STRUCTURED FINANCE
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In this issue

Editor’s Note

***Alston & Bird’s Single-Family Rental Team** serves as guest editor for this issue of the Spectrum. The team, 16 lawyers strong and located coast-to-coast, is the largest SFR team in the country. Alston & Bird was recognized as “SFR Law Firm of the Year” at IMN’s 2nd Annual Industry Awards on December 3, 2023.*

The landscape of the single-family home market has undergone remarkable shifts in recent years. A red-hot asset class during 2021 and 2022, the industry has experienced a cooling effect that demands our attention.

The surge in demand for single-family homes, driven by various factors such as remote work trends, lifestyle changes and low interest rates, recently propelled this market once again to the forefront of real estate investment. However, the trajectory took an unexpected turn as the Federal Reserve responded to rising inflation by increasing interest rates. This, coupled with a persistent lack of inventory, tempered capital deployment into the asset class and the fervor that characterized the market in previous years.

While some investors have been on the sidelines in 2023, they are now turning their gaze to the horizon with hopeful anticipation. The Federal Reserve has signaled that it might soon reverse its course and lower interest rates, which would no doubt reignite investment by institutional players in the single-family home market.

Should this materialize, we anticipate a resurgence of activity in the market, accompanied by the creation of new investment funds dedicated to the acquisition of single-family homes.

Dive into this issue of the Spectrum to read more from our SFR Team and for a variety of articles with a 2024 regulatory focus, including coverage of Basel III, EDGAR Next, and the Corporate Transparency Act. You will also find our lively January fireside chat with the Structured Finance Association’s Chief Economist & Head of Policy, Dr. W. Scott Frame.

We hope you enjoy this issue, and we look forward to seeing many of you in Vegas!

Alston & Bird’s Single-Family Rental Team

New Investments Breathe Life into Slumbering SFR

Recent announcements indicate that the single-family rental (SFR) industry is once again heating up. In mid-January, Tricon Residential announced that real estate giant Blackstone agreed to acquire the Canadian real estate firm for $3.5 billion. The deal, together with Blackstone's acquisition of Home Partners of America in 2021, will make Blackstone the second-largest owner of single-family rental homes in the United States. More recently, it was disclosed that Pretium Partners, one of the top five owners of single-family rental homes in the United States, is close to raising a fund of $1 billion, which would provide Pretium with enough buying power to acquire another 10,000 newly built rental homes from developers.

These announcements are notable because they demonstrate that institutional home rental firms are prepared to make new substantial bets on rental housing after somewhat of a slumber post-pandemic. Rental housing boomed during the pandemic, driven by record-low interest rates, skyrocketing rents, and demographic shifts out of apartment city living to more spacious detached rental homes in suburban and rural areas. But investment started to slow in late 2022 and through 2023 due to several challenges. These challenges are testing the vibrance of the industry, making it imperative for stakeholders to adapt and innovate to thrive.

- **High Interest Rates:** One of the primary hurdles facing the SFR industry is higher interest rates, which makes achieving desired returns more difficult, impacting the overall profitability of SFR properties.

- **Lack of Inventory and Rising Home Prices and Expenses:** The SFR market is grappling with a scarcity of available properties. Paradoxically, while home prices soar, growth in rental rates has declined. This imbalance poses a challenge for investors as the potential returns from rental income struggle to keep pace with the escalating costs of property acquisition, as well as surging expenses for property taxes, insurance, and maintenance.

- **Legislative Roadblocks:** Government intervention is another challenge facing the SFR industry, with legislative attempts aimed at limiting the ownership of single-family homes by institutional investors. At the end of last year, Senator Jeff Merkley (D-OR) introduced the "End Hedge Fund Control of American Homes Act of 2023," and Representative Adam Smith (D-WA) introduced the House version. These proposals, though they have little chance of becoming law, can inadvertently impede the growth and stability of the SFR market by raising some uncertainty.

- **Rental Moratoriums by Homebuilders:** Some homebuilders are instituting rental moratoriums for newly constructed communities, limiting the pool of available rental properties. This further exacerbates the supply-demand imbalance in the rental market and puts pressure on rental prices.

Despite these challenges, there is new optimism on the horizon for the SFR industry. Anticipated decreases in interest rates entice further investment, potentially unlocking a surge in new construction and additional inventory hitting the market. Lower interest rates could stimulate increased demand for new homes, encouraging homeowners with favorable mortgage rates to list their properties for sale. This influx of supply could help balance the market and provide relief to both investors and tenants. Further, an industry-wide shift away from traditional "scattered site" properties into purpose-built rental homes reduces costs for operators, provides new opportunities for investment, and abates concerns about new regulation.

The SFR industry is navigating a complex landscape marked by high interest rates, limited inventory, legislative uncertainty, builder moratoriums, and industry consolidation. However, the anticipated decrease in interest rates presents a promising opportunity for the industry to overcome these challenges, fostering growth and stability in the single-family rental market. ■

Virtual Fireside Chat with Scott Frame

Alston & Bird Structured & Warehouse finance partner Shanell Cramer had the opportunity to speak with Dr. W. Scott Frame, Chief Economist & Head of Policy at the Structured Finance Association (SFA), in a virtual fireside chat on January 17, 2024. We covered a variety of topics, including Scott's journey to his current SFA role, some of his personal goals, the SFA's recent Basel III response, and more.

What piqued your interest in pioneering this role and coming to the SFA from your previous background and employment?

Before and after the Global Financial Crisis, a significant amount of my policy and research attention was focused on securitization, albeit it was primarily for residential mortgages. I went to the Treasury in the fall of 2008 to work on implementing the conservatorships for Fannie Mae and Freddie Mac, then subsequently was involved in bank supervision and financial stability efforts at the Fed.

But, more recently and specifically related to securitization, with the onset of the COVID pandemic, I assisted with the rollout of the Fed's Term Asset-Backed Securities Loan Facility (TALF) program. I was tasked with putting together a small team to evaluate whether to include RMBS in TALF. As we were getting ready to roll out the TALF program, we had some interactions with the SFA and I was quite impressed by and appreciated the Association's efforts to promptly provide us with all the background information and data we needed and several industry contacts so we had people to talk to. We were moving quickly and wanted to be able to support markets, but we needed to feel like we had a very good handle on how certain things worked.

So, when I was contemplating a career move last year, the SFA was a very natural place for me to consider because I both had the necessary background and it seemed like a good group to be a part of.

Given your background at the Federal Reserve and most recently at the Federal Reserve Bank of Dallas as VP for Financial Research, how do you think those roles and the way you approached issues at those institutions will shape your perspective and what you'll be doing at SFA?

During my career at the Fed, I was involved at various times with virtually all of the core responsibilities, including monetary policy, bank supervision, financial stability, and even payment system policy. At a high level, my perspective is that it's important for trade associations to understand regulatory objectives and to provide well-reasoned advocacy. These government agencies employ a lot of smart people and they're not moved by weak arguments.

I think what contributes to my background for the work the SFA does is the time I spent within the strong leadership culture under Rob Kaplan, now former CEO of the Federal Reserve Bank of Dallas. That team was able to make tremendous progress building out and strengthening its research department in a relatively short period of time.

Since I've arrived to the SFA we've been able to fill out the policy group, get ourselves comfortable in our new seats, and build a cohesive team. The lessons I learned in Dallas about management and leadership have really served me well since I've been at the SFA.

Speaking of advocacy, how do you advocate effectively while taking a middle road in an industry in which some of the topics have two different sides? What have you learned about advocacy since you've now been on both sides of the table?

The SFA really tries hard to find consensus. I like to think about it as being more work up front to create that consensus, but I think it makes it easier on the backside when you're doing the advocacy because you can feel comfortable that you're correctly representing a collective and an oftentimes nuanced view of different issues.

In my past life at the Fed and at the Treasury, you interact with people representing the industry. You can learn a lot watching how people in the advocacy world approach their process. You learn about more nuanced views and how things work in practice. As economists we're trained to look at things through a particular lens, but the details often complicate the view.

Going back to my experience working on TALF, we knew what we wanted to accomplish, and we had an idea of a way to do it, but we acknowledged we didn't interact with the ABS markets every day. So, we knew we needed to talk to people who do this for a living to help us understand how we can be most effective and avoid certain pitfalls.

The SFA just released their response to the Basel III endgame proposal. Can you walk me through some of the important things your team wanted to focus on in your response?

