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SECURITIES

What Can Be Expected in Structured Finance and Securitization for 2018?

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A continuation of the market trends from last year can be expected in 2018. Structured finance and securitization markets had a period of relative calm in 2017 as new regulations were incorporated into transactions. While no major legislative or regulatory changes are on the horizon, the possibility of changes in law or regulation is looming, and this could affect the asset-based finance and securitization markets.

The Department of the Treasury came out with its long-awaited report, questioning the breadth and detail of Risk Retention — favoring a scale-back — and other changes that would positively affect the securitization markets. This seems to indicate that the current administration has no intention of expanding the risk retention requirements or upsetting existing markets.

Regulatory Developments

Residential Foreclosures on hold in Maryland. Four Maryland state court opinions have recently held that, absent an exemption, a holder of a residential mortgage acquired in default must be licensed as a "collection agency" under the Maryland collection agency licensing law to file a foreclosure action in the state. In these decisions, the defaulted loans had been acquired in the secondary market and had been transferred to trusts with national bank trustees. The courts held that because the trusts were not licensed as collection agencies or exempt from licensing, they could not foreclose on the loans. Ordinarily, a license is not required to acquire or sell residential mortgage loans in Maryland, and, customarily, it would be the sole obligation of the servicer or third-party debt collector — not the holder of the obligation — to obtain the collection agency license. Further, the trusts themselves had no contact with borrowers; all day-to-day contact was conducted by a fully licensed servicer. The courts also seemed to ignore that the bank trustees of the named trusts were statutorily exempt under the governing Maryland law. The decisions are being appealed to Maryland's highest state court. In the meantime, Maryland foreclosure counsel have stopped foreclosing on loans in the state when the holder is not licensed as a collection agency or statutorily exempt. If these decisions are upheld, they would have a chilling effect on the secondary market and prompt other courts and regulatory bodies to scrutinize the trust structure that is widely used to acquire loans in the secondary market.

The CFPB's TRID October Compliance Gap. The Consumer Financial Protection Bureau issued a final rule July 7, 2017, clarifying certain ambiguities in the "Know Before You Owe" Rule (commonly referred to as TRID), which became effective Oct. 3, 2015. The fi-

nal TRID rule memorializes the CFPB's informal guidance on various issues and makes additional clarifications and technical amendments. Among other revisions, the final TRID rule creates tolerances for the total of payments; adjusts a partial exemption mainly affecting housing finance agencies and nonprofits; extends coverage of the TRID requirements to all cooperative units; and provides guidance on the sharing of the integrated disclosures with various parties involved in the mortgage loan origination process. The Final TRID Rule does not resolve all ambiguities, including those related to cures for TRID disclosure errors or any resulting liability under TILA. The final TRID rule became effective Oct. 10, 2017. However, compliance for most amendments is mandatory only for transactions with application dates on or after Oct. 1, 2018. The CFPB has established this optional compliance period between the effective date of Oct. 10, 2017, and the mandatory compliance date of Oct. 1, 2018, when subject parties may comply with the current version of the TRID rule and or the amended version. The CFPB on July 7, 2017, also issued a new proposed rule with request for public comment that addresses certain TRID issues not addressed in the final TRID rule related to the redisclosure of loan-related fees and the determination of whether those fees were disclosed in ''good faith'' under the TRID rule.

FIRREA Weighs Valuation. Two recent developments in the appraisal and valuation space are anticipated to affect primary and secondary real estate finance transactions. First, the federal banking regulatory agencies — including the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corp. — are considering revising some of their appraisal requirements enacted pursuant to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Pursuant to Title XI of FIRREA, the agencies generally require the performance of an appraisal for most of the real-estate-secured transactions they regulate, but certain exceptions have been established by rule. The agencies are considering a proposal to increase to $400,000 from $250,000 the threshold at or below which appraisals would not be required for commercial real estate transactions. While limited to commercial real estate transactions, the proposed definition includes loans to consumers for the initial construction of their dwelling or transactions financing the construction of any building with one to four dwelling units as long as the loan doesn't include permanent financing. The proposed rule is part of a larger shift away from traditional appraisal processes and toward the use of valuation alternatives, including automated valuation models.

