe harbor under the ATR Rule if:

1. The loan is secured by a first lien;
2. The loan has a fixed rate for the full loan term, with fully amortizing payments and no balloon payment;
3. The loan term does not exceed 30 years; and
4. The total points and fees do not exceed specified limits (generally 3%).

In addition, the creditor must have considered the consumer's DTI or residual income and verified the consumer's debt obligations and income. In alignment with the CFPB's pending rulemaking revising the general QM definition described above, the creditor would not have to use the Rule's Appendix Q to determine the DTI. Also, as indicated above, a loan generally would be eligible as a seasoned QM only if the creditor holds it in portfolio until the end of the 3-year seasoning period.

SEASONING PERIOD

As to timely payments, the CFPB proposed that the loan must have no more than 2 delinquencies of 30 or more days, and no delinquencies of 60 or more days, at the end of the 36-month seasoning period. Those timely payment requirements would apply to the borrower's obligation to pay principal, interest and, if applicable, escrow items. If the borrower's failure to make those payments is the result of a disaster or pandemic-related national emergency, that payment deficiency would not impede the loan's status as a seasoned QM, although time spent in such a temporary

accommodation would not count toward the 36-month seasoning period. The proposed rule would allow an exception for certain small delinquencies ($50 or less) that the servicer does not otherwise treat as such. However, payment amounts advanced by the creditor or servicer or that are pulled from escrow would not count as timely for purposes of qualifying for the seasoned QM safe harbor.

The concept of a seasoning period constituting evidence that the lender met its obligations during the origination process is not unique. That 36-month seasoning period is somewhat similar in concept to the remedies frameworks of Fannie Mae and Freddie Mac, the GSEs, and mortgage insurers for breaches of loan-level underwriting representations and warranties. The GSEs clarify, however, that satisfaction of the seasoning requirement does not undo the prior breach; rather, they elect not to pursue an otherwise available repurchase remedy based on such breach. Either way, after a certain period of loan performance, the thought goes, subsequent defaults cannot reasonably be attributed to a failure of underwriting, but rather are largely due to unforeseeable events for which the originating lender should not be saddled with origination-related compliance risk.

While it is easy to say that a borrower who has successfully made payments on a mortgage loan for a period of time must have, by definition, the ability to repay that loan, commenters in connection with earlier CFPB outreach efforts argued that is not necessarily the case. Borrowers may neglect other financial obligations or necessities in favor of paying the debt secured by their home, the commenters argue, disguising the fact that they cannot actually afford the loan. To address that concern, as mentioned above, the CFPB would retain certain product restrictions and underwriting requirements (including the requirement to consider DTI) for those seasoned QMs to further ensure the lender is making a reasonable ATR determination.

The CFPB believes that the requirement for the lender to retain the loan in portfolio for the seasoning period also would help incentivize the lender's ATR determination. The Dodd Frank Act already imposes a similar skin-in-the-game incentive through its credit risk retention requirements for loans placed into securitization, with an exception granted for QRMs. A designated team of federal agencies has defined QRMs to be the same as QMs, and may continue to capture the CFPB's tweaks to the various QM categories.

EFFECTS ON THE MARKET

As to the possible effects on the mortgage market of a seasoned QM safe harbor, the CFPB predicts that the reduction in compliance uncertainty and litigation risk will expand lenders' ability to make affordable and innovative mortgage products available, at least marginally. The requirement that the originating lender must hold the loans in its portfolio for 3 years, however, means that not all lenders may be able to take advantage—independent mortgage bankers relying on short-term funding may not be able to wait that long, even if they are willing to retain the early default risk. At least after the seasoning period, those lenders may be able to find a better outlet for the loans than the scratch-and-dent market. Similarly, the limitation on buy-and-hold puts this seasoned QM out of reach for mortgage securitization. In short, depository institutions are the main beneficiary of this exception.

TIMING

The CFPB is suggesting that this new seasoned QM proposal would become effective at the same time as the CFPB's other QM proposals, and that as mentioned above it would apply to loans for which lenders receive applications on and after that date (i.e., not to existing loans).

The CFPB requested comments on all aspects of its seasoned QM proposal, but only for 30 days (until September 28, 2020). ■

Disclosure Technical Standards and Templates Published in Relation to the EU Securitisation Regulation

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Introduction

On 3 September 2020, two regulations were published regarding the detailed disclosure requirements under the Securitisation Regulation[1] (the **"Disclosure Technical Standards"**). These consist of regulatory technical standards concerning the information and the details of a securitisation to be made available (the **"Disclosure RTS"**),[2] and implementing technical standards with regard to the standardised templates (the "**Disclosure ITS**").[3] The Disclosure Technical Standards will enter into force 20 days after publication, i.e. on 23 September 2020.

Background

The Securitisation Regulation has been applicable since 1 January 2019 to all securitisations (as defined therein) other than securitisations existing prior to that date to the extent that they are grandfathered. Under Article 7 of the Securitisation Regulation, the originator, sponsor and SSPE[4] of a securitisation are required to make specified information available to the holders of a securitisation position, the relevant competent authorities and, upon request, to potential investors. This information includes reports on the underlying exposures and investor reports. The reports are required to be provided on a quarterly basis for non-ABCP securitisations and on a monthly basis for ABCP securitisations. In addition, Article 5 of the Securitisation Regulation requires institutional investors, other than the originator, sponsor or original lender, to verify (among other things) that the originator, sponsor or SSPE has, where applicable, made available the information required by Article 7 in accordance with the frequency and modalities set out therein.

The publication of the Disclosure Technical Standards in the Official Journal marks the end of a very lengthy process. ESMA[5] was mandated under Article 7 of the Securitisation Regulation to prepare draft technical standards as regards the detailed information on the underlying exposures and investor reports which are required to be provided, together with draft standardised templates. ESMA's initial Consultation Paper on the draft Disclosure Technical Standards was published in December 2017 and drafts of the Disclosure Technical Standards were published by ESMA over two years ago, in August 2018. Further revisions were made in January 2019 and the European Commission adopted the Disclosure RTS and published the Disclosure ITS in October 2019.

The Templates

The Disclosure RTS contain various Annexes setting out the information that needs to be provided with respect to the underlying exposures, the investor reports and also, for public securitisations,[6] inside information and significant events, and the Disclosure ITS contain Annexes with the templates which are required to be used. From the date on which the Disclosure Technical Standards come into force, the Securitisation Regulation transitional provisions mandating the use of the "CRA3" reporting templates will cease to apply.[7]

The templates are as follows:

Annex	Type of Template	Exposure Type	Type of Securitisation – ABCP / Non-ABCP
Annex II	Underlying exposures	Residential real estate	Non-ABCP
Annex III	Underlying exposures	Commercial real estate	Non-ABCP
Annex IV	Underlying exposures	Corporate	Non-ABCP
Annex V	Underlying exposures	Automobile	Non-ABCP
Annex VI	Underlying exposures	Consumer	Non-ABCP
Annex VII	Underlying exposures	Credit card	Non-ABCP
Annex VIII	Underlying exposures	Leasing	Non-ABCP
Annex IX	Underlying exposures	Esoteric[8]	Non-ABCP
Annex X	Underlying exposures	Add-on for non-performing exposures	Non-ABCP
Annex XI	Underlying exposures		ABCP
Annex XII	Investor report		Non-ABCP
Annex XIII	Investor report		ABCP
Annex XIV	Inside information/ significant event		Non-ABCP
Annex XV	Inside information/ significant event[9]		ABCP

No Data Options

The Disclosure RTS allow the use of certain "No Data" options (**"ND Options"**)[10] which may be used where information cannot be made available, or is not applicable, where this is permitted in the particular Annex. However, these should only be used where there are justifiable reasons and should not be used to circumvent the reporting requirements. In July 2020, ESMA published its Final Report on Guidelines on securitisation repository data completeness and consistency thresholds (the **"ND Guidelines"**).[11] The ND Guidelines are designed to assist securitisation repositories with their obligations to verify the completeness and consistency of the information provided to them with respect to public securitisations. Securitisation repositories are required to verify that the use of ND Options does not prevent the reported information from being sufficiently

representative of the underlying exposures, and certain percentage thresholds with respect to "legacy assets" and "legacy IT systems" apply to the use of ND Options ND1 to ND4.

