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MARKETS – Rocky Road Ahead for Leveraged Loans? Signs of Stress in the Market

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The Office of the Comptroller of the Currency (OCC) recently issued a final rule, effective December 1, 2019, to amend regulations regarding other real estate owned …

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Rocky Road Ahead for Leveraged Loans? Signs of Stress in the Market

The 2010s will be known for at least a few good things—the Pizza Rat, Finance-bro uniforms, *Game of Thrones*, and the doubling of the U.S. leveraged loan market to a fully matured $1.2 trillion market. Fueled by a combination of low interest rates and a robust economy, the growth of leveraged loans has helped produce strong returns for its investor base of banks, pension funds, hedge funds, structured vehicles, and other financial institutions. However, investors should proceed cautiously into this new decade given headwinds that suggest a slowing economy and rumblings about the turning of the credit cycle.

What are "leveraged loans"? For the uninitiated, "leveraged loans" are debts that have been extended to companies with credit ratings that are below investment grade. They are typically senior in the capital structure, carry a floating interest rate, and are usually secured with a lien on substantially all the borrower's assets. Private equity groups commonly use leveraged loans to fund leveraged buyouts. Remember *Barbarians at the Gate*? Like that, but lots of them.

Predictably, as demand for leveraged loans grew during the course of the decade, underwriting standards eased. According to published reports, approximately 80% of all leveraged loans outstanding are covenant-lite, which means the underlying loan documentation contains fewer covenant protections for lenders along with fewer requirements for borrowers to maintain or beat certain financial benchmarks. Without having to comply with maintenance ratios, many borrowers have been able to skirt default in situations where they otherwise might have defaulted. In fact, for the past 10 years, the default rate for leveraged loans has been well below its historical average of 3.1%.

Recent trends, however, indicate that the default rate for leveraged loans is slowly but steadily rising. After hitting a seven-year low of 0.93% in the first quarter of 2019, the default rate for U.S. leveraged loans currently stands at 1.48%. Some rating agencies anticipate that the default

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rate will climb to its historical average of 3% in 2020. Several factors point to this expected rise in default rates: (1) distress ratios have widened; (2) the share of performing loans priced below 70 and 80 on the secondary market has noticeably increased; and (3) the percentage of loan facilities with a single-B or below rating is at an all-time high.

With this background in mind, an economic downturn or an increase in interest rates could portend trouble for borrowers—any market event that causes borrowing costs to increase could result in highly leveraged borrowers having more difficulty meeting interest and/or amortization payments. A rise in credit downgrades could also adversely affect the leveraged loan market. Approximately 65% of leveraged loans are held by collateralized loan obligations (CLOs), which typically cannot hold more than 7.5% of their total assets in debt rated CCC or below. Given the number of deals currently rated single-B, any deterioration in credit quality could result in downgrades to CCC ratings and force CLO managers to sell out of their CCC loan positions, potentially causing a notable selloff in the loan market and a fall in seconary-loan prices. Without demand for these assets, overall liquidity would be impacted and access to capital would become more difficult for borrowers, which in turn could push more stressed borrowers into bankruptcy.

Investors in the primary and secondary markets for leveraged loans will need to deftly navigate potential changes in the landscape. Any rise in default rates coupled with credit downgrades could impair overall liquidity in the market and increase the likelihood of bankruptcy filings. On the other hand, any illiquidity in the loan market could also present an opportunity to capitalize on fire sales and depreciated prices. Accordingly, whether approaching an opportunity with a short-term or long-term horizon, it will be important for loan investors to be aware of various market risks and consider potential outcomes. ■

3 Key Takeaways from the 2019 U.S. CRE CLO Market

To say that 2019 was a robust year for commercial real estate collateralized loan obligations (CRE CLOs) would be an understatement. Although the year got off to a slow-ish start, issuance volume outpaced that of 2018, and we observed several important market developments.

1

Actively Managed Deals with Blind Reinvestment Periods Are Becoming More Common

Since the CRE CLO emerged as a securitization vehicle in 2012, deal structures have been slowly but steadily evolving. While these transactions remain almost exclusively collateralized by first-lien mortgage loans and senior and pari passu interests, the structures have morphed from predominantly static transactions in 2012 to fully managed structures in the last year or two.

As the CRE CLO market developed, a number of deals provided what has been characterized as "controlled reinvestment." Following the closing date, the issuer could purchase funded pari passu participations related to participation interests that were included in the securitization as of the closing date, increasing the concentration of certain loans in the pool. More recently, transactions are providing for a true blind investment period, generally for a period of two years following the closing date, when the issuer can acquire previously unidentified whole loans and participations that satisfy the specified parameters of the predetermined eligibility criteria that include asset-level and pool-level restrictions and concentration limits that must be satisfied. The blind reinvestment feature is akin to the reinvestment period feature contained in pre-crisis managed collateralized debt obligation transactions. The ability to reinvest in assets in addition to pre-identified participation interests, provided they fall within the established parameters, affords the collateral manager greater flexibility and diversity in optimizing investments during the reinvestment period. Investors have become comfortable with the concept of the blind reinvestment period, as evidenced by the continually shrinking pricing delta between managed and static deals.