The SFA's comment letter on Basel III focused principally on changes to the securitization framework. It had a very secondary market focus. As you know, banks are involved in securitization in various ways, as issuers of and investors in securities and as providers of financing facilities for nonbanks.

We were primarily focused on the mathematical function the banking agencies use to calibrate capital requirements for securitization. Basically, what the agencies had proposed was doubling what we refer to as the securitization surcharge. Meaning, you have a hypothetical pool of loans with a capital charge of X percent, you would need 2X to hold those these same assets, the whole capital stack of securities, in securitized form. Today, it's 1.5X – they are proposing to double the surcharge from 50% to 100%. In our letter we objected to that because, first and foremost, we argued the increase was arbitrary and excessive. There was no explanation or analysis for why this was happening beyond it being part of the process coming from Basel. But, important to note in the U.S. context, the existing standards were established after all the reforms that happened after the financial crisis.

It is also inconsistent in a couple of ways with the approach being taken in the EU. First, the Basel framework itself allows for what they call STC (simple, transparent, comparable) securitizations. Those securitizations have a lower capital charge than other securitizations. We don't have that framework in the U.S. Second, the EU is currently deliberating pulling back on these securitization surcharges. We sought to demonstrate in the letter just how much more capital would be required under this proposal relative to Europe or other developed jurisdictions.

Taking this back to Main Street, the increase in capital will result in higher costs and reduced credit availability for households and businesses. At the end of the day, the fundamental policy question is whether any improved resilience in the banking system associated with more capital is going to be worth that cost to society. Calibrating capital requirements is tricky, and one must try to properly balance the benefits and costs of any changes.

One of the things we noticed in the SFA's comment letter is you didn't address the primary market, particularly with respect to the mortgage market. Can you elaborate on that decision?

We decided early on that we wanted to dial in on the securitization framework that is more naturally the focus of our broader SFA membership. That includes banks and nonbanks. We felt the primary market focus on the calibration of capital charges for loans would be more closely aligned with the advocacy efforts of groups like the Bank Policy Institute and American Bankers Association. We knew they would be commenting a good bit on the charges. In terms of mortgages, you can even expand the box further and you bring in the Mortgage Bankers Association which I know is quite concerned about these increased charges. All that said, we made a deliberate decision to focus principally on the secondary market and the securitization framework, although we certainly have a lot of alignment with the other associations related to their concerns in the primary market.

In addition to the Basel III issues that the SFA has been focused on, what are some other challenges you see facing the structured finance market, particularly in 2024 and 2025?

At a high level, overall business activity is down the past couple years as rates have risen and spreads have generally widened. There are always ebbs and flows of securitization activity that move along with the credit cycle.

Thinking more specifically, one challenge from my perspective is the lingering regulatory perspectives about the structured finance industry. There were certainly many problems exposed by the subprime mortgage crisis that were subsequently addressed through various regulatory and market reforms, and the SFA has been very supportive of these efforts.

However, I continue to sense some residual skepticism by some agencies even though those problems occurred 15 years ago and in one market segment. I think the Basel III securitization framework is a prime example of this skepticism. For example, the doubling of the securitization surcharge. I feel the SFA has an important ongoing education and advocacy role to play to increase the likelihood that that regulatory innovations don't necessarily result in increased cost of credit to households and businesses. It's really about continuing to engage and a continual process to counter residual skepticism.

There has been a good bit of attention to banks engaging in capital risk trades to offload capital charges. The Fed has recently issued some related guidance. Can you describe these and do you have a perspective on those trades?

These capital risk trades are effected through the issuance of what are known as credit linked notes. I view these as a robust form of risk transfer from banks to capital markets where, and this is the important part, the notes are pre-funded and hence eliminate counterparty risk. The idea is the bank is issuing a security whose cash flows are dependent on the performance of a reference pool of assets that the bank holds. The investor is buying that security and the bank (this is the pre-funding part) has received the receipts and then the interest payments going back out to investors may vary over time depending on the performance of that underlying pool. As you mentioned the Fed recently issued some FAQs. I think the SFA is going to continue to engage on this issue in 2024. It'll be a priority for us.

Just to provide some additional context, this is not a brand-new construct. Fannie Mae and Freddie Mac have issued over $100 billion worth of these securities to a wide array of investors over the past decade to de-risk their balance sheets and protect taxpayers. In fact, the FHFA as conservator of Fannie and Freddie has really embraced this as a way to transfer risk out of those two entities.

More broadly, I see prefunded credit linked notes as part of a comprehensive risk management strategy that allows banks to more efficiently and effectively allocate their capital. The risk transfer enhances bank safety and soundness and allows the institutions to expand the availability of and reduce the cost of credit. I view these positively. I hope to spend some time during the first half of this year really digging into various issues around these things, but at a high level that's the way I think about these risk transfer trades.

I'm sure when you were offered the job at the SFA you were also handed a crystal ball. What do you see changing in 2024 and, aside from Basel III, what are some of the objectives that either you specifically or the SFA in general have this year?

While some uncertainty remains about the macro outlook, my baseline view is we're in a bit of a holding pattern as the Fed has stopped tightening policy. Furthermore, inflation has been trending down toward the central bank's 2% target. It's consistent with this "soft landing" narrative that's out there. If economic growth continues, the stable rate environment should support ongoing credit growth in 2024 and then, hopefully, we'll see an uptick in issuance. This should be a more supportive environment for the industry at a macro level.

I think as we look ahead to the first half of 2024, my own personal goals include beginning to expand what I consider my chief economist role. I've largely to this point focused on being the head of policy. As I mentioned, we were little shorthanded after I joined and through the back half of 2023. We've since built out the team and I think we're in a good place now. I'm going to try to devote a little more time to that, which should include a little more writing and public speaking.

In terms of areas of focus for the SFA, certainly Basel III advocacy is important. As you know, the conflicts of interest rule from the SEC was recently finalized. I think we're in a good place there, but there are a lot of open questions, particularly around compliance. That's an area where we'll be working with our members this year. The risk transfer trades topic we just talked about remains an area of lively discussion. I expect we will do a fair amount of advocacy work around that issue as well.

Scott, thank you so much for your time today. We look forward to seeing you in Las Vegas in late February. ■

Understanding the Corporate Transparency Act: What Structured Finance and Securitization Market Participants Need to Know

The Corporate Transparency Act (CTA), enacted into law on January 1, 2021 as part of the Anti-Money Laundering Act of 2020, provides for the collection of beneficial ownership information for corporations, limited liability companies, and other similar entities formed under the laws of the United States to enable intelligence and law enforcement agencies to counter money laundering, the financing of terrorism and other illicit activity and to bring the United States into compliance with international anti-money laundering (AML) and countering the financing of terrorism (CFT) standards.

Beginning January 1, 2024, nonexempt legal entities (reporting companies) were required to file a beneficial ownership information (BOI) report with the Financial Crimes Enforcement Network (FinCEN) within 90 days of formation. Reporting companies formed before January 1, 2024, must file their initial BOI report on or before January 1, 2025. All BOI reports must include (1) identifying information for the reporting company, such as name, address, and taxpayer identification number; and (2) personal identifying information for the beneficial owners of the reporting company. For a reporting company formed on or after January 1, 2024, its BOI report must also include personal identifying information for the applicants of the reporting company. The personal identifying information for beneficial owners and applicants includes each individual's full legal name, date of birth, current address, and a unique identifying number from, for example, a current passport or driver's license along with a copy of such document (or, in lieu thereof, a FinCEN identifier, which may be obtained from FinCEN).

Before the CTA's enactment, there generally was no federal requirement for a legal entity to notify the federal government of its formation, provide information on its beneficial owners or control persons, or notify the federal government of a change to the foregoing information. The lack of a centralized register of legal entities or their beneficial owners has consistently been cited by the Financial Action Task Force (FATF) as a key deficiency in the U.S. AML/CFT framework. International pressure to meet comparable AML and CFT standards has mounted, and the CTA is part of a suite of legislation aimed at implementing the FATF's recommendations. FinCEN published the final rule on beneficial ownership reporting requirements in September 2022.

While FinCEN has provided some guidance, substantial questions remain on the impact of the CTA on special purpose vehicles (SPVs) formed for the limited purpose of entering into complex structured finance and securitization transactions and how FinCEN will ultimately enforce the requirements of the CTA. Given the evolving nature of the new regulations, companies should carefully review the regulations and consult with legal professionals to determine their compliance obligations.