The ESMA Q&As

ESMA has published a set of questions and answers on the Securitisation Regulation (the **"ESMA Q&As"**)[12] and these provide some useful guidance as to the completion of the templates. The ESMA Q&As also give examples of submission deadlines and data cut-off dates for both ABCP and non-ABCP securitisations.

Other Related Regulations

Further regulations pursuant to the Securitisation Regulation were also published in the Official Journal on 3 September 2020. These relate to the following matters:

- regulatory technical standards specifying the information to be provided in accordance with the STS notification requirements;[13]
- implementing technical standards with respect to templates for the provision of information in accordance with the STS notification requirements;[14]
- regulatory technical standards with respect to the application for registration of a securitisation repository and the simplified application for an extension of registration of a trade repository;[15]
- implementing technical standards with regard to the format of application for registration of a securitisation repository and for extension of registration of a trade repository;[16] and
- regulatory technical standards on securitisation repository operational standards for data collection, aggregation, comparison, access and verification of completeness and consistency.[17]

Conclusion

Market participants have been awaiting the publication of the Disclosure Technical Standards, together with the other regulations referred to above, for some time. While the disclosure templates are detailed and fairly onerous, particularly where asset-level data is required to be reported, market participants have had some time to consider the requirements. We anticipate that market practice as to the interpretation of the precise reporting requirements will continue to develop as the templates are completed in practice. However, the publication of the various regulations should now provide the market with greater certainty.

Endnotes

[1] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

[2] Commission Delegated Regulation (EU) 2020/1224 of 16 October 2019 supplementing Regulation (EU) 2017/2402 of the European Parliament and of the Council with regard to regulatory technical standards specifying the information and the details of a securitisation to be made available by the originator, sponsor and SSPE., available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R1224&from=EN

[3] Commission Implementing Regulation (EU) 2020/1225 of 29 October 2019 laying down implementing technical standards with regard to the format and standardised templates for making available the information and details of a securitisation by the originator, sponsor and SSPE, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R1225&from=EN

[4] Securitisation special purpose entity.

[5] European Securities and Markets Authority.

[6] Transactions for which a prospectus needs to be drawn up under the Prospectus Regulation (Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC).

[7] Article 43(8) of the Securitisation Regulation.

[8] It has been confirmed in the ESMA Q&As (as defined below) that this is the appropriate underlying exposures template for non-ABCP trade receivables.

[9] The ESMA Q&As (as defined below) indicate that the templates in Annexes XIV and XV of the Disclosure ITS are not required to be used for private securitisations, but this dœs not imply that the originator, sponsor and SSPE in a private securitisation do not have to comply with the reporting requirements under Articles 7(1)(f) and 7(1)(g) of the Securitisation Regulation.

[10] The ND Options are as follows:

1. where the required information has not been collected because it was not required by the lending or underwriting criteria at the time of origination of the underlying exposure (ND1);
2. where the required information has been collected at the time of origination of the underlying exposure but is not loaded into the reporting system of the reporting entity at the data cut-off date (ND2);
3. where the required information has been collected at the time of origination of the underlying exposure but is loaded onto a separate system from the reporting system of the reporting entity at the data cut-off date (ND3);
4. where the required information has been collected the time of origination of the underlying exposure but it will only be possible to make it available at a date taking place after the data cut-off date (that later date must be specified) (ND4); and
5. where the required information is not applicable to the item being reported (ND5).

[11] ESMA Final Report on Guidelines on securitisation repository data completeness and consistency thresholds dated 10 July 2020, available at https://www.esma.europa.eu/press-news/esma-news/esma-publishes-guidelines-securitisation-repository-data-completeness-and

[12] Questions and Answers On the Securitisation Regulation, Version 5, last updated on 28/05/2020, available at https://www.esma.europa.eu/press-news/esma-news/esma-updates-its-questions-and-answers-securitisation-regulation

[13] Commission Delegated Regulation (EU) 2020/1226 of 12 November 2019 supplementing Regulation (EU) 2017/2402 of the European Parliament and of the Council and laying down regulatory technical standards specifying the information to be provided in accordance with the STS notification requirements, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R1226&from=EN

[14] Commission Implementing Regulation (EU) 2020/1227 of 12 November 2019 laying down implementing technical standards with regard to templates for the provision of information in accordance with the STS notification requirements, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R1227&from=EN

[15] Commission Delegated Regulation (EU) 2020/1230 of 29 November 2019 supplementing Regulation (EU) 2017/2402 of the European Parliament and of the Council with regard to regulatory technical standards specifying the details of the application for registration of a securitisation repository and the details of the simplified application for an extension of registration of a trade repository, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R1230&from=EN

[16] Commission Implementing Regulation (EU) 2020/1228 of 29 November 2019 laying down implementing technical standards with regard to the format of applications for registration as a securitisation repository or for extension of a registration of a trade repository pursuant to Regulation (EU) 2017/2402 of the European Parliament and of the Council, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R1228&from=EN

[17] Commission Delegated Regulation (EU) 2020/1229 of 29 November 2019 supplementing Regulation (EU) 2017/2402 of the European Parliament and of the Council with regard to regulatory technical standards on securitisation repository operational standards for data collection, aggregation, comparison, access and verification of completeness and consistency, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R1229&from=EN

Recommendations for Developing the EU Securitisation Market – Report by the High Level Forum on Capital Markets Union

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Introduction

A recent report, entitled "A New Vision for Europe's Capital Markets"[1] (the "**Report**"), sets out some key recommendations for how the EU securitisation market can be scaled up. The Report has been published by the High Level Forum on the Capital Markets Union (the "**HLF**") which was established by the European Commission (the "**Commission**"). The recommendations cover some key areas of interest for market participants.

Background

Capital Markets Union has been an important part of the European regulatory agenda for some time, and was the subject of an Action Plan adopted by the Commission in September 2015.[2] The HLF is composed of experts in the European capital markets, alongside a number of observers from European supervisory bodies and institutions. The views expressed in the Report are those of its members and not the Commission. Nonetheless, the views expressed in the Report are expected to inform the future work of the Commission.

The Report makes seventeen sets of recommendations in relation to different aspects of the EU markets. In this Legal Update, we have focused solely on the recommendations relating to the EU regulatory framework which applies to securitisation.

The Report

The Report expresses clear support for securitisation and recognises the important role that securitisation transactions can play in the European economy. It notes that securitisation offers opportunities for investors to invest in credit exposures that otherwise would not be available to them. Credit risk can be diversified so that it does not solely stay with banks, and instead other funding sources can be accessed. Banks can also free up their balance sheets which gives them more opportunities to provide funding, in particular to small and medium-sized enterprises (SMEs). Securitisation also provides financing to specialist lenders who provide loans to borrowers who are not served by bank lending. In addition, it is recognised that securitisation can have a key role in dealing with the economic effects of the COVID-19 pandemic. Given these benefits, the Report recommends a review of various items with a view to making targeted and prudentially sound modifications which would improve the regulatory regime for securitisation.

It is worth keeping in mind that the regulatory regime applying to EU market participants in securitisations has developed significantly since the financial crisis. Investors have for a number of years been required to ensure compliance with risk retention and other requirements, and the Securitisation Regulation,[3] which became applicable from 1 January 2019, further expanded and consolidated the rules relating to securitisation, including the introduction of direct risk retention obligations for originators, sponsors and original lenders, enhanced transparency obligations and a framework for "simple, transparent and standardised", or "STS", securitisation. In addition, regulatory capital requirements have been increased in various respects, including under the amended Capital Requirements Regulation[4] (the "**CRR**"). This means that securitisations are generally subject to significantly higher regulatory capital requirements than they were previously, and this is out of line with the capital requirements for non-securitised exposures and other products such as covered bonds. Given that European securitisations have for the most part performed well in recent years, the Report suggests that there has been an overreaction in terms of the regulatory regime and that some streamlining of the regulations is required. It is also noted that the STS framework is very conservative and this has prevented it from reaching its objective.

The recommendations relating to securitisation in the Report cover the following areas:

- unlocking the significant risk transfer ("**SRT**") assessment process;
- recalibrating the capital charges which are applicable to senior tranches under the CRR;
- recalibrating the capital charges for securitisation tranches under the Solvency II regime;[5]
- reducing the costs of SME financing;
- equivalent regulatory treatment for cash and synthetic securitisations;
- upgrading the eligibility of senior STS and non-STS tranches in the Liquidity Coverage Ratio (the "LCR"); and
- differentiating the disclosure and due diligence requirements for public and private securitisations.