2

The Deemed Consent for Amending the Indenture Is Being Eliminated

Typically, CRE CLO indentures permit terms to be amended without having to obtain the affirmative consent of the noteholders. Notice of any such amendment must be provided to noteholders on the indenture trustee's website, and consent is deemed granted unless the majority of any class or classes of noteholders object because they are materially and adversely affected by the proposed amendment. Investors have expressed general uneasiness with the "deemed consent" mechanism and raised more specific concerns during the course of the year. In at least one case, an amendment was effectuated because no responses were received from noteholders following the posting of the notice, but the noteholders conveyed that they never received the notice. Some issuers have amended existing indentures to remove the deemed-consent language, and other issuers are removing such language going forward.

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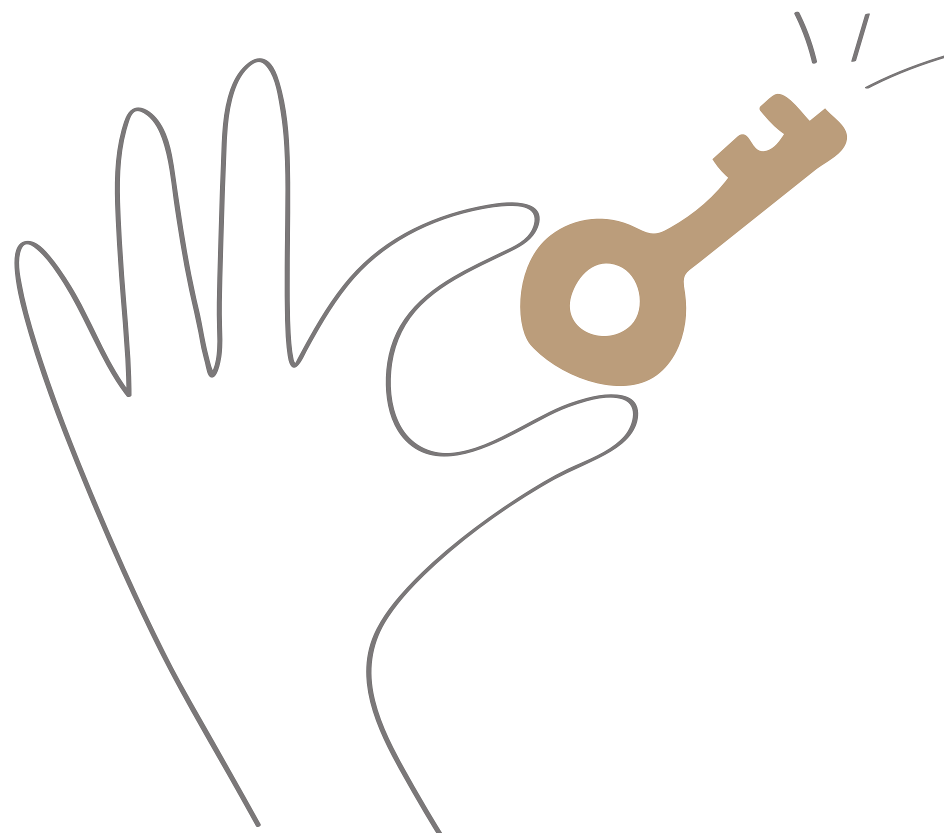
3

Modifications to Performing Loans

Lastly, over the past year, deals have started to incorporate the concept of permitted modifications to a limited number of performing loans in managed transactions. This important feature enables the collateral manager to modify a limited number (generally 10) of performing loans in the transaction. CRE CLO structures are highly sensitive to prepayments of the related loan, and with this feature, the collateral manager can work with the borrower to meet its needs and potentially avoid prepayments. Generally, the ability to modify a performing loan is subject to a set of parameters and limited to a certain number of loans in the transaction; however, the right to do so is an important tool for a manager, particularly portfolio lenders, to retain control over the borrower relationship and provide the flexibility the borrower needs, particularly in the context of transitional property collateral.

The CRE CLO market shows no signs of slowing down, and innovation in the space has continued to be thoughtful and carefully implemented. The increase in the popularity of managed structures and related features, coupled with heightened investor vigilance, suggests that CRE CLOs will continue to remain a viable and popular product as long as rates remain favorable throughout the year. The managed structure is likely to retain its popularity, and we expect to see more features emphasizing managerial control, such as more performing loan modifications and more blind reinvestment, well into 2020 and beyond. ■