Reporting Companies

The CTA defines a reporting company as "a corporation, limited liability company or any other entity created by the filing of a document with a secretary of state of any similar office under the law of a state or Indian tribe." This includes corporations, limited liability companies, and similar entities formed in the United States (even if they operate abroad) and non-U.S. entities that are registered to do business in the United States. Notably excluded from this definition are common-law trusts, sole proprietorships, and certain types of general partnerships, even when such organizations may file a document with a secretary of state to, for example, register a trade name, establish a tax account, or to establish a court's jurisdiction over a trust or other organization. Any legal entities that qualify as reporting companies must report detailed information about their beneficial owners and the individuals that helped form them.

While many participants in the structured finance and securitization market will likely qualify for one of the 23 exemptions contained in the CTA, the CTA will likely impose additional compliance obligations on such market participants even when the sponsor is exempt. SPVs formed to facilitate a transaction may not qualify for an exemption and so must comply with the reporting requirements of the CTA or risk civil penalties and criminal liability.

The CTA provides 23 exemptions. Participants in the structured finance market will most likely use the following exemptions: SEC Reporting Issuers (1); Banks (3); Broker or Dealer in Securities (7); Investment Companies or Investment Advisers (10); Insurance Companies (12); Financial Market Utilities (17); Large Operating Companies (21); and Subsidiaries of Certain Exempt Entities (22).

Given the evolving nature of the new regulations, companies should carefully review the regulations and consult with legal professionals to determine their compliance obligations.

Given the limited purposes of leveraging an SPV with a securitization, it is unlikely that SPVs will directly qualify for any exemption other than SEC Reporting Issuers (1) or Subsidiaries of Certain Exempt Entities (22). There may be circumstances when the availability of the SEC Reporting Issuers exemption is not clear, but in most cases the determination should be straightforward.

The Subsidiaries exemption applies to entities whose "ownership interests are controlled or wholly owned, directly or indirectly, by one or more" exempt entities, but it is not available for those subsidiaries that are exempt due to their status as a money services business, a pooled investment vehicle, an entity assisting a tax-exempt entity or as an inactive entity. For entities that may qualify for the Subsidiaries exemption due to their ownership interests being wholly owned by an exempt entity or entities, FinCEN has stated that the introduction of any nonexempt owner into the chain of ownership will disqualify an entity from the exemption, even when the nonexempt owner owns less than 25% of the ownership interests of the entity. With respect to entities that may qualify for the Subsidiaries exemption due to their ownership interests being controlled by an exempt entity or entities, control in this context refers to control over the ownership interests of the entity and not control over the entity itself. In transactions where the SPV's ownership interest is held directly by an exempt sponsor, the SPV should qualify for the exemption. However, in other transactions the SPV's eligibility for the Subsidiaries exemption may not be as clear.

One compliance nuance arises from the timing of the underlying transaction. SPVs are often legally formed more than 30 days before the execution of the related transaction, which may pose challenges for sponsors relying on certain exemptions. If a sponsor is utilizing the SEC Reporting Issuers exemption or its ownership interests will change upon the execution of the related transaction, the SPV may not qualify for the exemption by the reporting deadline.

Structures with multiple owners may also introduce similar compliance nuances. SPVs with multiple unaffiliated owners may encounter difficulties in determining whether the SPV continues to qualify for the Subsidiaries exemption after the transaction is executed because there is a risk that one of its owners may become nonexempt due to events beyond the SPV's control. Negotiating contractual notice and transfer restrictions can help mitigate that risk. As a backstop, the ultimate holders should also contractually agree to cooperate with the SPV to fulfill its CTA obligations.

Additionally, entities whose ownership interests are held through the Depository Trust Company's (DTC) book-entry system may face challenges in determining the identity of their owners and, as a result, whether they qualify for the Subsidiaries exemption. Without further guidance from FinCEN, sponsors will be obligated to look through the DTC to identify the true beneficial owners of the SPV's ownership interest. This will involve obtaining securities position reports, communicating with DTC participants, and acquiring information on the participant's customers. Even if the SPV obtains this information by the reporting deadline, an updated BOI report must be filed within 30 days of any change to information previously reported, presenting ongoing challenges for compliance.

Beneficial Owners

A reporting company's beneficial owners include (1) individuals with direct or indirect ownership of 25% or more, and (2) individuals with substantial control over the reporting company, of another individual (such as nominees or intermediaries); and individuals acting through trusts or similar arrangements. The CTA requires information to be reported on individuals (i.e., natural persons) rather than on legal entities. When an entity owns the reporting company or exercises control over the executive functions of the reporting company or directs, determines, or substantially influences its important decision organizational structures, the CTA requires the reporting company to look through such intermediate entities to identify and report on the individuals that indirectly own or control the reporting company.

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While the CTA provides various tests for measuring ownership interests and substantial control, most of the tests contemplate individuals, rather than entities, having the power and authority to control the reporting company. In contrast, it is common in a securitization for control over legal entities to be vested in legal entities rather than individual natural persons. It is therefore unlikely that a securitization SPV will have an individual that *directly* owns or controls a reporting company that could be listed as a beneficial owner of the SPV. This structural feature further complicates the identification of an SPV's owners and controllers.

The typical securitization involves (1) an SPV issuer, often a Delaware statutory trust; (2) an owner trustee of the issuer appointed to satisfy the requirements of the Delaware Statutory Trust Act and to perform other tightly prescribed activities; (3) an administrator that is appointed to actively manage or oversee the activities of the SPV issuer; (4) a depositor, which contributes the trust estate and is often the initial holder of the beneficial interest in the SPV issuer; (5) certificate holders, which hold the beneficial interests in the SPV issuer; (6) servicers, which are contractually engaged to service the assets of the SPV issuer; and (7) the sponsor, which is the entity that organizes the securitization and is often the ultimate economic owner of the SPV issuer.

In a typical securitization, management and control over the SPV issuer is vested in the depositor and the administrator. The depositor and administrator are often, but not always, affiliated with the sponsor of the transaction. When the depositor, the administrator, or the sponsor directs or determines the important decisions of the SPV, they will likely have substantial control over the activities of the SPV within the meaning of the CTA. When individuals associated with the depositor, the administrator, or the sponsor exercise substantial control over the SPV, such individuals should be listed as beneficial owners of the reporting company. When the administrator's authority is limited solely to nonmaterial matters, as is often the case when the administrator is not affiliated with the sponsor, the administrator's control may not rise to the level of "substantial control" within the meaning of the CTA.

While the owner trustee of a Delaware statutory trust SPV is given the power and authority to take certain actions, the right to exercise such power and authority is sharply limited by the terms of the related trust agreement. Even when the owner trustee is given the legal power and authority to take important actions, in almost every instance the owner trustee is only able to take such actions at the written direction of another party (e.g., the depositor, the administrator, the sponsor, or the certificate holders). Even when the owner trustee has consent rights and not the ability to affirmatively direct or determine such decisions, the owner trustee's influence over the important decisions of the SPV likely does not rise to the level of "substantial control" within the meaning of the CTA.

Certificate holders typically have substantial control over the activities of the SPV in addition to their ownership of the SPV. Individuals associated with the certificate holder that exercise substantial control over the SPV should be listed as beneficial owners of the reporting company. When the certificate holder's authority is limited to that of a passive beneficiary, however, the certificate holder's control may not rise to the level of "substantial control" within the meaning of the CTA.

The role of a servicer is generally limited solely to servicing the underlying pool of assets owned by the SPV. In most transactions, the servicer is not given the power or authority to make important decisions over the SPV. Without any unusual facts or circumstances, individuals associated with a servicer should not be listed as beneficial owners of the reporting company.

Penalties for Noncompliance

While enforcement actions and subsequent penalties for noncompliance have yet to occur, Congress and FinCEN have made clear that ignoring the CTA's requirements will result in hefty penalties. Willful reporting violations can result in civil fines of up to $500 per day (capped at $10,000) and potential criminal charges with imprisonment of up to two years, or both.

Looking Ahead

Participants in the structured finance and securitization industry should be aware of the requirements of the CTA and how they may apply to SPVs formed in related transactions. Particular care should be taken to determine the availability of exemptions before the relevant reporting deadline. Due to the substantial uncertainties surrounding the subsidiary exemption, sponsors should proactively develop internal procedures for identifying beneficial owners and company applicants when forming any new SPVs and before the applicable reporting deadline. ■

Navigating Basel III Waters: Lenders Restructure Loans and Repos as Synthetic Securitisations for Optimal Regulatory Capital Treatment

Since Basel III was finally implemented, after a Covid-related delay, on 1 January 2023, financial institutions have been innovating within this new regulatory framework to optimise their capital resources. Over the last year, we have seen lenders strategically manage their risk-weighted exposure assets, balance sheets, and loan portfolios, and a new financial engineering technique has emerged – the process of restructuring repos and secured loans as synthetic securitisations, a technique we refer to as 'repo risk transfer (RRT)'. This is a strategic response by lenders to the significant discrepancies in capital charges levied by Basel III on different types of investments.