Unlocking the SRT Assessment Process

The Report proposes that the Commission should review the SRT assessment process and recalibrate when an advance (or "ex-ante") assessment by the competent authority is required. It states that, provided the required quantitative and qualitative criteria are met and the transaction is in line with standard market practice, it should not be necessary for the regulator to carry out a systematic review of the transaction in advance. Such an assessment should be limited to those complex transactions that include structuring features that diverge from generally accepted market standards and/or from the quantitative and qualitative criteria set out in the CRR.

Market participants are likely to welcome these proposals as they would make the process of achieving SRT quicker and simpler for market standard transactions, and would provide certainty as to whether SRT can be achieved. This could then free up capital for the banks.

Recalibrating Capital Charges Applied to Senior Tranches Under the CRR

The Report proposes that the following should be considered:

- recalibration of the capital charges applicable to senior tranches in line with their risk profile and reduction of risk weighted capital floors (especially for originator and sponsor banks);
- establishing risk-sensitive calculations of the weighted average maturity (WAM) of tranches for both cash and synthetic securitisations;
- reviewing the loss given default (LGD) input floors; and
- encouraging further development of the European non-performing exposure securitisation market.

Making regulatory capital requirements more risk-sensitive, particularly in comparison with other products like covered bonds and the requirements for non-securitised exposures, would be extremely helpful and would assist banks in holding securitisation exposures.

Recalibrating Capital Charges for Securitisation Tranches Under the Solvency II Regime

The Report proposes a review of whether the capital charges for securitisation positions applicable to insurers under Solvency II should be recalibrated in order to reduce the gap, and in some cases realign the capital charges, between STS securitisations and covered/corporate bonds, STS and non-STS securitisations and senior and non-senior tranches.

Such amendments are likely to be beneficial in encouraging insurance companies to invest in securitisations.

Reducing the Costs of SME Financing

The Report recommends that the Commission should encourage significantly higher investment in SMEs. The proposals concern data collection and disclosure. It suggests the creation of an EU version of the US EDGAR system and that rules are made to ensure credit data and filings will be compatible with this database. It is envisaged that the central collection of such information will facilitate the financing of SMEs by means of securitisation. In addition, efforts should be continued to improve credit underwriting standards and reduce nonperforming loans in the SME sector.

Equivalent Regulatory Treatment For Cash And Synthetic Securitisations

The Report recommends that the Commission should consider extending the STS framework to synthetic securitisations and granting preferential regulatory capital treatment to senior tranches of synthetic securitisations which meet the STS requirements. This follows the recent report by the European Banking Authority on this topic.[6]

The development of an STS framework for synthetic securitisations, together with reductions in the regulatory capital requirements, would be a very welcome development which would facilitate the development of this market.

Upgrading the Eligibility of Senior STS and Non-STS Tranches in the LCR

The Report proposes that the Commission should consider whether the eligibility criteria for the LCR should be amended. This would involve the following:

- upgrading the treatment of large senior tranches of STS securitisations;
- allowing senior tranches which formerly qualified as Level 2B to requalify even if they do not meet all the requirements.

It had been hoped that, under the new regime, exposures to STS transactions would be able to be treated more favourably for LCR purposes in recognition of their STS status, and in line with the treatment of covered bonds, but instead STS securitisation exposures are currently treated as Level 2B, while asset-backed securities can no longer qualify as Level 2B securitisations unless they are STS.

If this could be remedied, it is likely that this would significantly incentivise banks to acquire senior securitisation positions, both STS and non-STS.

Differentiating the Disclosure and Due Diligence Requirements for Public and Private Securitisations

The Report proposes simplifying and clarifying the due diligence and disclosure provisions of the Securitisation Regulation.

Firstly, it is proposed that the disclosure requirements under the Securitisation Regulation should be different depending on whether the securitisation is public[7] or private. It is recommended that the disclosure technical standards[8] being developed under Articles 7(3) and 7(4) of the Securitisation Regulation should only apply to public securitisations. In relation to private securitisations, a proportionate approach should be allowed with respect to the due diligence and disclosure requirements, with reference to the risk profile of the securitisation.

In addition, it is suggested that it should be possible to allow "No Data" fields to be used in the reporting templates in the long term and, where the use of "No Data" fields needs to be reduced, to allow for a transition period.

Furthermore, it is proposed that it should be clarified that Article 5(1)(e) of the Securitisation Regulation does not apply with respect to third-country securitisations, i.e. where the originator, sponsor or securitisation special purpose entity ("SSPE") are not established in the EU. Instead, EU-regulated investors would be able to meet their due diligence obligations under Article 5 if they receive sufficient information which is proportionate to the risk profile of the securitisation.

Finally, securitisation of legacy portfolios should be facilitated by allowing entities that acquire such portfolios to re-underwrite the loans. The suggested amendment would allow an originator which purchases exposures from a third party and then securitises them to carry out due diligence with respect to compliance with the credit-granting requirements, which would be disclosed to investors.

The above points are particularly significant. The completion of the detailed asset-level reporting templates is expected to be time-consuming and onerous, and may not be considered to be

of much value in some private transactions, for example, in a trade receivables transaction where the banks will be working closely with the originator in structuring the transaction and will in any event specify detailed requirements for the information they require to be included in the reports. The recognition of the need for proportionality will be welcomed.

In many cases originators and banks will welcome some flexibility and tolerance as to the use of "No Data" options under the reporting templates, for example, where data is not easily available or where it is difficult to complete the templates.

The interpretation of Article 5(1)(e) of the Securitisation Regulation has been the subject of much debate with respect to EU investors involved in securitisations where the originators, sponsors or SSPEs are not established in the EU. Article 5(1)(e) provides that an institutional investor (other than an originator, sponsor or original lender) must verify that "the originator, sponsor or SSPE has, where applicable, made available the information required by Article 7 in accordance with the frequency and modalities provided for in that Article". The jurisdictional scope of this requirement is not explicitly specified. Whilst it is generally agreed that Article 7 does not apply directly to non-EU entities, it is not clear from the wording of Article 5(1)(e) whether institutional investors, as part of their due diligence obligations, need to verify that originators, sponsors and SSPEs which are not established in the EU have provided the relevant information in accordance with the Article 7 requirements. This issue is causing significant practical issues. Asset-level data may not be required for a particular type of transaction or asset class in the originator's jurisdiction, and in cases where asset-level data is required it may not be provided in the form of the reporting templates. While clarification that Article 5(1)(e) does not apply to such third country securitisations will certainly be welcomed, the recommendation indicates that it will still be necessary for EU investors to obtain some information, and it will be essential that the wording of this requirement is sufficiently clear for investors to be able to determine with confidence whether they have complied with their obligations.

Verifying compliance with the credit-granting requirements has been a practical problem for some securitisations involving legacy portfolios and the proposed wording would go some way towards facilitating these transactions.

Conclusion

The above recommendations reflect issues which have been discussed by market participants for some time, and as such are likely to be received very positively. There are also other issues which have been raised by market participants which have not been addressed in the Report. Given the urgent need to revitalise the European economy, particularly in the wake of the COVID-19 pandemic, it is likely that a piecemeal approach will not be sufficient and a comprehensive package of reforms will have the most impact on the securitisation market. In terms of next steps, some of the reforms depend on amendments to the Level 1 text, which will require the agreement of the European Parliament and the Council as well as the Commission. Certain reforms may take longer if they are to be aligned with the Basel regulatory capital requirements. Where issues may be

clarified by providing guidance, for example with respect to due diligence requirements, it would be beneficial if this could be provided quickly. While any changes may take some time to put into effect, many market participants will be keen to see progress as soon as possible in order to facilitate the expansion of the European securitisation market and to allow increased funding to be provided to the European economy in the near future. ■

Endnotes

[1] A new Vision for Europe's capital markets – Final Report of the High Level Forum on the Capital Markets Union, published on 10 June 2020, available at https://ec.europa.eu/info/sites/info/files/ business_economy_euro/growth_and_investment/ documents/200610-cmu-high-level-forum-final-report_en.pdf

[2] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – Action Plan on Building a Capital Markets Union, 30 September 2015.

[3] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

[4] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, as amended.

[5] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast), as amended.