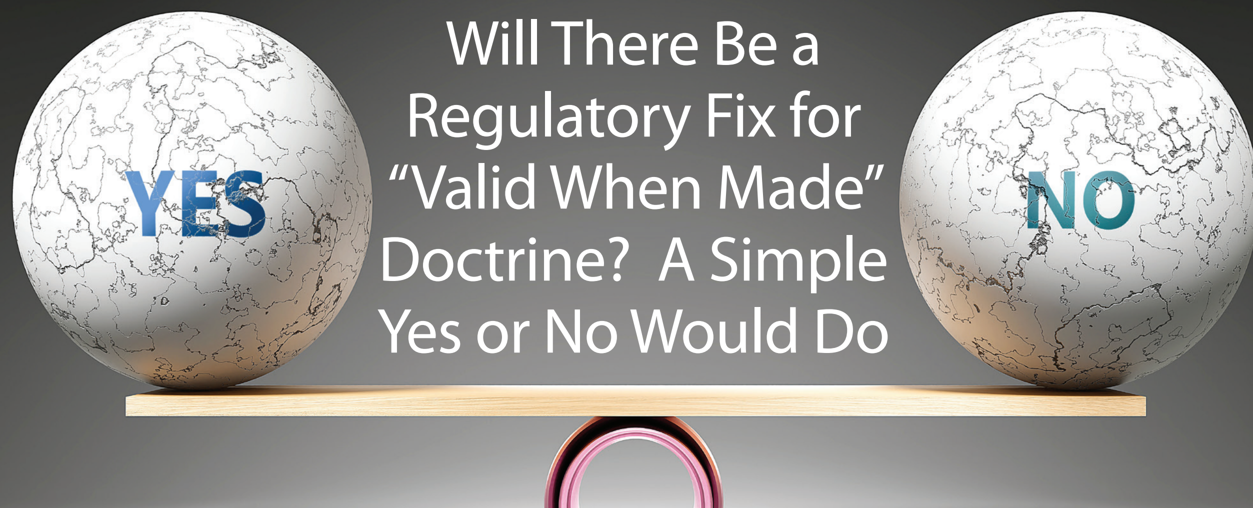


Reflections and Prognostications on CRE Investing in Europe and the U.S.

This past November, we hosted a CREFC After-Work Seminar, where we discussed late-cycle commercial real estate investment in the UK and U.S. The panel discussed opportunities to invest in the UK and Europe (post-Brexit) and in the U.S. (pre-election) and where investors were looking to invest late-cycle—UK or U.S., neither, or both. We heard perspectives from investors (both debt and equity) and financiers in both the UK and U.S., including commentary about political incentives and consequences, and the panelists gave color to the investment landscape in Europe and how the U.S. market is impacted by the European market.

Notable discussion points included:

- The frustration of the German banks, which have been on the sidelines waiting for Brexit. UK banks, other international banks, and insurers and nonbank lenders have flourished in the space throughout the year, while German bank loan origination has declined by 30% since 2018.
- Despite increased political risks, UK loan origination remains high, with a 6% increase over 2018. As in the U.S., UK retail was noted to be struggling as a change in customer preferences and online shopping continue to proliferate and work their way into the markets.
- The UK is beginning to see an increase in the private rented sector/build-to-rent sector—following the long-standing trends in the U.S. multifamily market. The tailwind in this asset class is expected to continue.
- Basel IV is having, and will continue to have, a significant impact on European banks and their ability to compete with U.S. bank and nonbank lenders. A level playing field was called for.
- Globally, it was acknowledged that the U.S.-China disagreement should come to an end in 2020 and that China may emerge as the world's largest economy with buying opportunities and distressed opportunities abounding, leading to further opportunistic buying, especially in logistics.
- The phenomenon of co-living (and to a lesser extent co-working) remains a very attractive investment opportunity, with potential for continued expansion. Demographics on both sides of the pond favor the powerful spending power of the young(er) millennials interested in living together in an urban, more social, connected ecosystem. ■



Will There Be a Regulatory Fix for "Valid When Made" Doctrine? A Simple Yes or No Would Do

Since the Second Circuit's 2015 ruling in *Madden v. Midland Funding LLC*, we've all been just a tad uncertain about what the future holds for the "valid when made" doctrine. To recap, *Madden* held that an interest rate that was attached to a transferred debt from a bank to a nonbank could be found to violate state usury laws if the rate exceeded the state's threshold under its usury laws. *Madden* turned on its head the long-standing common-law doctrine that bank loans are valid when made, and will remain valid and enforceable, under applicable federal law notwithstanding the subsequent sale, assignment, or transfer of the debt to a third party. As a result, lending in the Second Circuit (Connecticut, New York, Vermont) has declined, bills have been introduced and reintroduced to overturn *Madden* that are currently stalled in the U.S. Senate, and much gnashing of teeth and screams into the void have ensued.

Late last month, both the Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC) weighed in and proposed rules that would effectively legislate the valid-when-made doctrine. The OCC's proposal would add this language to the interest rate regulation (12 C.F.R. § 7.4001): "(e) *Transferred loans*. Interest on a loan that is permissible under 12 U.S.C. 85 shall not be affected by the sale, assignment, or other transfer of the loan." The FDIC's proposal is substantively identical.