The discrepancy in capital charges between a synthetic securitisation and a loan or a repo means that, once an RRT is complete, there is an immediate reduction in capital requirements. This capital relief then leads to a number of other benefits, including an enhanced internal rate of return (IRR) on investments and a newfound agility in liquidity management.

However, the path to reaping these benefits is not without its challenges for lenders. Regulatory scrutiny looms large, demanding transparency and stringent adherence to the economic substance of transactions. Borrowers, on the other hand, should weigh the pros and cons of agreeing to any restructuring and consider whether benefits of their own could be negotiated as part of the restructure.

Understanding an RRT

Using securitisation to transfer risk is not new. For decades, securitisation markets have been utilised to transfer the credit risk associated with a regulated firm's balance sheet to others with an appetite for credit risk. With the transfer of credit risk, financial services institutions may redeploy, or leverage, the capital released.

Since the global financial crisis, there have been numerous methods adopted for utilising securitisation transactions to achieve regulatory capital relief. Banks are increasingly exploring the RRT, a process that involves bundling financial assets into tradable securities without the actual transfer of assets to a separate entity. This move is primarily driven by the significant disparity in capital charges imposed by Basel III on securitisations as against repos and loans. With a synthetic securitisation, for example, the capital charge to the bank under Basel III is much lower than the capital charge for a real estate loan. For example, a bank would incur a hefty capital charge of 100% of the principal amount of a real estate loan. In contrast, the capital charge for synthetic securitisations is considerably lower, standing at just 25%.

This is a strategic response by lenders to the significant discrepancies in capital charges levied by Basel III on different types of investments.

Capital Optimisation Benefits

An RRT provides several key advantages for lenders:

- ***Reduced Capital Requirements***: By opting for synthetic securitisations, banks can significantly lower their regulatory capital requirements compared to traditional loans or repos. This reduction allows lenders to allocate capital more efficiently, freeing up resources for additional loans and investments.
- ***Enhanced IRR***: The lower capital charge associated with synthetic securitisations translates into a higher internal rate of return on the investment for the lender. This improved IRR boosts the overall profitability of the investment.
- ***Liquidity Management***: Synthetic securitisations offer lenders a more liquid and flexible investment structure.
- ***Portfolio Diversification***: By diversifying their portfolios through synthetic securitisations, lenders can spread risk more effectively. This diversification contributes to a more resilient and adaptive financial profile.

Lender Considerations

While the benefits of synthetic securitisations are evident, lenders should consider the possible downsides:

- ***Regulatory Scrutiny***: Regulatory bodies closely monitor financial engineering activities. Lenders must ensure compliance with the regulatory intent behind synthetic securitisations and demonstrate the legitimacy and economic substance of their transactions.
- ***Market Perception***: Transparency and communication are crucial to gaining investor and market trust. Lenders engaging in synthetic securitisations should proactively address any concerns related to market perception and credit ratings.

Borrower Considerations

Borrowers approached by lenders to restructure an existing line, or asked to treat a new line as a synthetic securitisation for the purposes of the EU or UK Securitisation Regulations, should understand that a request from a lender to restructure their deal as a securitisation is not an obligation.

Borrowers involved in securitised transactions must comply with the EU and UK Securitisation Regulations if based in the EU or UK. Compliance with the Securitisation Regulation(s) includes a number of further obligations which would not exist under a straightforward repo or loan, most notably:

- ***Risk Retention***: The requirement to retain, on an ongoing basis, a material net economic interest in the securitisation of not less than 5%.
- ***Transparency / Disclosure***: The requirement to make available, on an ongoing basis, certain information on the transaction and underlying exposures as specified in template reports published by the UK Financial Conduct Authority or the EU European Securities and Markets Authority (so called "Article 7 reporting").

These additional obligations on the borrower, coupled with all the potential benefits of restructuring for the lender, should give a borrower pause to consider whether it is willing to agree to the lender request. Further, the borrower should consider whether there are terms that the borrower would like to revisit as a quid pro quo for the restructure, for example, pricing, covenants, or other financial terms.

Summary

As lenders continue to adapt to the dynamic regulatory landscape, the financial engineering of utilising an RRT is rapidly emerging as a key strategy for optimising capital under the Basel III regime. Lenders must strike the right balance between regulatory compliance, risk management, and financial innovation. Borrowers, on the other hand, should not take these restructurings lying down and should consider how they can be used to the borrower's advantage. ■

What's Next for EDGAR Next? The Who, Why, When, What, and Where of EDGAR Next

On September 13, 2023, the U.S. Securities and Exchange Commission (SEC) issued a proposed rule and proposed form amendments with technical changes to the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. Collectively termed "EDGAR Next," these changes are intended to enhance the security of EDGAR with the specific goal of enabling the SEC to identify individuals that file on EDGAR. The EDGAR Next proposal includes amendments to Rule 10 of Regulation S-T (and the related definitions under Rule 11 of Regulation S-T) and Form ID.

WHO does the proposed amendment affect?

All filers and their agents that file on EDGAR on their behalf (including law firms, filing agents, and printers).

WHY has the SEC proposed this change?

Currently, to file on EDGAR, the only information required is the filing entity's Central Index Key (CIK), CIK Confirmation Code (CCC), and password. This information is not tied to an individual and is often widely distributed inside a company and to multiple vendors or agents. The result is that the SEC is unable to trace a filing to a specific person within a company or to the company's vendors or agents.

EDGAR Next aims to increase security for filing on EDGAR by creating a traceable path from an account administrator to the ultimate individual filer. As proposed, the new amendments will require any individual accessing EDGAR to obtain unique account credentials and log in through a new multifactor authentication process. EDGAR Next will require each filer to authorize and maintain designated individuals as account administrators to manage the filer's EDGAR account on a new EDGAR dashboard. Account administrators will be responsible for adding users and technical administrators and for managing delegations through the dashboard.

WHEN will EDGAR Next become effective?

The comment period for the proposed rule ended on November 21, 2023. While specific timing is unknown, the SEC could release the final rule as early as the first quarter this year. The proposed rule contemplates a six-month mandatory enrollment period that begins one month after the final rule is adopted. Existing EDGAR filers that fail to timely enroll would lose EDGAR access and be required to reapply for EDGAR access on Form ID.

WHAT should you do now to prepare for EDGAR Next?

- Confirm your CIK, CCC, and related "passphrase." This information will be necessary to establish the account on the EDGAR Next system. Note that the passphrase is different from the password used to currently file on EDGAR. If you do not know your passphrase, a new one will need to be created.

- Identify the individuals who will serve as account administrators (minimum of two individuals and up to 20) who will be responsible for managing your EDGAR dashboard.
- Update your EDGAR profile to provide the SEC with current contact information.
- Obtain Login.gov credentials. Login.gov is the multifactor authentication system that the SEC has proposed to use to authenticate individuals using the system. When creating a Login.gov account, you should use your real name and a valid email address. Login.gov individual account credentials created to test the EDGAR Next Proposing Beta are actual Login.gov credentials that will persist and may be used to log in to EDGAR if the SEC adopts the EDGAR Next proposal and Login.gov is specified as the credential provider.
- Access and test the SEC's EDGAR Next Proposing Beta. Login.gov credentials will allow you to access the beta testing environment. Any information used in the beta testing environment (other than logging in) should be fictional data. The SEC has provided multiple test cases for filers to use when testing. The beta testing environment will remain open until March 15, 2024. While the comment period for the proposed rule has closed, the SEC's online portal to submit "technical bugs" identified during testing is still open.
- Begin a dialogue. If you are a filer who uses an agent or, conversely, you are an agent for a filer, begin discussions to ensure that each entity is prepared for EDGAR Next.

WHERE can additional information be found?

Proposed rule

Comments received by the SEC

SEC's EDGAR Next Proposing Beta testing environment

SEC's Online form to report technical bugs identified on the EDGAR Next Proposing Beta

Second Circuit Confirms Syndicated Loans Are Not Securities

In last year's biggest court case decided involving the $1.5 trillion syndicated loan credit market, the U.S. Court of Appeals for the Second Circuit affirmed the District Court for the Southern District of New York's decision in *Kirschner v. JP Morgan Chase Bank N.A.* holding that a syndicated term loan is not a "security" under the Securities Exchange Act of 1934 and the Securities Act of 1933.