[6] Please see our Legal Update - EBA publishes its report on the creation of an STS framework for synthetic securitisations, available at https://www.mayerbrown.com/en/perspectives-events/ publications/2020/06/ eba-publishes-its-report-on-the-creation-of-an-sts-framework-for-synthetic-securitisations

[7] Public securitisations are those where a prospectus is required to be drawn up under the Prospectus Regulation (Regulation (EU) 2017/1129 of the European Parliament and of the Council of 4 of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC).

[8] The regulatory technical standards specifying the information that originators, sponsors and securitisation special purpose entities are required to provide in order to comply with their transparency obligations under Article 7 of the Securitisation Regulation, and the related implementing technical standards regarding the reporting templates, have been adopted by the Commission but are not yet in force.

Securitisation after Brexit — Considerations for Securitisations Involving UK Entities

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Introduction

The UK left the EU on 31 January 2020 at 11:00 p.m. UK time. This legal update summarises the application of EU law in the UK after Brexit, with particular reference to the Securitisation Regulation.

Brexit and the Application of EU Law in the UK after the Transition Period

On 17 October 2019, the UK and the EU entered into a withdrawal agreement in relation to Brexit (the **"Withdrawal Agreement"**).

The Withdrawal Agreement provides for a transition period from the exit date until 31 December 2020 (unless such period is extended). During this transition period, EU directives which have already been implemented into UK law and EU regulations (which are directly applicable in EU member states without the need for any local law implementing measures) will continue to apply in the UK. New EU regulations will also automatically become part of UK law during that period. Any reference to "Member States" in such EU laws will be construed to include the UK (unless otherwise stated in the Withdrawal Agreement).

Consequently, although the UK is no longer in the EU, it will continue to be treated as an EU member state during the transition period and the EU Securitisation Regulation will apply with respect to institutional investors, originators, sponsors, original lenders and securitisation special purpose entities (**"SSPEs"**) which are established in the UK.

Since any new EU regulations will be directly applicable in the UK during the transition period, any new technical standards relating to the Securitisation Regulation which are finalised before the end of that period will also apply in the UK (although it is likely that they will need to be amended through statutory instruments as regards their application after the transition period - as to which please see below). These are likely to include the EU delegated regulations setting out the technical standards relating to disclosure, which will include the new mandatory forms of reporting templates, and those relating to risk retention.

The Application of EU Law in the UK after the Transition Period

The European Union (Withdrawal) Act 2018, as amended by the European Union (Withdrawal Agreement) Act 2020, provides for the repeal of the European Communities Act 1972, thus ending the supremacy of EU law in the UK. It also provides that at the end of the transition period, existing EU laws will be "onshored", i.e. become part of a new category of UK domestic law known as "retained EU law", which after that can only be amended by UK legislation (not by subsequent EU legislation).

In connection with this onshoring process, government ministers have been granted the power to make secondary legislation to amend such retained EU law in order to prevent, remedy or mitigate any failure of retained EU law to operate effectively, or any other "deficiency" in such law, in each case which arise as a result of Brexit. Several hundred UK statutory instruments have been put in place under these powers, in order to make sure this retained EU law functions in the UK following the end of the transition period. Originally designed to come into effect in the event of a no-deal Brexit, these regulations will now apply from the end of the transition period.

One of these statutory instruments is the Securitisation (Amendment) (EU Exit) Regulations 2019 (the **"UK Securitisation Regulations 2019"**), which amend the Securitisation Regulation as it will apply in the UK after the transition period.

These regulations make a number of general amendments to the Securitisation Regulation such as changing references to "the Union" to "the United Kingdom" and removing references to "the EBA" and "ESMA" so that supervisory responsibility is assumed by the appropriate UK regulator. In addition, there are other important changes which go further.

The UK Securitisation Regulations 2019 make certain amendments to the definition of "sponsor", which are likely to be seen as helpful. These include changes to make it clear that an "investment firm" will be capable of being a sponsor if it is located in a "third country" (i.e., outside the UK). It is not clear from the wording of the Securitisation Regulation how the sponsor definition should be interpreted with respect to third country investment firms, and it remains to be seen whether the EU supervisory authorities will interpret the sponsor definition in the EU regime in a similar way.

There are also amendments which provide some flexibility in the requirements for simple, transparent and standardised, or "STS" securitisations and which allow for a limited grandfathering period for transactions which have been notified as being STS under the EU regime. However, there are currently no reciprocal arrangements in the EU securitisation regime to recognise transactions which would be STS under the UK regime, for the purposes of the EU regime.

Nor are there any grandfathering provisions in the EU regime for transactions with UK originators, sponsors and SSPEs which have been notified as being STS before the end of the transition period (the Securitisation Regulation requires such entities to be established in the EU as a condition for STS treatment).

In addition, the UK Securitisation Regulations 2019 amend the due diligence requirements for institutional investors under Article 5(1)(e) of the Securitisation Regulation with respect to disclosure

by originators, sponsors and SSPEs in accordance with Article 7 of the Securitisation Regulation. The interpretation of Article 5(1)(e) of the Securitisation Regulation, which concerns the question of whether an EU institutional investor needs to obtain the relevant disclosure from a non-EU originator, sponsor or SSPE in order to comply with its due diligence requirements, is an area of uncertainty. Non-EU originators, sponsors and SSPEs are generally not considered to be directly subject to the Article 7 disclosure requirements, and may be unwilling or unable to provide such disclosure, in the form of the new reporting templates or otherwise. Market participants are hoping for guidance from the European Supervisory Authorities which will allow EU investors to invest in such transactions. Depending on the approach taken in the EU, the position set out in the UK Securitisation Regulations 2019 could result in different interpretations being taken of the due diligence requirements in the UK, compared to that taken in the EU.

Further details of the changes to the Securitisation Regulation in the UK under the UK Securitisation Regulations 2019 can be found in our previous Legal Update "Onshoring the Securitisation Regulation – How will it apply in the UK in the event of a no-deal Brexit?" (except that the changes are now expected to take effect following the transition period rather than on exit day as originally intended).

The amendments made to the Securitisation Regulation by the UK Securitisation Regulations 2019 will result in a parallel UK securitisation regime from the end of the transition period which will be similar to, but not identical to, the Securitisation Regulation. This will be subject to any further amendments which may be made as a result of the negotiations between the UK and the EU, and any future amendments that may be made in the UK.

What about Offering Documents and Transaction Documents?

While it is not possible to predict fully the situation after the end of the transition period, there are some steps that can be taken when drafting offering documents and transaction documents for transactions entered into during that period in order to reflect the fact that the UK is no longer part of the EU.

In the case of offering documents, amendments may be required to deal with this. For example, changes may be required to be made to legends and selling restrictions, since they may refer in some places to member states of the EEA (which consists of the EU member states together with Iceland, Liechtenstein and Norway). These amendments will not be major, since EU regulations (such as the Prospectus Regulation and the PRIIPs Regulation) will continue to apply in the UK during the transition period. However, where there is a reference to a member state of the EEA, small amendments will need to be made to ensure that it is clear that the relevant wording is referring to the UK as well as to the EEA member states. In addition, a Brexit risk factor (updated to reflect that Brexit has now occurred) will often be included.

In the case of transaction documents, these should also be reviewed in order to consider whether any changes are required, for example to check whether any references to the EU need to be updated to add references to the UK.

Further changes are likely to be required for transactions entered in or amended following the transition period, and it is important to monitor the situation closely where UK entities are involved in a securitisation.

US Agencies Finalize Revisions to Volcker Rule Covered Funds Provision

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On June 25, 2020, the Board of Governors of the Federal Reserve System ("Board"), the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC") (collectively, the "Agencies") finalized revisions to the covered funds provisions of the Volcker Rule (the "2020 Revisions").[1] The 2020 Revisions address the prohibitions and restrictions regarding covered fund activities. The Agencies intend for the 2020 Revisions to clarify, streamline, and ease the compliance burden of the covered funds provisions of the Volcker Rule by:

- Codifying foreign excluded fund relief for non-US banking entities;
- Incorporating some Section 23A exemptions relating to certain transactions with affiliates into the "Super 23A" restrictions;
- Easing the compliance burden for loan securitizations, foreign public funds, and small business investment companies;
- Creating four new exclusions for banking entities to invest in or sponsor credit funds, venture capital funds, customer facilitation funds, and family wealth management vehicles;[2]
- Narrowing the scope of the definition of ownership interest; and
- Clarifying the treatment of parallel direct investments by a banking entity in the same underlying investments as a sponsored covered fund.