The proposals would codify the principle that that if a loan is transferred, sold, or assigned, any interest that was permissible before the transfer will continue to be permissible once the transfer occurs, regardless of whether the transferee is a national bank and regardless of the laws of the states in which the investors are located—essentially returning to the status quo for banks transferring loans across state lines. Preemption of state usury laws would presumably be consistent with the fundamental principles of contract law and would mitigate the potential for future disruption to the markets for loan sales and securitizations and a resulting contraction in availability of consumer credit. Comments to the OCC's proposed rule are permitted until January 21, 2020, and comments on the FDIC's proposed rule are permitted until February 4, 2020.

Don't breathe a sigh of relief just yet—a group of Senators, including Sherrod Brown (D-OH) and Elizabeth Warren (D-MA), have lodged strong opposition to the rules in a submitted comment, and "rent a bank" concerns were raised during the recent House Financial Services and Senate Banking Committees oversight hearings with prudential regulators. While the OCC and FDIC may promulgate and implement regulations without congressional input, they can certainly be influenced by Congress, particularly if the issue is contentious.

Seems like the time for the industry to get this done is now, given the impending presidential election and the uncertainty that could arise after November. ■

SDNY Delivers One-Two Punch, but No TKO, to OCC FinTech Charter

Before a FinTech company can provide financial services or products in the U.S., it must obtain a license in each state where it plans to do business. But obtaining a license can be time-consuming and expensive. As a result, to promote innovation, improve efficiency, and bring FinTech companies within its regulatory regime, the Office of the Comptroller of the Currency (OCC) announced that it will accept and review applications for the special purpose national bank (SPNB) charter submitted by nondepository FinTech companies. Earlier last year, however, the U.S. District Court for the Southern District of New York struck down the OCC's decision in a challenge brought by the New York Department of Financial Services (NYDFS). The full effects of the court's decision on the FinTech sector are uncertain. Nevertheless, even after the decision, several chartering and licensing options remain available to FinTech companies.

The OCC first considered issuing the SPNB charter to FinTech companies in March 2016. After examining the issue and discussing it with FinTech companies, the OCC announced in July 2018 that it would begin accepting applications for the SPNB charter from FinTech companies.

Two months later, the NYDFS sued the OCC in the Southern District of New York (*Lacewell v. Office of the Comptroller of the Currency, et al.*, No. 1:18-cv-08377) on the grounds that the OCC's decision undermined New York's ability to regulate and protect its financial markets, deprived New York of revenues from future assessments on FinTech companies, and exceeded the OCC's statutory authority.

The OCC derives its authority to charter national banks from the National Bank Act (NBA), under which the OCC may issue charters to associations entitled to engage in the business of banking. The OCC's authority to issue SPNB charters specifically is also tied to the meaning of "business of banking," since that authority is based on an OCC regulation permitting it to charter a special purpose bank that limits its activities to those within the business of banking.

The *Lacewell* court held that the business of banking—properly understood in light of the statute's text, history, and legislative context—allows only depository institutions to receive national bank charters from the OCC. In the court's view, not only would the OCC's position

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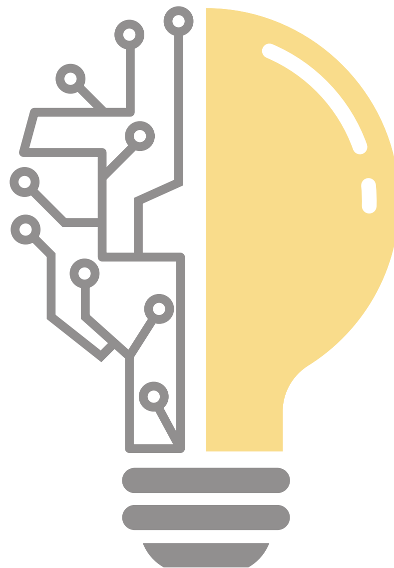
conflict with the plain text of the NBA but it would also (1) violate the Federal Deposit Insurance Act (FDIA), which requires a national bank to be engaged in the business of receiving deposits to obtain insurance under the FDIA; and (2) create an exception to the Bank Holding Company Act's regulatory scheme, which defines a "bank" as a deposit-receiving institution. The court also declined to limit its holding to New York–based companies or companies doing business in New York; only depository institutions are eligible, no matter where they are. All of this means that, unless Congress steps in, FinTech companies are not eligible to receive SPNB charters.

This case is something of a Pyrrhic victory for the NYDFS since no FinTechs have applied for an SPNB charter to date. Nevertheless, the full impact of the *Lacewell* decision on the FinTech sector remains unclear, in large part because the decision may not withstand appeal to the U.S. Court of Appeals for the Second Circuit. Meanwhile, the OCC's authority to issue the SPNB charter to FinTech companies may face a similar attack in the U.S. District Court for the District of Columbia, where the Conference of State Bank Supervisors (CSBS) sued the OCC and raised the same challenge. Although the DC court dismissed CSBS's lawsuit on the ground that its claims were premature since no charter applications had been approved, CSBS could re-file if that changes.