The highly anticipated ruling upheld the historical convention and understanding of borrowers and lenders alike that syndicated loans are not securities. After the U.S. Supreme Court denied Kirschner's writ of certiorari in February 2024, the issue is settled: syndicated term loans are not securities.

The Case

The *Kirschner* case stemmed from a 2014 refinancing transaction where Millennium Laboratories LLC secured a syndicated term loan from various institutional investors. Millennium was the subject of a Department of Justice (DOJ) investigation during the loan syndication process, and after the loan closed, Millennium agreed to a DOJ settlement of more than $250 million, which contributed to Millennium filing for bankruptcy in 2015. Marc S. Kirschner was appointed as litigation trustee, and he brought suit against the defendants (as the arrangers for that syndicated loan) in the bankruptcy case with claims that included federal and state securities laws violations for failure to disclose the 2014 DOJ investigation.

In 2020, the district court dismissed the case on account of Kirschner failing to plausibly suggest that the Millennium loans were securities when applying the four-factor "family resemblance" test outlined by the U.S. Supreme Court in 1990 in *Reves v. Ernst & Young*. Kirschner appealed to the Second Circuit in 2021, but the Second Circuit also utilized the *Reves* test in upholding the district court decision in a direct and concise opinion. Under *Reves*, there is a presumption that a note is a security, though this presumption can be rebutted if the note bears a strong "family resemblance" to notes that are not characterized as securities.

The "Family Resemblance" *Reves* Test

There are four factors of the "family resemblance" test weighed by courts to determine whether a note was issued in an investment context (and would be considered a security) or in a consumer or commercial context (when it would not be considered a security).

1. *Motivations that would prompt a reasonable seller and buyer to enter into the transaction*

A court must determine whether the motivations of the seller and buyer are investment or commercial/consumer. The Second Circuit stated that a buyer's motivation is investment if it expects a profit from its investment (specifically highlighting that profit may be through variable or fixed-rate interest), while a seller's motivation is investment if it intends to raise capital for general business enterprise use or to finance significant investments (specifically highlighting that the seller's motivation is commercial if the loan is exchanged for "the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose").

While the Second Circuit reasoned that Millennium had commercial motivation due to its intent to use the syndicated loan to pay off a then-existing credit facility, the court also noted that the lenders' motivation was investment-driven due to the scheduled interest payments under the syndicated loan. Because of the mixed motivations of the parties, the Second Circuit intimated that, at the early stage of the *Kirschner* case, the first factor leaned in favor of the Millenium loans resembling securities.

2. *Plan of distribution of the instrument*

The court must look to the distribution plan of the instrument to determine whether it was offered and sold to a broad segment of the public. The Second Circuit highlighted that the lead arrangers offered the Millennium loan solely to institutional investors who would receive an allocation of the loan only after submitting a legally binding offer. The Second Circuit found that the loan syndication process was not a broad, unrestricted sale to the general public.

The Second Circuit also found unpersuasive Kirschner's argument that the existence of a secondary market for the Millennium loan demonstrated an offering to the general public. In particular, the court referenced credit agreement transfer restrictions, such as minimum transfer requirements, agent and borrower consent, and restricting transfer of the loans only to current lenders or affiliates of lenders. It further noted that such assignment restrictions were similar to those in the 1992 Second Circuit case *Banco Espanol de Credito v. Security Pacific National Bank*, which concluded that loan participations were not securities because of the restrictions preventing participations from being sold to the general public.

The Second Circuit held these transfer restrictions coupled with the syndication procedure for Millenium "rendered [the loans] unavailable to the general public." Therefore, the second factor weighed in favor of the Millennium loans not being securities.

3. *Reasonable expectations of the investing public*

This factor requires a court to examine the public's expectations for the notes. If the public was given sufficient notice that the notes were loans and not an investment in a business, then the loans are not securities. The Second Circuit highlighted that before purchasing the Millennium loan, the lenders certified that they were sophisticated and experienced in credit matters similar to the Millennium transaction and that they independently and without reliance on any agent or lender made their own determination whether to extend its portion of the Millennium loan. That certification was substantively identical to the certification made by the *Banco Espanol* participation purchasers, which was central to determining whether those buyers would have perceived the participations as securities. Additionally, the Second Circuit rejected Kirschner's argument that the use of the term "investors" sporadically throughout the Millennium loan documents fostered a reasonable expectation among the lenders that they were investing in securities. Consequently, the Second Circuit found that the pleaded facts did not support the argument that the lenders reasonably believed the Millennium loans were securities.

4. *Whether some factors significantly decrease the instrument's risk rendering the application of the Securities Act unnecessary*

The final factor requires the court to evaluate whether there is another regulatory scheme that substantially reduces the risk that the sale of the instrument will cause harm to the public, rendering application of the Securities Act unnecessary. Here, the Second Circuit found that there were other sufficient risk-reducing factors weighing against the loans qualifying as securities. More precisely, the court pointed to the fact that the loans in *Kirshner* were secured by perfected security interests in all the borrower's tangible and intangible assets, reducing the risks associated with the notes.

Furthermore, the Second Circuit stated that the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation issued specific policy guidelines addressing syndicated term loans. The Second Circuit recognized that these guidelines were meant to reduce the risk to banks and, in doing so, also sought to reduce risk to consumers and investors. Taking into account the reduction of risk by way of the security interest and the regulatory guidelines, the court found the application of the Securities Acts unnecessary. Therefore, the pleaded facts did not support the claim that the Millennium loans were securities.

Key Takeaways

Despite the Second Circuit ruling that the first factor weighed in favor of Kirschner, the remaining three factors were held to be in favor of the defendants and, consequently, the *Kirschner* decision was affirmed by the Second Circuit. That decision has been lauded as a major win for leveraged loan market participants because it validates the long-standing approach that syndicated loans are not securities. One item of note is that though the Second Circuit requested the position of the Securities and Exchange Commission, the SEC declined to submit a brief on the *Kirschner* question.

Had the *Kirschner* decision gone the other way, requiring market participants to comply with cumbersome securities laws requirements would have caused a monumental shift in loan issuance and trading. Characterizing loans as securities would severely impact secondary trading liquidity due to the enhanced transfer restrictions necessitated by securities laws, in addition to trading potentially requiring use of registered broker-dealers. It is not uncommon for syndicated lenders to receive nonpublic information about a borrower, and if loans were deemed securities, then lenders may have run into issues with remaining "public" in order to potentially still trade in that borrower's securities.

Additionally, applying securities laws to loans would require substantially more extensive due diligence on borrowers due to heightened disclosure requirements under securities laws. For borrowers, securities registration requirements would result in considerable additional time and costs and diminish the borrowers' control over the composition of the lender group and to whom material nonpublic must be disclosed.

Kirschner also highlighted the importance in properly drafting loan documentation to avoid loans potentially being characterized as securities. When issuing a syndicated loan, market participants should consider:

- Limiting the potential lender universe to sophisticated investors.
- Including clearly defined assignment provisions and consent requirements in loan documents, such as minimum transfer requirements and a definition of an eligible assignee.
- Adding language to the issuance documents reflecting the understanding that the notes being issued are loans and not investments in a business, while making it clear that the issuance is not considered a securities offering.
- Ensuring the loans are secured by collateral whenever possible.
- Continuing to request bank regulators to issue and update guidance aimed at protecting consumers in the syndicated loan market. ■

Recent Tax Developments: The YA Global Tax Court Opinion

Perhaps the one thing less appealing for banking and other finance professionals than spending time discussing "tax issues" on a deal is not having already addressed tax issues that could arise mid-deal and cause changes to a deal's pricing or delays to its closing. Given this lesser of two evils conundrum, the recent November 2023 opinion of the U.S. Tax Court in *YA Global Investments LP v. Commissioner* is worth at least a high-level overview of its facts and holdings.

The facts of the *YA Global* case dealt with offshore lending activities and U.S. borrowers. YA Global, a Caymanian partnership, acquired debt and equity instruments from U.S. issuers. YA Global appointed Yorkville Advisors LLC as its investment adviser under a management agreement that permitted YA Global to periodically revise its investment restrictions in connection with its investment strategy. Yorkville (which also served as YA Global's general partner for certain years at issue), had U.S. employees that executed YA Global's investment strategy and received a management fee based on assets and a 20% incentive fee based on profits. During the years at issue, YA Global was either Yorkville's sole or primary client.