The 2020 Revisions are largely consistent with the notice of proposed rulemaking published six months ago and incorporate comments received to questions posed in a 2018 proposal.[3] However, the 2020 Revisions also reflect some important, and welcome, clarifications and other adjustments.

In particular, non-US banks should appreciate the greater certainty under the codification of the exemptions for qualifying foreign excluded funds. Similarly, the structured finance industry should have a clearer and easier path to follow for its offerings, and issuers of structured products will have greater flexibility to design new and innovative products for their customers. All market participants should benefit from the adoption of exemptions from the Super 23A restrictions.

The 2020 Revisions become effective on October 1, 2020, and, unlike the Agencies' 2019 rulemaking focused on the proprietary trading provisions of the Volcker Rule, do not contain a transitional period or option for early adoption.[4]

We have summarized the finalized revisions below.

Exemptions for Qualifying Foreign Excluded Funds

The 2020 Revisions create new exemptions to the prohibitions against proprietary trading and covered fund activities (as opposed to exclusions) for qualifying foreign excluded funds. Currently, a non-US fund that is offered and sold outside of the United States could become subject to the prohibitions against proprietary trading and engaging in covered fund activities as a result of being excluded from the definition of a covered fund. This would occur if a non-US banking entity controlled the excluded fund (e.g., based on common corporate governance, such as if the fund's sponsor selects the majority of the fund's directors or trustees), with the result that the excluded fund would itself be considered a banking entity and therefore be subject to the Volcker Rule's proprietary trading and covered fund restrictions.

The federal banking agencies initially addressed this issue by announcing in a joint policy statement that they would not take enforcement action against a non-US banking entity based on the activities and investments of its foreign excluded funds that met certain criteria, referred to as "qualifying foreign excluded funds."[5] The 2020 Revisions codify this regulatory relief by creating an exemption for such funds using the same criteria as the policy statement. Specifically, the exemptions will be available to a banking entity (i.e., the foreign excluded fund) that:

- Is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States;
- Would be a covered fund if the entity were organized or established in the United States or is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments;
- Would not otherwise be a banking entity except by virtue of the acquisition or retention of an ownership interest in, sponsorship of, or relationship with the entity by another banking entity that meets the following criteria: (i) the banking entity is not organized, or directly or indirectly controlled by a banking entity that is organized, under the laws of the United States or of any state and (ii) the banking entity's acquisition or retention of an ownership interest in or sponsorship of the fund meets the requirements for permitted covered fund activities and investments solely outside the United States, as provided in Section __.13(b);
- Is established and operated as part of a bona fide asset management business; and
- Is not operated in a manner that enables the foreign banking entity or an affiliate of the foreign banking entity (other than the foreign excluded fund) to evade the requirements of the Volcker Rule.[6]

The 2020 Revisions also provide that foreign excluded funds are not required to maintain a Volcker Rule compliance program or comply with the reporting and documentation requirements of the Volcker Rule. However, a foreign excluded fund remains a banking entity under the Volcker Rule, and, therefore, transactions with a foreign excluded fund may be subject to the restrictions of Super 23A (discussed below).

Modifications to Existing Exclusions

LOAN SECURITIZATIONS[7]

The existing loan securitization exclusion ("LSE") excludes certain loan securitization vehicles[8] from the definition of covered funds if they hold only loans and certain loan-related rights and assets. The 2020 Revisions relax two key eligibility criteria to rely on the LSE.

First, the 2020 Revisions permit a qualifying loan securitization to hold debt securities (excluding asset-backed securities and convertible securities) of no more than 5 percent of the securitization's total assets.[9] This partially responds to industry feedback that historically such vehicles incorporated "bond buckets" and other types of non-loan assets in the pool of securitized loan assets. However, it is somewhat narrower than the proposal, which would have allowed holdings of any non-loan asset.[10]

Second, the 2020 Revisions codify an FAQ issued by the Agencies in 2014, which indirectly addressed a typographical error in the regulation by stating that, while a servicing asset may or may not be a security, if the servicing asset is a security, it must be a permitted security under the exclusion.[11] The definition of "cash equivalents" in the FAQ relating to the definition of "permitted security" also is codified by the 2020 Revisions, clarifying that cash equivalents are not required to be short-term.[12] The preamble to the 2020 Revisions further states that the Agencies are not modifying or revoking any previously issued staff FAQs, unless otherwise specified.

In response to industry concern, the preamble to the 2020 Revisions explicitly clarifies that leases and leased property should be permissible assets under the LSE. Specifically, the preamble states that leases are already included in the definition of "loans," and thus are already permitted assets under the current exclusion, and notes that any residual value of such leased property upon expiration of an operating lease should meet the requirements to constitute an asset that is related or incidental to purchasing or otherwise acquiring and holding loans.

While not specifically addressed by the Agencies, the 2020 Revisions have the effect of relaxing the eligibility criteria for qualifying asset-backed commercial paper conduits and qualifying covered bonds. Those exclusions incorporate the LSE, and, therefore, vehicles that rely on those exclusions should be able to rely on the 5 percent bond bucket, expanded definition of cash equivalents, and clarified guidance on leases and leased assets.

FOREIGN PUBLIC FUNDS

The 2020 Revisions modify the current exclusion for foreign public funds by updating relevant definitions, requirements, and limitations.[13] Currently, a "foreign public fund" is defined as any investment fund that is organized outside of the United States, the ownership interests of which are (1) authorized

to be sold to retail investors in the fund's home jurisdiction and (2) sold predominantly through one or more public offerings outside of the United States. The 2020 Revisions replace these requirements with a single requirement that ownership interests in the putative covered fund are offered and sold through at least one public offering outside of the United States.

To help ensure that funds qualifying for the exclusion are sufficiently similar to US registered investment companies, the 2020 Revisions modify the definition of "public offering" to add a new requirement that the distribution is subject to substantive disclosure and retail investor protection laws or regulations in the jurisdiction where it is made. Additionally, the 2020 Revisions limit the requirement that distributions comply with all applicable requirements in the jurisdiction where it is made to apply only to instances when a banking entity acts as the investment manager, investment adviser, commodity trading advisor, commodity pool operator, or sponsor of the fund, addressing potential difficulties faced by a banking entity investing in a fund sponsored by a third party.

The 2020 Revisions also eliminate the limitation on selling ownership interests of the foreign public fund to US and non-US employees (other than senior executive officers) of the sponsoring banking entity or fund (or affiliates of the banking entity or fund). The limits on the sale of ownership interests to directors or senior executive officers of the sponsoring banking entity or the fund (or their affiliates) remain in place.[14]

The 2020 Revisions clarify that attribution of ownership requirements in Section __.12(b) (which apply to certain registered investment companies, SEC-regulated business development companies, and foreign public funds), more clearly indicating that the ownership limit applies to the banking entity and its affiliates, in the aggregate, and the requirement that the banking entity provide advisory or other services can be satisfied by the banking entity or its affiliates.

PUBLIC WELFARE FUNDS AND SMALL BUSINESS INVESTMENT COMPANIES

Public Welfare Funds, Rural Business Investment Companies, and Qualified Opportunities Funds

The 2020 Revisions expand the exclusion for public welfare investment funds to explicitly incorporate funds, the business of which is to make investments that qualify for consideration under the federal banking agencies' regulations implementing the Community Reinvestment Act. They also add similar exclusions for rural business investment companies ("RBICs") and qualified opportunities funds (established under the "opportunity zone" program from the Tax Cuts and Jobs Act) ("QOFs").[15]

Small Business Investment Companies

The 2020 Revisions revise the small business investment companies ("SBICs") exclusion to clarify how the exclusion would apply to SBICs that surrender their license during wind-down phases. The revision specifies that the exclusion for SBICs applies to an issuer that was an SBIC that has voluntarily surrendered its license to operate as a small business investment company in accordance with 13 C.F.R. § 107.1900 and does not make new investments (other than investments in cash equivalents) after such voluntary surrender. The expanded exclusion, however, will not be available for an SBIC that has had its license revoked.