In any event, even in a post-*Lacewell* world, a FinTech company wishing to engage in regulated activities has several options available to it, none of which require the SPNB charter. Most FinTech companies have chosen to enter into partnerships with existing banks, obtain trust company charters, or acquire alternative licenses, such as a consumer loan lender or money transmitter licenses. Another option is to apply for a regular OCC national bank charter, which grants full banking powers but can be expensive and can subject the company to bank regulations and compliance obligations. A FinTech company can also apply for the industrial loan company (ILC) federal charter, although the Federal Deposit Insurance Corporation (FDIC) has not approved an ILC application in over a decade. Finally, a FinTech company can seek a state bank charter, which would afford it exemptions from certain state licensing law requirements as well as the right to "export" the interest rate of the state where the bank is located, but would subject it to federal regulatory requirements, such as anti-money laundering and capital adequacy, and dual federal/state oversight.

Unless and until the *Lacewell* ruling is overturned by Congress or the courts, which may never happen, FinTech companies wishing to engage in regulated activities will likely have to rely on these alternatives to the SPNB charter. ■



Supreme Court to Bang the Gavel on the CFPB

In October, the Supreme Court granted certiorari to a case challenging the constitutionality of the Consumer Financial Protection Bureau (CFPB), a regulatory agency established under Dodd–Frank that is charged with enforcing consumer financial laws and bringing legal action against offending companies. The CFPB also has the authority to seek restitution for harmed consumers and impose fines.

The case, *Seila Law v. Consumer Financial Protection Bureau*, was brought in the Ninth Circuit by a California-based law firm alleging that the agency's structure grants too much power to its director in violation of the Constitution's separation of powers. Unlike the heads of many other federal agencies, the CFPB director—who serves a five-year term—may only be removed by the President for "inefficiency, neglect of duty, or malfeasance in office." The Ninth Circuit ruled that it is "constitutionally permissible" for the director to be protected from removal other than for cause, but Seila Law has argued that such limited removal powers unduly restricts presidential authority, leaves the director with unchecked authority, and therefore violates the Constitution's separation of powers.

These are the arguments that have consistently been made by critics of the CFPB, who view the agency as shielded from presidential and congressional oversight, without checks on the scope of its power over the financial services providers it regulates. Indeed, there have been previous legal challenges to the CFPB. In a separate case decided in 2018, *PHH Corp. v. CFPB*, the D.C. Circuit upheld the agency's structure on the ground that the Supreme Court approved of the similarly structured Federal Trade Commission in a 1935 case. In dissent, then-Judge Brett Kavanaugh wrote that he believes the structure is unconstitutional. With Kavanaugh now on the Supreme Court, we can speculate that the agency's structure is more likely to be struck down. Notably, however, Kavanaugh wrote that he believed the director's independence could be limited while leaving the agency in existence.

The challenge to the CFPB comes amid a significant rollback in the agency's role as an overseer. According to a March 2019 report by the Consumer Federation of America, the CFPB had reduced enforcement activity by 80% in 2018 when compared to its 2015 high point. For example, enforcement in the residential mortgage market has declined dramatically. The CFPB announced 61 mortgage lending cases between 2011 and 2017 that returned nearly $3 billion in restitution to consumers, averaging over $10 million per week. Under acting director Mick Mulvaney (2017–2018), mortgage-related restitution declined to under $5,000 per week. Under current director Kathy Kraninger, nominated by President Trump, the CFPB has not yet announced any residential mortgage cases nor any related restitution.

The resolution of *Seila Law* has important political and enforcement ramifications. If the Court holds that the agency violates the Constitution, the ruling could potentially invalidate some or all CFPB decisions since its inception. Significantly, in the Supreme Court's order, the Court asked the parties to address whether the CFPB can remain intact even if it's structurally unconstitutional. Politically, a decision is expected during summer 2020 as the presidential election enters the final stretch. It is feasible that the Court holds that the CFPB remains viable but only if its director can be removed at the President's whim. Should that happen, if President Trump loses reelection, a Democrat would be able to replace the current appointee. As the structure currently exists, Kraninger serves until December 2023. ■

Doing the Safe Harbor Cha-Cha: One Step Forward, One Step Back

The year 2019 was not a big one for seminal Bankruptcy Code "safe harbor" cases, but if the safe harbors are your thing (they're certainly ours), there were a couple of cases worth noting.