As investment manager, Yorkville performed extensive lending, investment, and stock distribution activities for the benefit of U.S. borrowers and portfolio companies. These activities included direct negotiation with U.S. borrowers over loan terms and negotiations for standby equity distribution agreement (SEDA) terms with U.S. portfolio companies. These portfolio companies paid various amounts designated as fees to both Yorkville and YA Global. The opinion indicates that YA Global's and Yorkville's industry reputations were such that many companies in need of funding would reach out to Yorkville directly.

The U.S. tax treatment of various offshore lending structures and strategies often present certain gray or unclear tax issues. Unlike some areas of tax law, this lack of clarity is not due to a lack of IRS or judicial authorities addressing the tax treatment of non-U.S. persons acquiring debt instruments from U.S. individuals and entities. Rather, the lack of clarity arises from an over-abundance of such authority over many years, with much of it inconsistent and in some cases, conflicting.

> The U.S. tax treatment of various offshore lending structures and strategies often present certain gray or unclear tax issues.

Without application of a tax treaty or specific statutory exception, the general tax rule is that a non-U.S. person is taxable on a net basis at applicable rates on any income it derives if that income is "effectively connected" with the conduct of a U.S. "trade or business." The U.S. Tax Code does not contain a precise definition of the term "trade or business." Rather, tax professionals rely on a line of judicial decisions and administrative interpretations of this phrase. In very general terms, this guidance indicates that a U.S. trade or business is conducted for profit and requires some degree of continuity and regularity. In addition, several cases provide that the actions of at least some U.S. agents may be attributed to non-U.S. persons in determining whether its activities rise to the level of a U.S. trade or business.

Case law holds that "mere investment activities" do not amount to a U.S. trade or business. In addition, the U.S. Tax Code and specific tax regulations contain safe harbor exceptions that provide that a U.S. trade or business generally does not include the activities of trading in securities and commodities. These safe harbors apply even if the trading activity would otherwise constitute a U.S. trade or business under common law but, importantly, may not cover many activities that may take place in conjunction with such trading, such as loan origination activities and distressed loan workout activities.

So assume an offshore investor in a country without a U.S. tax treaty decides to acquire debt instruments issued by one or more U.S. borrowers. If the acquisition or acquisitions are treated as mere investment activities for tax purposes, then the net earnings from the debt instruments will not be subject to U.S. income taxes. But if its acquisition of these debt instruments is treated as part of a U.S. trade or business, but falls within the scope of the securities and commodities trading safe harbor exceptions, then its net earnings from its debt instrument trading activities are likewise not subject to U.S. income taxes (in both instances, a component of the earnings could potentially be subject to U.S. withholding taxes upon distribution from the U.S., but several withholding tax exceptions and techniques could be available to substantially reduce the tax burden of the U.S. withholding tax rules on the investor).

However, if the offshore investor's acquisition activities are neither mere investing nor specially excepted securities and commodities trading activities, the net earnings of the offshore investor from its U.S. debt instrument holdings will be subject to U.S. tax if those earnings are effectively connected with its conduct of a U.S. trade or business and potentially a 30% branch profits tax at the time of the actual distribution of the earnings to the offshore investor. So those are the stakes – a relatively low, or nonexistent U.S. tax burden if the activities are that of an investor or trader in debt securities, or a significant U.S. tax drag on the investor's earnings otherwise.

The YA Global case took over a decade to conclude. In the interim, tax professionals eagerly anticipated the various directions the Tax Court might take in arriving at its conclusions and speculated on what extent the case might resolve or at least provide further clarity in the grayer areas of the tax law such as addressing the application of current authorities clarifying the categories of investing, trading, and lending activities in the United States to several structures and strategies developed by offshore investors and their advisers over the past couple of decades.

The Tax Court did conclude that YA Global was engaged in a U.S. trade or business, but without much specificity on the particular U.S. trades or businesses it was engaged in. The facts of YA Global's and Yorkville's operations and activities were fairly unhelpful in making a persuasive argument to the Tax Court that these various activities of Yorkville, and the portfolio company fees paid to both YA Global and Yorkville, did not evidence at least some form of U.S. trade or business being attributed to YA Global. Once the Tax Court arrived at its conclusion of the existence of a U.S. trade or business by YA Global based on a mix of some lending, some underwriting, and some other general profit-making activities, the opinion did not make any finer factual distinctions about YA Global's specific structure or strategies.

YA Global did not challenge the IRS's position that Yorkville's U.S. advising and structuring activities could be attributed to it under agency principles in determining whether YA Global was engaged in a U.S. trade or business. Instead, YA Global argued that Yorkville was not its agent but a service provider and thus Yorkville's activities with U.S. portfolio companies should not be attributed to YA Global. In analyzing the distinction between a service provider and an agent, and concluding that Yorkville was an agent of YA Global, the Tax Court put significant weight on YA Global's ability to issue interim investment instructions to Yorkville under the terms of the management agreement.

When exploring whether YA Global was merely managing its investments rather than regularly and continually involved in a U.S. trade or business, the opinion reasons that when a provider of capital is otherwise receiving a market return, the presence of fees and similar amounts indicates that something more, in terms of value and services, exists. The opinion noted the important role Yorkville performed in identifying, sourcing, and negotiating transactions, conducting due diligence, and structuring and managing transactions went beyond that of a mere investor, resulting in fees paid to both Yorkville and YA Global from the underlying portfolio companies. According to the Tax Court, this receipt by YA Global of a "something more" above an invested capital market return, combined with the agency analysis, removed YA Global's activities from qualifying as mere investment activities.

The Tax Court's analysis of the availability of the securities trading safe harbors was brief. It determined that YA Global did not qualify for the securities trading safe harbor because the fee income it received from portfolio companies exceeded a market return on invested capital, suggesting compensation for activities beyond the mere buying and selling of securities.

While the opinion may be appealed, the IRS and the Treasury Department could also take advantage of this YA Global "win" to issue some bright-line administrative guidance via a notice, revenue procedure, or Treasury regulation incorporating certain aspects of the Tax Court's ruling. That guidance might take the form of safe harbors that state the IRS will not challenge a particular offshore investment structure or strategy assuming it satisfies certain requirements (e.g., adopting some version of the "season-and-sell" strategy, requiring certain arm's-length, fair market value limits on an offshore investor's aggregate return from an investment) The guidance could provide the clarity on the offshore lending issue that many advisers were expecting but that the opinion mostly failed to provide.

Regardless of what future guidance may or may not be issued, the Tax Court's review of the pertinent economic realities surrounding YA Global's and Yorkville's intertwined operations reinforces the importance of analyzing the potential tax treatment of a transaction by taking into account all the direct and indirect economic and commercial circumstances among the parties.

Further, while the opinion did not rely merely on the labeling of certain amounts as fees, the presence of amounts designated by the parties as fees in the transaction documents whose purpose was not readily explainable proved problematic to explain at trial. When structuring a debt securities offering, finance professionals and their counsel should carefully review their term sheet descriptions, marketing and offering materials, and the underlying transaction documents to ensure that the particular terms used to describe the parties' intended economic arrangements are consistent with the parties' intended tax treatment. ■

Complying with the "Consider" Requirement Under the Revised Qualified Mortgage Rules

This article originally appeared on Alston & Bird's Consumer Finance blog.

Purchasers of residential mortgage loans conducting audits of residential mortgages that they buy in the secondary market are struggling to determine what documentation satisfies the "consider" requirement of the revised qualified mortgage (QM) standards that became mandatory on October 1, 2022. In fact, originators of residential mortgage loans can't agree on what particular written policies and procedures they must promulgate and maintain and the documentation they should include in the loan files. Here's what we believe are the policies and procedures and the documentation that creditors must maintain and provide to their counterparties to comply with the consider requirement.

The Revised QM Rules

On December 10, 2020, Kathy Kraninger, who was the director of the Consumer Financial Protection Bureau (CFPB), issued the revised QM rules that replaced Appendix Q and the strict 43% debt-to-income ratio (DTI) underwriting threshold with a priced-based QM loan definition. The revised QM rules also terminated the QM Patch, under which certain loans eligible for purchase by Fannie Mae and Freddie Mac do not have to be underwritten to Appendix Q or satisfy the capped 43% DTI requirement. Compliance with the new rules became mandatory on October 1, 2022.