New Covered Fund Exclusions

CREDIT FUNDS

The 2020 Revisions create a new exclusion for credit funds that make loans, invest in debt, or otherwise extend the type of credit that banking entities may provide directly under applicable banking law. A "credit fund" is defined as an issuer whose assets consist solely of: (i) loans; (ii) debt instruments; (iii) related rights and other assets that are related or incidental to acquiring, holding, servicing, or selling loans or debt instruments (excluding commodity forward contracts and derivatives); and (iv) certain interest rate or foreign exchange derivatives.

The exclusion is subject to certain limitations and conditions. Under the 2020 Revisions, a credit fund may not (i) engage in activities that would constitute proprietary trading, as defined in Section __.3(b)(1)(i) of the Volcker Rule[16] (as if the fund were a banking entity), or (ii) issue asset-backed securities.[17] Additionally, the availability of the credit fund exclusion is subject to compliance with the following conditions:

- If a banking entity sponsors or serves as an investment adviser or commodity trading advisor to a credit fund, the banking entity is required to provide disclosures specified in Section __.11(a)(8) to any prospective and actual investor (e.g., that losses will be borne solely by investors and not the banking entity and that the ownership interests in the fund are not insured by the FDIC and are not deposits, obligations of, or endorsed or guaranteed by the banking entity, among others) and ensure that the activities of the credit fund are consistent with safety and soundness standards that are substantially similar to those that would apply if the banking entity engaged in the activities directly;
- A banking entity may not rely on the credit fund exclusion if (i) it guarantees, assumes, or otherwise insures the obligations or performance of the fund or (ii) the fund holds any debt securities, equity, or rights to receive equity that the banking entity would not be permitted to acquire and hold directly under applicable federal banking law;
- A banking entity's investment in and relationship with a credit fund is required to comply with the "Super 23A" restrictions in Section __.14 (except the banking entity is permitted to acquire and retain any ownership interest in the credit fund), and the prudential limitations in Section __.15 regarding material conflicts of interest, high-risk investments, and safety and soundness and financial stability, in each case as though the credit fund were a covered fund;
- A banking entity's investment in, and relationship with, a credit fund also are required to comply with applicable safety and soundness standards; and
- A banking entity that invests in or has a relationship with a credit fund continues to be subject to capital charges and other requirements under applicable banking law.[18]

VENTURE CAPITAL FUNDS

The 2020 Revisions create a new exclusion for a qualifying "venture capital fund," which is defined as an issuer that meets the definition in Rule 203(l)-1 under the Investment Advisers Act of 1940 and that does not engage in any activity that would constitute proprietary trading (as defined in Section __.3(b)(1)(i) of the Volcker Rule), as if it were a banking entity.[19] In order to rely on the exclusion, any banking entity that acts as a sponsor,

investment adviser, or commodity trading adviser to the venture capital fund is required to provide in writing to any prospective and actual investor the disclosures required under Section __.11(a)(8), as if the venture capital fund were a covered fund, and ensure that the activities of the fund are consistent with safety and soundness standards that are substantially similar to those that would apply if the banking entity engaged in the activities directly.

The exclusion also requires a banking entity's ownership interest in or relationship with a qualifying venture capital fund comply with the restrictions imposed by Super 23A (discussed below) (except the banking entity could acquire and retain any ownership interest in the fund) and by the prudential backstops, as if the venture capital fund were a covered fund. It also must be conducted in compliance with, and subject to, applicable banking laws and regulations, including applicable safety and soundness standards. A banking entity that relies on the exclusion may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the venture capital fund.

The preamble to the 2020 Revisions indicates that the Agencies determined not to impose a cap on the total annual revenue of an excluded venture capital fund. Additionally, other similar restrictions that were considered in the proposal, but generally were not supported by commenters, were not adopted.

FAMILY WEALTH MANAGEMENT VEHICLES

The 2020 Revisions create a new exclusion for family wealth management vehicles. Under the new exclusion, a "family wealth management vehicle" includes any entity that is not, and does not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities, provided that (i) if the entity is a trust, the grantor(s) of the entity are all family customers[20] and (ii) if the entity is not a trust, a majority of the voting interests and a majority of all interests are owned (directly or indirectly) by family customers and the entity is owned only by family customers and up to five closely related persons[21] of the family customers.[22]

Under the 2020 Revisions, this exclusion is available to a banking entity only if it (or an affiliate):

1. Provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the family wealth management vehicle;
2. Does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of such family wealth management vehicle;
3. Complies with the disclosure obligations under Section __.11(a)(8), as if the family wealth management vehicle were a covered fund;[23]
4. Does not acquire or retain, as principal, an ownership interest in the entity, other than up to 0.5 percent of the entity's outstanding ownership interests that may be held by the banking entity and its affiliates (or another third party) for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns;
5. Complies with the Super 23A restrictions and prudential backstops (i.e., Sections __.14(b) and __.15) as if the family wealth management vehicle were a covered fund; and
6. Complies with the low-quality assets prohibition of Regulation W (12 C.F.R. § 223.15(a)), as if such banking entity and its

affiliates were a member bank and the family wealth management vehicle were an affiliate thereof, although the banking entity may make such purchases from family wealth management vehicles if they are riskless principal transactions.

CUSTOMER FACILITATION VEHICLES

The 2020 Revisions create a new exclusion for customer facilitation vehicles. A customer facilitation vehicle will include any issuer formed by or at the request of a customer of a banking entity for the purpose of providing such customer (which may include one or more affiliates of such customer) with exposure to a transaction, investment strategy, or other service provided by the banking entity, including, for example, in connection with structured note issuances. Customers have considerable flexibility as there are no restrictions on the types of instruments which may be included within a customer facilitation vehicle.

While customer facilitation vehicles must be formed by or at the request of a customer, there is no reverse-inquiry requirement. A banking entity may discuss the potential structure of a customer facilitation vehicle and the related benefits, including legal, accounting and counterparty risk management advantages, with customers prior to the creation of any vehicle. Additionally, a banking entity may market its customer facilitation vehicle services.

A banking entity is required to satisfy the following conditions to rely on the exclusion for customer facilitation vehicles:

1. All of the ownership interests of the customer facilitation vehicle are owned by the customer (which may include one or more of its affiliates) for whom the vehicle was created, subject to paragraph 2.d. below; and
2. The banking entity and its affiliates:
    a. Maintain documentation outlining how the banking entity intends to facilitate the customer's exposure to such transaction, investment strategy, or service;
    b. Do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the customer facilitation vehicle;
    c. Comply with the disclosure obligations under Section __.11(a)(8), as if the customer facilitation vehicle were a covered fund;[24]
    d. Do not acquire or retain, as principal, an ownership interest in the customer facilitation vehicle, other than up to 0.5 percent of the vehicle's outstanding ownership interests that may be held by the banking entity and its affiliates (or another third-party) for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns;
    e. Comply with the Super 23A restrictions and prudential backstops (i.e., Section __.14(b) and __.15) as if the customer facilitation vehicle were a covered fund; and
    f. Comply with the low-quality assets prohibition of Regulation W (12 C.F.R. § 223.15(a)), as if such banking entity and its affiliates were a member bank and the customer facilitation vehicle were an affiliate thereof, although the banking entity may make such purchases from customer facilitation vehicles if they are riskless principal transactions.

Exemptions from Super 23A Restrictions

The Volcker Rule generally prohibits a banking entity from entering into a transaction with a covered fund that would be a covered transaction as defined in Section 23A of the Federal Reserve Act (e.g., a loan or extension of credit to an affiliate, or a purchase of or an investment in securities issued by an affiliate). Section 23A of the Federal Reserve Act, as implemented by the Board in Regulation W, includes a number of exemptions from its restrictions that were not incorporated by the Volcker Rule. This resulted in the restrictions under the Volcker Rule (referred to as "Super 23A" because it applies the Section 23A restrictions to a broad set of transactions by nonbank affiliates) applying to a much larger universe of relationships.

EXEMPT TRANSACTIONS UNDER SECTION 23A AND THE BOARD'S REGULATION W

The 2020 Revisions permit a banking entity to engage in covered transactions with a related covered fund that would be exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition under Section 23A of the Federal Reserve Act, including transactions that would be exempt pursuant to 12 C.F.R. § 223.42. Such exempt transactions include making correspondent banking deposits, giving credit for uncollected items, and transactions secured by cash or US government securities, among others. However, the preamble to the 2020 Revisions clarifies that exemptions under Regulation W that require the related covered fund to be a securities affiliate generally would be available only if the related covered fund actually is a securities affiliate.