In re Tribune Co. Fraudulent Conveyance Litigation

A recent decision from the U.S. District Court for the Southern District of New York, *In re Tribune Co. Fraudulent Conveyance Litigation*, No. 1:11-md-02296 (S.D.N.Y. Apr. 23, 2019), reexamined the application of the securities safe harbor under Section 546(e) of the Bankruptcy Code and found that a trustee could not assert a claim for constructive fraudulent transfer to avoid a settlement payment because those payments were made by or to certain protected entities and were preempted by the safe harbor provisions of the Bankruptcy Code. The court noted that the Tribune Company was protected as a financial institution because, during the transactions at issue, it was a customer of an intermediary that is a financial institution. The court's decision in *Tribune* came on the heels of a 2018 U.S. Supreme Court decision in *Merit Management Group LP v. FTI Consulting Inc.*, in which the Court held that a court must look to the overarching transfer at issue to evaluate whether the transfer would be protected by the safe harbor provisions of the Bankruptcy Code. The Court, however, failed to specifically address whether an entity qualifies as a "financial institution" if the entity is a "customer" of a financial institution—the exact question at issue in the *Tribune* case.

The dispute in the *Tribune* case arose out of a massive, failed leveraged buyout (LBO) in which Tribune utilized the services of Computershare Trust Company to act as "depositary" for payments made to shareholders in connection with the LBO tender offer. As a result of the failed LBO, Tribune filed for bankruptcy in the Southern District of New York. The litigation trustee, relying on the *Merit Management* case, sought to amend its complaint to add constructive fraudulent transfer claims against the Tribune shareholders and claw back certain payments made to those shareholders.

Section 546(e) of the Bankruptcy Code shields certain transactions from a bankruptcy trustee's avoidance powers, including transfers by or to a financial participant or financial institution in connection with a securities contract (except through intentional fraudulent conveyance). The court held that while Tribune is not a "financial participant," Tribune met the definition of a financial institution because of its business relationship with Computershare. Specifically, the court noted that Computershare was a financial institution because it was both a bank and trust company, and because Tribune was a customer of Computershare and Computershare was acting as Tribune's agent, it acted "in connection with a securities contract." In other words, because Tribune was a customer of Computershare, it too was a financial institution for the purposes of the LBO. This means that the fiduciary relationship between an agent and a principal that becomes a debtor in a bankruptcy case may, in certain cases, offer a potential defense to a constructive fraudulent transfer claim under the Bankruptcy Code and protect transfers between the parties.

On December 19, 2019, the Second Circuit Court of Appeals issued an opinion, *In re Tribune Company Fraudulent Conveyance Litigation*, Nos. 13-3992-cv; 13-3875-cv; 13-4178-cv; 13-4196-cv (2d Cir. Dec. 19, 2019), affirming the holding in the *Tribune* case. Significantly, this is the first circuit-level opinion that addressed the customer/financial institution issue left open by the Supreme Court's decision in *Merit Management*.

In re FirstEnergy Solutions Corp.

Due to a clarifying decision rendered by the court in *In re FirstEnergy Solutions Corp.*, 596 B.R. 631 (Bankr. N.D. Ohio Jan. 15, 2019), access to a safe harbor for forward contract parties has narrowed. While the forward market has generally retained its ability to shield itself from ripple effects of an entity's bankruptcy via the use of the forward contract merchant (FCM) safe harbor, the court in the *FirstEnergy* case determined that only merchants and those in the business of entering forward contracts purely for profit are entitled safety under the FCM safe harbor. This means any producers or end-users of commodities that hedge their exposures through forward contracts and are not also in the market of entering forward contracts purely for profit are no longer afforded protection under the FCM safe harbor should their contract counterparty file for bankruptcy.

This case involved FirstEnergy Solutions Corporation, an entity in the business of purchasing and selling energy in the retail space, and one of its forward contract counterparties—Meadville Forging Company LP, a limited partnership in the business of forging metal automotive parts. Meadville in no way traded or resold electricity, nor did it have a way to do so. Because Meadville's business necessitated heavy use of electricity, it hedged its exposure to the fluctuating cost of electricity through a forward contract with FirstEnergy that included the following provisions: (1) a party would be in default upon filing for bankruptcy; (2) the contract is a forward contract; (3) each party was an FCM; and (4) the non-filing party could terminate the contract upon written notice to the bankrupt party.

FirstEnergy filed for bankruptcy on March 31, 2018. Soon after, Meadville terminated the contract, claiming it was allowed to do so under the safety of the FCM safe harbor. In response, FirstEnergy filed a motion to enforce the automatic stay against Meadville. The case turned on whether the court believed that Meadville met the requirements to be an FCM and could thus take advantage of the termination clause in the contract.

In order to claim FCM status, an entity must be a merchant or in the "business of" making a profit off of forward contracts. The court adopted the narrow analysis of *In re Mirant Corp.*, 310 B.R. 548 (Bankr. N.D. Tex. 2004), which defined "merchant" as a party that engages in buying, selling, or trading in a market and is not an end-user or producer of the commodity, and "business" as "something one engages in to generate a profit." Since Meadville was an end-user of electricity only and entered into forward contracts to hedge its own exposure to the cost of electricity it utilized in carrying out its actual business of manufacturing auto parts, the court held that it was not an FCM.