Under the revised rules, for first-lien transactions, a loan receives a conclusive presumption that the consumer had the ability to repay (and hence receives the safe harbor presumption of QM compliance) if the annual percentage rate (APR) does not exceed the average prime offer rate (APOR) for a comparable transaction by 1.5 percentage points or more as of the date the interest rate is set. A first-lien loan receives a "rebuttable presumption" that the consumer had the ability to repay if the APR exceeds the APOR for a comparable transaction by 1.5 percentage points or more but by less than 2.25 percentage points. The revised QM rules provide for higher thresholds for loans with smaller loan amounts, for subordinate-lien transactions, and for certain manufactured housing loans.

To qualify for QM status, the loan must continue to meet the statutory requirements for the 3% points and fees limits, and it must not contain negative amortization, a balloon payment (except in the existing limited circumstances), or a term exceeding 30 years.

Consider and Verify Consumer Income and Assets

In lieu of underwriting to Appendix Q, the revised rule requires that the creditor consider the consumer's current or reasonably expected income or assets other than the value of the dwelling (including any real property attached to the dwelling) that secures the loan, debt obligations, alimony, child support, and DTI ratio or residual income. The final rule also requires the creditor to verify the consumer's current or reasonably expected income or assets other than the value of the dwelling (including any real property attached to the dwelling) that secures the loan and the consumer's current debt obligations, alimony, and child support.

In particular, to comply with the consider requirement under the rule, the CFPB provides creditors the option to consider either the consumer's monthly residual income or DTI. The CFPB imposes no bright-line DTI limits or residual income thresholds. As part of the consider requirement, a creditor must maintain policies and procedures for how it takes into account the underwriting factors and retain documentation showing how it took these factors into account in its ability-to-repay determination.

The CFPB indicates that this documentation may include, for example, "an underwriter worksheet or a final automated underwriting system certification, in combination with the creditor's applicable underwriting standards and any applicable exceptions described in its policies and procedures, that shows how these required factors were taken into account in the creditor's ability-to-repay determination."

CFPB Staff Commentary

Paragraph 43(e)(2)(v)(A) of the CFPB staff commentary to Regulation Z requires creditors to comply with the consider requirement of the new QM rule by doing the following:

> a creditor must take into account current or reasonably expected income or assets other than the value of the dwelling (including any real property attached to the dwelling) that secures the loan, debt obligations, alimony, child support, and monthly debt-to-income ratio or residual income in its ability-to-repay determination. A creditor must maintain written policies and procedures for how it takes into account, pursuant to its underwriting standards, income or assets, debt obligations, alimony, child support, and monthly debt-to-income ratio or residual income in its ability-to-repay determination. A creditor must also retain documentation showing how it took into account income or assets, debt obligations, alimony, child support, and monthly debt-to-income ratio or residual income in its ability-to-repay determination, including how it applied its policies and procedures, in order to meet this requirement to consider and thereby meet the requirements for a qualified mortgage under § 1026.43(e)(2). This documentation may include, for example, an underwriter worksheet or a final automated underwriting system certification, in combination with the creditor's applicable underwriting standards and any applicable exceptions described in its policies and procedures, that show how these required factors were taken into account in the creditor's ability-to-repay determination.

The Secondary Market's Review of Creditors' Policies and Procedures and File Documentation

The revised rules suggest that, at a minimum, to ensure that the creditor has satisfied the "consider" requirement, a creditor must promulgate and maintain policies and procedures for how it takes into account the underwriting factors and retain documentation showing how it took these factors into account in its ability-to-repay determination. Ideally, the creditor should make these written policies and procedures available to the creditor's secondary market counterparties.

Further, and more importantly, the revised rules indicate that the individual loan files should contain a worksheet, Automated Underwriting Systems (AUS) certification, or *some other written evidence* documenting how the enumerated factors were taken into account in meeting the enhanced ability-to-repay standards. The underwriters should document their use of applicable exceptions to the creditor's general policies and procedures in underwriting the loan.

> In its early meetings, the task force confirmed that creditors have not uniformly developed written policies and procedures documenting the consider requirement.

It is our understanding that compliance with these requirements has been uneven in the industry and that certain creditors have not promulgated the requisite written policies and procedures related to the consideration of income, assets, and debt. In addition, documentation (i.e., worksheets and AUS certifications) of these factors in individual loan files has been haphazard and inconsistent.

In March 2023, the Structured Finance Association convened an ATR/QM Scope of Review Task Force, comprising rating agencies, diligence firms, issuers, and law firms, to develop uniform best practice testing standards for performing due diligence on QM loans. Discussion topics included the documentation of the consider requirement of the revised QM rules.

In its early meetings, the task force confirmed that creditors have not uniformly developed written policies and procedures documenting the consider requirement. Participants have focused more on the creditor's actual documentation of income, assets, and debt in individual loan files they believe would demonstrate substantive compliance with the underwriting requirements of the revised rules.

Because compliance with the revised rule became mandatory in October 2022, it may be premature for secondary market purchasers of residential mortgage loans to cite their sellers or servicers for substantive noncompliance with the revised QM rules if these entities have not developed robust written policies and procedures that show how they consider income, assets, and debt.

It may be more fruitful for the secondary market to focus on the actual file documentation itself and determine whether the creditors have satisfied the consider requirement by properly underwriting the loans in accordance with the requisite elements and documenting the file with the appropriate worksheets and other written evidence.

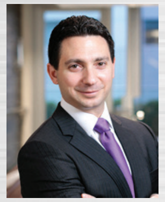
The creditor's failure to maintain the general policies and procedures does not necessarily render the subject loans non-QM if the loan files are adequately underwritten and amply documented. Compliance with the new QM rules and the documentation of the consider requirement is still at a rudimentary stage, and the secondary market will have to periodically revisit the way it audits mortgage loans. ■

Contributing Authors

Steve Blevit
Partner, Finance
Co-Leader, Single-Family Rental Team
Guest Editor

Aimee Cummo
Partner, Finance
Co-Leader, Single-Family Rental Team
Guest Editor

Tara Castillo
Partner, Finance

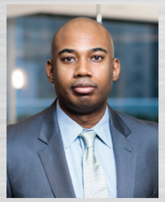


Russell Chiappetta
Partner, Finance

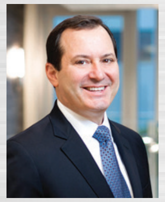
Shanell Cramer
Partner, Finance

Jason Cygielman
Counsel, Finance

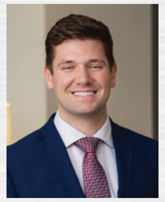
Thomas Dunn
Senior Associate,
Finance



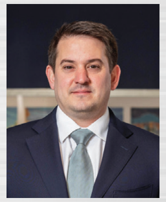
Mathew Gray
Counsel, Finance



David Hoyt
Partner, Finance

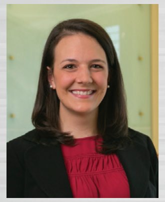


Thomas Kelly
Associate, Finance



Edward Leaf
Associate, Finance

Clay Littlefield
Partner,
Global Tax Services



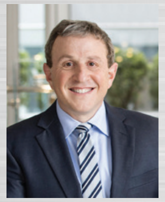
Debra Lofano
Partner, Finance

Terence McAllister
Senior Associate,
Global Tax Services

Chip More
Senior Associate,
Finance

Steve Ornstein
Partner, Financial
Services & Products

Andrew Petersen
Partner, Finance



Ken Rothenberg
Partner, Finance

Jaime Turcios Zacarias
Senior Associate,
Finance

Structured & Warehouse Finance Multipractice Team

Finance

Steve Blevit
Partner
+1 213 576 2663
stephen.blevit@alston.com

Tara Castillo
Partner
+1 202 239 3351
tara.castillo@alston.com

Shanell Cramer
Partner
+1 212 210 9580
shanell.cramer@alston.com

Aimee Cummo
Partner
+1 212 210 9428
aimee.cummo@alston.com

Anna French
Partner
+1 212 210 9555
anna.french@alston.com

Katrina Llanes
Partner
+1 212 210 9563
katrina.llanes@alston.com

Peter McKee
Partner
+1 214 922 3501
peter.mckee@alston.com

Joe McKernan
Partner
+1 212 210 9476
joseph.mckernan@alston.com

Andrew Petersen
Partner
+44 0 20 3823 2230
andrew.petersen@alston.com

Jon Ruiss
Partner
+1 202 210 9508
jon.ruiss@alston.com

Pat Sargent
Partner
+1 214 922 3502
patrick.sargent@alston.com

Kristen Truver
Partner
+1 202 210 9567
kristen.truver@alston.com

Robin Boucard
Counsel
+1 212 210 9454
robin.boucard@alston.com

Troy Doll
Counsel
+1 212 210 9449
troy.doll@alston.com

Solmaz Kraus
Counsel
+1 213 576 1032
solmaz.kraus@alston.com

Emily Redmerski
Counsel
+1 212 210 9589
emily.redmerski@alston.com

Bill Springer
Counsel
+1 212 210 9521
bill.springer@alston.com

Structured & Warehouse Finance Multipractice Team

Karen Wade
Counsel
+1 214 922 3510
karen.wade@alston.com

Briana Costa
Senior Associate
+1 212 210 9485
briana.costa@alston.com

Thomas Dunn
Senior Associate
+1 212 905 9061
thomas.dunn@alston.com

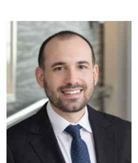
Chris Juarez
Senior Associate
+1 213 576 1095
chris.juarez@alston.com