SHORT-TERM EXTENSIONS OF CREDIT AND ACQUISITIONS OF ASSETS IN CONNECTION WITH PAYMENT, CLEARING, AND SETTLEMENT SERVICES

The 2020 Revisions permit a banking entity to provide short-term extensions of credit to and purchase assets from a related covered fund, subject to limitations. Such limitations include:

- Each short-term extension of credit or purchase of assets must be made in the ordinary course of business in connection with payment transactions; securities, derivatives, or futures clearing; or settlement services;
- Each extension of credit is required to be repaid, sold, or terminated no later than five business days after it was originated; and
- Each short-term extension of credit must also meet the same requirements applicable to intraday extensions of credit under 12 C.F.R. § 223.42(l)(1)(i) and (ii) as if the extension of credit was an intraday extension of credit, regardless of the duration of the extension of credit.[25]

Additionally, each extension of credit or purchase of assets permitted by these revisions would be required to comply with the prudential backstops.

RISKLESS PRINCIPAL TRANSACTIONS

The 2020 Revisions expand on the proposal by permitting a banking entity to engage in riskless principal transactions with a related covered fund. For these purposes, a riskless principal transaction means a transaction in which a banking entity, after receiving an order from a customer to buy (or sell) a security, purchases (or sells) the security in the secondary market for its own account to offset the contemporaneous sale to (or purchase from) the customer.

This standalone provision is modeled on the exemption in Regulation W, but is available even if the related covered fund is not a securities affiliate.

Narrowing of Definition of Ownership Interest

The Volcker Rule defines an "ownership interest" in a covered fund as any equity, partnership or other similar interest. An "other similar interest" is defined by reference to a broad list of characteristics, which included certain provisions that are standard creditor remedies in debt instruments of certain asset classes (e.g., the right to vote to remove an investment manager or to vote on a nominated replacement manager upon an investment manager's resignation or removal). To address this issue, as further described below, the Agencies (i) finalized clarifying amendments to the definition of "other similar interest" and (ii) created an express safe harbor for senior loans and senior debt. The Agencies also amended the manner in which banking entities must calculate their ownership interests for purposes of complying with the limits for certain exempted covered fund activities.

Additionally, in response to Question 79 from the proposal, the Agencies helpfully clarify that a debt interest in a covered fund would not be considered an ownership interest solely because the interest is entitled to receive an allocation of collections from the covered fund's underlying financial assets in accordance with a contractual priority of payments.

We anticipate that these adjustments to the definition of "ownership interest" will enable banking entities to invest in CLOs and other ABS loans and debt instruments without the need to rely on a specific covered fund exclusion. This should ease the compliance burden for banking entities that finance the securitization of loans.

CREDITOR REMEDIES

The 2020 Revisions expand on the proposal by more broadly revising the definition of ownership interest to provide clarity about the types of creditor rights that may attach to an interest without that interest being deemed an ownership interest. As was contemplated in the proposal, the 2020 Revisions modify the scope of the definition of ownership interest to allow for certain additional rights of creditors that are not triggered exclusively by an event of default or acceleration to attach to a debt interest without such interests being deemed ownership interests. Under the 2020 Revisions, the definition of ownership interest does not include rights of a creditor to participate in the removal or replacement of an investment manager for cause in connection with:

1. The bankruptcy, insolvency, conservatorship or receivership of the investment manager;
2. The breach by the investment manager of any material provision of the covered fund's transaction agreements applicable to the investment manager;
3. The breach by the investment manager of material representations or warranties;
4. The occurrence of an act that constitutes fraud or criminal activity in the performance of the investment manager's obligations under the covered fund's transaction agreements;
5. The indictment of the investment manager for a criminal offense or the indictment of any officer, member, partner or other principal of the investment manager for a criminal offense materially related to his or

her investment management activities;

6. A change in control with respect to the investment manager;
7. The loss, separation or incapacitation of an individual critical to the operation of the investment manager or primarily responsible for the management of the covered fund's assets; or
8. Other similar events that constitute "cause" for removal of an investment manager, provided that such events are not solely related to the performance of the covered fund or to the investment manager's exercise of investment discretion under the covered fund's transaction agreements.

SAFE HARBOR

The 2020 Revisions create a safe harbor from the definition of ownership interest. Specifically, any senior loan or other senior debt interest that meets all of the following characteristics would not be considered to be an ownership interest under the proposed rule:

- Under the terms of the interest, the holders of such interest do not receive any profits of the covered fund but may only receive: (i) interest payments which are not dependent on the performance of the covered fund and (ii) repayment of a fixed principal amount, on or before a maturity date, in a contractually determined manner;
- The entitlement to payments under the terms of the interest is absolute and may not be reduced because of the losses arising from the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the principal and interest payable; and
- The holders of the interest are not entitled to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event).

The Agencies did not define "senior" in the 2020 Revisions, but clarified that a senior loan or senior debt interest involves, among other things, repayment of a fixed principal amount, on or before a maturity date, in a contractually determined manner (which may include prepayment premiums intended solely to reflect, and compensate holders of the interest for, forgone income resulting from an early prepayment). Our initial view is that, even without an explicit definition of "senior," the safe harbor provides greater clarity around certain debt interests that structured finance industry participants ordinarily would not consider to be an ownership interest.

FUND INVESTMENT LIMITS

The 2020 Revisions modify the implementing regulations to better align the manner in which a banking entity calculates the aggregate fund limit and covered fund deduction with the manner in which it calculates the per-fund limit, as it relates to investments by employees of the banking entity. Specifically, the 2020 Revisions modify Sections __.12(c) and __.12(d) to require attribution of amounts paid by an employee or director to acquire a restricted profit interest only when the banking entity has financed the acquisition.

Parallel Direct Investments

The 2020 Revisions clarify that a banking entity need not include investments made alongside a covered fund in its per-fund and aggregate funds ownership limitations calculations as long as certain conditions are met. The clarification takes the form of a rule of construction which provides that:

- A banking entity is not required to include in the calculation of the investment limits under Section __.12(a)(2) any investment the banking entity makes alongside a covered fund as long as the investment was made in compliance with applicable laws and regulations, including applicable safety and soundness standards; and
- The amount of any investment the banking entity makes alongside a covered fund is not restricted under Section __.12 as long as the investment is made in compliance with applicable laws and regulations, including applicable safety and soundness standards.

Conclusion

Overall, the 2020 Revisions represent a meaningful step toward rationalizing the Volcker Rule. The revisions include several changes that were requested by the structured finance industry as well as some other changes that likely will be welcomed by the banking entities subject to the Volcker Rule.

There remain several areas in which the Volcker Rule can be further refined, such as with respect to the treatment of long-term investment funds, which could be the subject of future rulemakings. Given the upcoming federal elections in the United States, such rulemakings are unlikely to commence before mid-2021, at the earliest. ■

Endnotes

[1] Press Release, *Financial Regulators Modify Volcker Rule* (June 25, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625a.htm

[2] The preamble to the 2020 Revisions indicate that the Agencies declined to adopt an exclusion for long-term investment funds. Some agency principals have left open the door to consider such an exclusion in the future. See Statement on Amendments to the Volcker Rule "Covered Fund" Provisions (June 25, 2020) ("we will continue to consider the treatment of long-term investment vehicles and remain open to hearing any additional suggestions for further improving the regulations implementing the Volcker Rule"), https://www.sec.gov/news/public-statement/peirce-roisman-volcker-rule-2020-06-25

[3] 85 Fed. Reg. 12,120 (Feb. 28, 2020), https://www.federalregister.gov/documents/2020/02/28/2020-02707/prohibitions-and-restrictions-on-proprietary-trading-and-certain-interests-in-and-relationships-with; 83 Fed. Reg. 33432 (July 17, 2018), https://www.federalregister.gov/documents/2018/07/17/2018-13502/proposed-revisions-to-prohibitions-and-restrictions-on-proprietary-trading-and-certain-interests-in The comment period on the 2020 proposal was informally extended until May 1, 2020 in light of the COVID-19 pandemic. Press Release, *Agencies Will Consider Comments on Volcker Rule Modifications Following Expiration of Comment Period* (Apr. 2, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200402a.htm

[4] The 2019 revisions included incremental adjustments to limited aspects of the covered funds provisions, but deferred further action on other covered funds issues to the present rulemaking. See Mayer Brown's Legal Update on the 2019 Revisions: https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/08/volcker-rule-2019-revisions-new.pdf

[5] See Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act (July 17, 2019), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190717a1.pdf; Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act (July 21, 2017), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170721a1.pdf

[6] The proposal would have extended the anti-evasion requirement to any banking entity. The 2020 Revisions limit the anti-evasion requirement to the foreign banking entity that sponsors or controls the foreign excluded fund and any affiliate thereof (except for the foreign excluded fund).