The court left open whether or not the FCM safe harbor will continue to apply to parties that can claim both the status of merchant or being in the business of forward contracts and the status of producer or end-user. It seems for now those parties should be able to rely on the FCM safe harbor since the court did not expressly disqualify those with dual status from utilizing it. ■

LIBOR Transition: Report from Across the Pond

For the blissfully unaware, the end of LIBOR may still seem a long way off given its anticipated discontinuation at the end of 2021, but there is still so much to address between now and then. Some are in full-fledged panic mode, others are actively rolling out ARRC transition or other institutionally developed transition provisions, and yet others are just now waking up to reality. Our London office is happy to report that the UK loan markets are finally getting busy shifting, albeit slowly, to risk-free rates as the basis for floating rate deals.

The end of LIBOR was announced by the UK's Financial Conduct Authority (FCA) back in 2017. Fast forward two years, and while the derivatives and securities markets have made significant progress in transitioning to alternative benchmark rates (nearly half the swap trades executed in 2019 referenced the Sterling Overnight Index Average (SONIA)), the loan markets have barely moved off the starting blocks. But as the second half of 2019 drew to a close, LIBOR transition in the UK loan markets finally began gathering some speed. It was only last July that the first loan benchmarked to SONIA closed in the corporate loan market (provided by NatWest, which has closed a small number of such loans in the second half of 2019 as it looks to lead the way) and only this past November that the first SONIA loan, arranged by Deutsche Bank, closed in the real estate loan market. This particular loan referenced a compounded average of SONIA set in arrears with a five-business-day lag and is thought to be one of the first adoptions of a loan referencing an average of overnight SONIA in the entire CRE market.

In another sign that the transition away from LIBOR to SONIA is picking up pace in the London market, Clydesdale Bank (a UK bank specializing in residential real estate) has launched a consent solicitation to replace LIBOR as the reference rate for some of the notes issued on recent deals by its UK residential mortgage master trust, Lanark Master Issuer. The deals are part of a residential mortgage-backed note program for Clydesdale Bank through which sterling LIBOR instruments have been issued; Clydesdale Bank intends to transition some of these sterling LIBOR-linked funding sources to SONIA. Because the interest rate step-up date for each series of issued notes falls after 2021, Clydesdale has convened meetings to enable noteholders to approve the implementation of changes to the interest basis from LIBOR to SONIA.

For the UK at least, SONIA has been named by the Bank of England's Working Group on Sterling Risk-Free Reference Rates as its preferred primary interest rate benchmark for the sterling bond, loan, and derivative markets. SONIA reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions. It is based on actual transactions and is published by the Bank of England.

The proposed LIBOR-replacement formula for facilitating the calculation of interest is a compounded daily SONIA. Due to the differences in the nature of LIBOR and SONIA, the replacement of LIBOR as the reference rate for the notes will also require corresponding adjustments to the existing margin payable for each series of notes. The proposed methodology to effect such a change in the interest basis uses market-observable screen spot rates and an adjustment for the period from the relevant pricing date to the "forward start adjustment date" (reflecting the forward starting nature of the next interest payment date relative to the pricing date). The proposed methodology is considered by the market to be appropriate to achieve an economically neutral outcome in the wider context of LIBOR replacement with SONIA, taking into account various factors, including the known weighted average life of each series of notes and general industry and market feedback.

Although SONIA is a long-standing published rate, there is currently no chosen administrator that is providing compounded average rate calculations to the market for any given period. Accordingly, this will fall on the facility agents to unilaterally make those calculations and requires borrowers to place a lot of confidence in the facility agent's operating systems and calculation methodology at a time when they will still be implementing their new systems and facing wider administrative pressures surrounding the migration. This past July, NatWest issued a free service to calculate compounded SONIA rates, which may well help many transition over from LIBOR.

Additional administrative challenges include the need for lenders to create new underwriting and pricing models to address the benchmark change, and for lenders and facility agents to implement new systems and processes for communicating with borrowers the amount of interest that needs to be paid on each interest payment date.

The Loan Market Association (LMA) has recently issued "exposure drafts" of its reference rate selection agreement. The draft, which is open to industry comment and not yet a recommended form, is intended to lay the framework for parties to efficiently transition existing loans from LIBOR to SONIA. The LMA has also issued exposure draft facility agreements (one for SONIA and one for the Secured Overnight Financing Rate (SOFR)) for market commentary and feedback; the draft is welcome and lays a proposed legal framework for how interest on SONIA/SOFR-based facilities will be calculated. Consistent with the approach adopted in the early deals, the exposure draft calculates interest on a compounded-in-arrears basis by reference to an observation period starting before the start of, and ending before the end of, the relevant interest period.

Without doubt, migrating from LIBOR is not going to be easy. There are many economic, structural, administrative, and documentary hurdles that the UK loan market needs to clear. But progress is being made, and the pace will quicken now that the market has seen a few SONIA-based deals and the LMA has very helpfully provided exposure draft documentation. The year 2020 will be very busy for all. ■

Shameless Plug: Alston & Bird Tackles LIBOR Transition Through Tech

Imagine thousands of legacy customer accounts spanning all parts of an institution's operation. Deep within the recesses of the related closing binders, these accounts can have anywhere from one document to 50 documents that include an interest rate determination methodology referencing the soon-to-be-replaced LIBOR, the London Interbank Offered Rate. Is there a fallback mechanism in place for each and every one of those accounts? One that actually works? As many of us know by now, most of these documents do not contemplate the cessation of LIBOR in any effective way. Grappling with this is the nightmare scenario, and the reality for many institutions.