Ashley Kennedy
Senior Associate
+1 212 210 9516
ashley.kennedy@alston.com

Lindsay Klein
Senior Associate
+1 212 210 9513
lindsay.klein@alston.com

Sherry Scrivens
Senior Associate
+44 0 20 3823 2228
sherry.scrivens@alston.com

Jaime Turcios Zacarias
Senior Associate
+1 212 210 9406
jaime.turcioszacarias@alston.com



Jacob Walpert
Senior Associate
+1 212 210 9489
jacob.walpert@alston.com

Shazell Archer
Associate
+1 212 210 9467
shazell.archer@alston.com

Lydia Balestra
Associate
+1 212 905 9073
lydia.balestra@alston.com

Carly Bennett
Associate
+1 212 210 9597
carly.bennett@alston.com

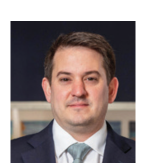
Ethan Dodd
Associate
+44 0 20 3907 1290
ethan.dodd@alston.com

Brenna Dorgan
Associate
+1 212 210 9439
brenna.dorgan@alston.com

Lea Elston
Associate
+1 212 210 9588
lea.elston@alston.com

Jonathan Fenster
Associate
+1 212 905 9077
jonathan.fenster@alston.com

Donald Gallino
Associate
+1 212 905 9034
donald.gallino@alston.com



Edward Leaf
Associate
+1 202 239 3246
edward.leaf@alston.com

Structured & Warehouse Finance Multipractice Team

Mark LoBiondo
Associate
+1 212 210 9455
mark.lobiondo@alston.com

Anissa Malik
Associate
+1 212 210 9468
anissa.malik@alston.com

Sarah McClellan
Associate
+1 212 210 9557
sarah.mcclellan@alston.com

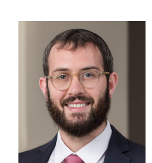
Michael McEvoy
Associate
+1 212 905 9080
michael.mcevoy@alston.com

Krishna Pathak
Associate
+1 202 239 3638
krishna.pathak@alston.com

Kirby Shilling
Associate
+1 212 210 9488
kirby.shilling@alston.com

Ashlyn Stone
Associate
+1 212 905 9083
ashlyn.stone@alston.com

Morgan Thaler
Associate
+1 213 576 1118
morgan.thaler@alston.com



Aryeh Wolosow
Associate
+1 212 210 9599
aryeh.wolosow@alston.com

Financial Restructuring & Reorganization

Stephen Blank
Partner
+1 212 210 9472
stephen.blank@alston.com

William Hao
Partner
+1 212 210 9417
william.hao@alston.com

Jacob Johnson
Partner
+1 404 881 7282
jacob.johnson@alston.com

Matthew Kelsey
Partner
+1 212 210 9572
matthew.kelsey@alston.com

Leah McNeill
Partner
+1 404 881 7822
leah.mcneill@alston.com

Will Sugden
Partner
+1 404 881 4778
will.sugden@alston.com

Eric Wise
Partner
+1 212 210 9496
eric.wise@alston.com

Structured & Warehouse Finance Multipractice Team

Regulatory

Anoush Garakani
Partner
+1 213 576 1181
anoush.garakani@alston.com

Steve Ornstein
Partner
+1 202 239 3844
stephen.ornstein@alston.com

John Redding
Partner
+1 213 576 1133
john.redding@alston.com

Cliff Stanford
Partner
+1 404 881 7833
cliff.stanford@alston.com

Nanci Weissgold
Partner
+1 202 239 3189
nanci.weissgold@alston.com

Morey Barnes Yost
Counsel
+1 202 239 3674
morey.barnesyost@alston.com

Josh Dhyani
Senior Associate
+1 202 239 3160
josh.dhyani@alston.com

Tax

John Baron
Partner
+1 704 444 1434
john.baron@alston.com

Kendall Houghton
Partner
+1 202 239 3673
kendall.houghton@alston.com

Clay Littlefield
Partner
+1 704 444 1440
clay.littlefield@alston.com

Ashley Menser
Partner
+1 919 862 2209
ashley.menser@alston.com

Andrew Claytor
Senior Associate
+1 704 444 1081
andrew.claytor@alston.com

ERISA

Blake MacKay
Partner
+1 404 881 4982
blake.mackay@alston.com

Kyle Woods
Partner
+1 404 881 7525
kyle.woods@alston.com

Structured & Warehouse Finance Multipractice Team

‘40 Act

David Baum
Partner
+1 202 239 3346
david.baum@alston.com

Martin Dozier
Partner
+1 404 881 4932
martin.dozier@alston.com

Derivatives

Blake Estes
Partner
+1 212 210 9415
blake.estes@alston.com

REITs

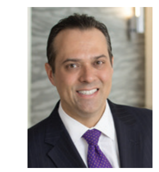
Don Hammett
Partner
+1 214 922 3413
donald.hammett@alston.com

Sarah Ma
Partner
+1 202 239 3281
sarah.ma@alston.com

Shawna Tunnell
Partner
+1 202 239 3040
shawna.tunnell@alston.com

Securities

David Baum
Partner
+1 202 239 3346
david.baum@alston.com



Matthew Mamak
Partner
+1 212 210 1256
matthew.mamak@alston.com

Litigation–Lending & Structured Finance

John Doherty
Partner
+1 212 210 1282
john.doherty@alston.com

Litigation–Trusts

Alex Lorenzo
Partner
+1 212 210 9528
alexander.lorenzo@alston.com

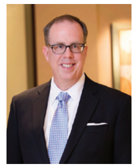
Chris Riley
Partner
+1 404 881 4790
chris.riley@alston.com

Insurance

Tejas Patel
Counsel
+1 404 881 4987
tejas.patel@alston.com

Structured & Warehouse Finance Multipractice Team

Funds



Tim Selby
Partner
+1 212 210 9494
tim.selby@alston.com

144A

Justin Howard
Partner
+1 404 881 7758
justin.howard@alston.com

CDOs/CLOs

Patrick Hayden
Partner
+1 704 444 1453
patrick.hayden@alston.com

Corporate Debt

Paul Hespel
Partner
+1 212 210 9492
paul.hespel@alston.com

Specialty Finance

Maria Merritt
Counsel
+1 404 881 7645
maria.merritt@alston.com

Corporate Transparency Act

Chip More
Senior Associate
+1 202 239 3282
chip.more@alston.com

Delaware Trust

Jason Solomon
Partner
+1 704 444 1295
jason.solomon@alston.com

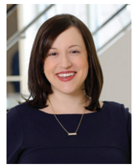
Private Real Estate Funds

Amie Benedetto
Partner
+1 404 881 4830
amie.benedetto@alston.com

Health Care

Dawnmarie Matlock
Partner
+1 404 881 4253
dawnmarie.matlock@alston.com

Mergers & Acquisitions and Joint Ventures



Alison LeVasseur
Partner
+1 404 881 4475
alison.levasseur@alston.com

Jeremy Silverman
Partner
+1 404 881 7855
jeremy.silverman@alston.com

Structured & Warehouse Finance Multipractice Team

Private Equity

Scott Kummer
Partner
+1 704 444 1077
scott.kummer@alston.com

William Snyder
Partner
+1 650 838 2119
william.snyder@alston.com

PSAs

Nikki Ott
Counsel
+1 704 444 1005
nikki.ott@alston.com

Real Estate

Eric Berardi
Partner
+1 404 881 7863
eric.berardi@alston.com

Ellen Goodwin
Partner
+1 212 210 9447
ellen.goodwin@alston.com

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