[7] See also Mayer Brown's blog post on the securitization-related changes in the 2020 Revisions: https://www.retainedinterest.com/2020/06/volcker-rule-revision-complete-easing-the-compliance-burden-for-banks/

[8] A loan securitization vehicle that relies on the exemption provided in Rule 3a-7 under the Investment Company Act of 1940 would not need to rely on the LSE because it is not a covered fund.

[9] The value of debt securities is calculated at the most recent time of acquisition of such assets and generally with respect to the par value of the vehicle's loans, cash and cash equivalents, and debt securities at the time any such debt security is purchased (i.e., excluding the value of other rights or incidental assets, as well as derivatives held for risk management). In certain circumstances, fair market value may be used instead of par value.

[10] The 2020 Revisions retain the concept of impermissible assets, which include asset-backed securities and equity and debt securities (other than non-convertible debt securities up to the 5 percent limit and permitted securities), derivatives (other than interest rate and foreign exchange hedges), and commodity forward contracts.

[11] The Loan Securitization Servicing FAQ (#4) is available at https://www.federalreserve.gov/supervisionreg/faq.htm

[12] The Loan Securitization Servicing FAQ defines "cash equivalents" as high quality, highly liquid investments whose maturity corresponds to the securitizations' expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities. The Agencies are not requiring cash equivalents to be short term.

[13] The Agencies also addressed the seeding period discussed in FAQ #14 and clarified, depending on the facts and circumstances of a particular foreign public fund, the appropriate duration of its seeding period may vary and, under certain facts and circumstances, may exceed three years.

[14] The 2020 Revisions also codify that "predominantly" for foreign public funds means "more than 75 percent."

[15] The proposal questioned the treatment of RBICs and QOFs in relation to small business investment companies (discussed below). The preamble to the 2020 Revisions, however, discusses RBICs and QOFs in relation to the public welfare investment fund exclusion. SBICs and public welfare investment funds are addressed in the same section of the Volcker Rule.

[16] Proprietary trading means engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments and includes purchasing or selling a financial instrument with a short-term trading intent. Section __.3(a)-(b). The preamble to the 2020 Revisions notes that it may be possible for an excluded credit fund to engage in otherwise prohibited proprietary trading if it complies with the requirements of an exclusion or exemption from the prohibition against proprietary trading.

[17] The 2020 Revisions note that the proposed exclusion for credit funds is similar to the current exclusion for loan securitizations (other than the fact that the LSE requires the issuance of asset-backed securities, and the credit fund exclusion would prohibit it).

[18] For example, a banking entity's investment in or relationship with a credit fund could be subject to the regulatory capital adjustments and deductions relating to investments in financial subsidiaries or in the capital of unconsolidated financial institutions, if applicable. See 12 C.F.R. § 217.22.

[19] The preamble to the 2020 Revisions notes that it may be possible for an excluded venture capital fund to engage in otherwise prohibited proprietary trading if it complies with the requirements of an exclusion or exemption from the prohibition against proprietary trading.

[20] The 2020 revisions define "family customer" as (i) a family client, as defined in Rule 202(a)(11)(G)-1(d)(4) of the Investment Advisers Act of 1940 (17 C.F.R. § 275.202(a)(11)(G)-1(d)(4)) or (ii) any natural person who is a father-in-law, mother-in-law, brother-in-law, sister-in-law, son-in-law or daughter-in-law of a family client, spouse or spousal equivalent of any of the foregoing.

[21] The 2020 Revisions define "closely related person" as a natural person (including the state and estate planning vehicles of such person) who has longstanding business or personal relationships with any family customer.

[22] This is an incremental change from the proposal, which would have permitted only up to three closely related persons.

[23] The 2020 Revisions recognize that the banking entity may need to modify (i) disclosures to prevent the disclosure from being misleading and (ii) the manner of disclosure to accommodate the specific circumstances of the entity.

[24] As with family wealth management vehicles, the 2020 Revisions recognize that the banking entity may need to modify (i) disclosures to prevent the disclosure from being misleading and (ii) the manner of disclosure to accommodate the specific circumstances of the entity.

[25] Such requirements include that an institution establish and maintain policies and procedures that are reasonably designed to manage credit exposure arising from the institution's intraday extensions of credit to affiliates. Additional guidance for compliance with this requirement can be found in Section 2020.1.8 of the Board's Bank Holding Company Supervision Manual, available at https://www.federalreserve.gov/publications/files/bhc.pdf

Volcker Rule Revision Complete — Easing the Compliance Burden for Banks

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On June 25, 2020, five federal financial regulatory agencies published the long awaited Final Revisions to the Volcker Rule (the "Final Revisions") which revise certain aspects of the Volcker Rule (Section 13 of the Bank Holding Company Act) with respect to the identification and treatment of covered funds. The Final Revisions follow three years of the agencies' consideration of changes to the Volcker Rule, originally prompted by the June 2017 Treasury Report that solicited changes to ease the compliance burden on banks. The Final Revisions are largely consistent with the notice of proposed rulemaking (the "NPR") published 6 months ago, but with some important, and welcome, clarifications and other adjustments. Many of the changes from the NPR contained in the Final Revisions are in response to industry requests designed to clarify and ease the compliance burden of banking entities subject to the Volcker Rule.

For those entities relying on the loan securitization exclusion under the Volcker Rule (the "LSE"), the Final Revisions added to the LSE an allowance to own up to 5% of non-loan debt instruments (such as corporate bonds). This 5% bucket is calculated based on the par value of assets at the time of each acquisition.

In a shift from the NPR, the Final Revisions limit the 5% non-complying assets bucket to debt securities (other than ABS or convertible securities). Although this change from the NPR technically narrows the non-complying assets bucket, the agencies helpfully clarified in the adopting release for the Final Revisions that all leases and leased property are permissible assets under the LSE. This clarification alleviates the need for further broadening of the non-complying assets bucket for typical ABS transactions while closing any gap in the NPR that would have permitted funds relying on the LSE to acquire equity securities.

The Final Revisions include a safe-harbor carve-out to the definition of "ownership interest" under the Volcker Rule in substantially the same manner as proposed in the NPR. The safe harbor applies to certain senior loan or other senior debt interests that satisfy three tests. The safe harbor provides greater clarity around certain debt interests that structured finance industry participants ordinarily would not consider to be an ownership interest. Unfortunately, the agencies declined to provide further clarity around the meaning of "senior".

The need for further clarification with respect to this safe harbor, however, is largely mitigated by the helpful change and clarifications to the definition of "ownership interest" in the Final Revisions and accompanying adopting release. Importantly, and as requested by industry participants, the Final Revisions provide that the right to remove a collateral manager or similar entity for cause generally does not convert a debt instrument into an "ownership interest", regardless of the existence of an event of default or acceleration event. Although the Final Revisions include a list of specific "cause" events on the basis of which holders of debt instruments may remove a manager without their instruments being rendered "ownership interests", we believe these are generally consistent with industry standards – and moreover the list includes a catch-all for other similar "cause" events that are not solely related to the performance of the covered fund or the investment manager's exercise of investment discretion under the covered fund's transaction agreements. The adopting release also helpfully clarifies that the existence of a typical cash waterfall for the allocation of collections to an interest in an issuer is not a "right to share in income, gains or profits" that would result in the interest constituting an ownership interest in a covered fund. We anticipate that these adjustments to the definition of "ownership interest" will enable banking entities to invest in CLOs and other ABS loans and debt instruments without the need to rely on a specific covered fund exclusion. This should ease the compliance burden for banking entities that finance the securitization of loans.

The Final Revisions are effective as of October 1, 2020. The agencies considered a longer transition period but believe the nature of the changes permit an accelerated effective date. We agree. ■

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