Developing first an understanding of what is, and what isn't, there and then a comprehensive, workable approach to these legacy accounts seems like a nearly impossible task that requires countless hours of grinding diligence done by a massive team of attorneys. But it doesn't have to be. In working through these issues for our clients, we've found that certain technology and software solutions are drastically reducing the time it takes to find and identify the relevant provisions. While there are no "off-the-shelf" tech solutions that can handle all the challenges created by the disappearance of LIBOR, these tech tools can be "trained" to find all the iterations of LIBOR and related fallback provisions. That said, finding the provisions is only the first step. Then comes the analysis and the solution—and we are actively employing tech to assist with that as well.

As an example, take a deal whose fallback provision might not be operable. If a tech tool is properly trained, it can also extract the relevant amendment, consent, and notice provisions so that remediation strategies can be quickly and efficiently considered. Follow-on questions include: If the deal has a trustee or other third-party calculator of LIBOR, will that party have the right to seek direction from other deal parties on how to resolve the issues? Do the documents give that party the right to consult with the borrower, a lender, or someone outside the immediate sphere of control? A properly trained tech tool could assist with that as well by focusing on those provisions in the first place and ensuring the remediation strategy is well-planned.

At their core, tech tools are extremely helpful but are useless without the right human interaction on the front end. That person must understand the portfolio in question, know where the LIBOR issues reside, then think ahead to the range of possible remediation strategies. Then, working together with IT and other professionals, they must train the technology, organize a workflow, and create a project-reporting function to help make sense of those thousands of documents spread across thousands of accounts.

Alston & Bird's LIBOR Task Force has worked to harness the power of tech to assist with these issues and has started to deploy tech tools to solve LIBOR problems. Given our knowledge of the structured finance industry and representation of parties on all sides of transactions, from issuer to underwriter to servicer to trustee to borrower to lender, we've been able to efficiently employ these tech solutions to help clients manage their thousands of customer accounts. We're happy to help you, too. Call your Alston & Bird contact to discuss how to solve your LIBOR problem. ■

OCC Releases Delicious Final Rule on OREO Properties

The Office of the Comptroller of the Currency (OCC) recently issued a final rule, effective December 1, 2019, to amend regulations regarding other real estate owned (commonly called "OREO," bank-owned real estate consisting of former banking premises and real estate acquired in satisfaction of a debt) for national banks and federal savings associations. These regulations are predicated on the principle that banks should not invest directly in real estate, but rather should lend money to those who do. The regulations have not been updated for more than 20 years.

The amendments generally maintain the existing framework and standards of the regulations, but, notably, clarify certain requirements and extend the standards applicable to national banks to federal savings associations, due to the OCC's new supervisory authority over federal savings associations under the Dodd–Frank Wall Street Reform and Consumer Protection Act. The rule generally gives such institutions more latitude in holding and disposing of OREO.

Changes under the final rule include:

Holding period. Federal savings associations now benefit from the same holding period permitted to national banks: an initial five-year period, with up to an additional five years if the OCC so approves. The rule also clarifies that when a national bank or federal savings association acquires OREO through a merged or acquired institution, the holding period begins on the effective date of the merger or acquisition and not on the date the former institution acquired the OREO.

Disposition. In addition to generally allowing federal savings associations to dispose of OREO in the same ways as national banks, the new rule permits both types of institutions to dispose of OREO in other ways that may be approved by the OCC, including donating or escheating OREO or negotiating early terminations of OREO leases. It should be noted that writing OREO (whether owned or leased) down to zero for accounting purposes is not considered a valid disposition under either the prior rules or the final rule.

Appraisal requirements. Federal savings associations are now under the same OREO appraisal requirements as national banks. The regulations generally require an appraisal consistent with certain specified standards, followed by periodic subsequent monitoring. Certain existing exceptions remain unchanged, including that no appraisal is required if there is still a valid appraisal that was created in a transaction involving the OREO.

OREO expenses. In addition to codifying certain existing interpretations of permissible expenses on OREO, the new rule applies the same requirements for advances to complete an OREO development or improvement project to federal savings associations as those placed on national banks. ■

ALSTON & BIRD ANNOTATIONS

Alston & Bird recently launched a London office focused on finance and payments systems. The new office was founded by Finance partners Andrew Petersen and James Spencer, along with Payments partners James Ashe-Taylor and Rich Willis.

Alston & Bird welcomes Robin Regan, formerly of Kroll, as Finance counsel in our New York office.

Please join Alston & Bird at our Structured Finance Association kickoff reception in Vegas.

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