Appraisal Management Companies Face Fees. Second, effective Nov. 24, 2017, the Appraisal Subcommittee has adopted a rule directing states that register appraisal management companies (AMCs) to collect a fee from each registered entity to support a national AMC registry. The fee would be $25 for each appraiser who has performed appraisal services involving a ''covered transaction'' (one secured by the consumer's principal dwelling) for the entity during the previous 12 months. Some states have anticipated the registry fees by creating new regulations — either precluding an AMC from passing the fee on to an appraiser or providing for the collection of a processing fee on top of the fee set by rule — raising the possibility that AMCs will raise their fees accordingly. AMCs also have indicated that their existing processes do not provide for the automatic identification of covered transactions; the information an AMC gets from a lender in connection with an appraisal order usually does not include a copy of the loan application or other documentation that would indicate whether the assignment involves the borrower's primary residence. Accordingly, AMCs may have to revise their systems — and their interactions with lender clients — to facilitate identification of covered transactions.

2017 Tax Reform. The Tax Cuts and Jobs Act of 2017 (TCJA), as signed into law Dec. 22, 2017, made several changes to the federal tax laws that could have ancillary impacts on structured finance and securitization markets. For example, the TCJA reduced the cap on principal balances entitled to take mortgage interest deductions from $1 million to $750,000 for mortgage loans originated (or subject to a written binding contract) after Dec. 15, 2017. The TJCA also suspended the ability of borrowers to deduct interest for existing and future home equity lines of credit (HELOCs) for the taxable years beginning on or after Jan. 1, 2018, with such suspension ending for taxable years beginning after Dec. 31, 2025. While it remains unclear to what extent these new rules will affect borrowers' behavior, they could feasibly negatively impact the market for higher balance mortgage loans and HELOCs, potentially affecting the value of the related mortgaged properties and the ability of borrowers to sell or refinance their mortgaged properties in the future.

The TCJA also imposes new limits on the ability of certain debt issuers to take ''net business interest expense'' deductions (generally, a borrower's business interest deductions in excess of its business interest income). While the calculation of this new business interest deduction limitation is subject to numerous conditions and exceptions, it can generally be described as denying certain debt issuer's business interest deductions for a taxable year in excess of 30 percent of such issuer's ''adjusted taxable income.'' To the extent this limitation applies to an issuer, such issuer (or potentially its partners or members from noncorporate issuers), will no longer be able to deduct his or her business interest expenses in excess of this 30 percent threshold for a taxable year, potentially resulting in additional taxes to such issuer for that year. We expect issuers subject to this new interest deduction limitation will explore various nondebt strategies and techniques to attempt to achieve the economically equivalent result of an interest deduction but free of this new limitation; however, it is too early to tell whether any such strategies or techniques will work from a technical tax perspective or, more importantly, will be feasible and practical from a nontax corporate and business perspective.

Commercial Mortgages. After a slow start in the first quarter, the CMBS market accelerated and is on pace to reach $90 billion in issuance, a substantial increase over the $76 billion for 2016. The year has been marked by a few twists and turns. First, risk retention took effect on Christmas Eve 2016, and banks were prepared with market-tested, sponsor-retained vertical deals. However, preservation of the B-piece buyer construct as third-party purchaser (TPP) to meet risk retention requirements brought drawn-out negotiations over indemnities and financial covenants since the issuer remains responsible for TPP compliance. Finally re-

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solved, deals emerged in the first quarter with all variants of risk retention, including horizontal, vertical and L-shaped interests, with the L-shaped often viewed as the most economical.

The major accounting firms threw market participants a curveball in June. After six months and dozens of deals into risk retention, issuers were advised that the purported sales to a TPP in compliance with risk retention would not meet accounting sale treatment under ASC topic 860, Transfers and Servicing. The accountants and issuers, through the Securities Industry and Financial Markets Association, wrote to the SEC Office of the Chief Accountant requesting interpretation and a CMBS life preserver. Fortunately, that life preserver came early in the fourth quarter via a call from the Securities and Exchange Commission advising that, based on the intent of the rule and facts outlined in the letter, it had no objection to recognizing sale treatment when using a TPP.

While issuance is on the upswing, the number of originators has nonetheless declined over the past few years, in large part due to the regulatory overlay imposing greater liability on sponsors for all pooled loans, as well as investor reticence to accepting loans from organizations with weaker capitalization. So, this has led to fewer lenders but increased volume. Yet the market metrics are strong and positive: CMBS spreads on the benchmark triple A bonds have dropped from over 100bp at the start of the year to under 80bp on fourth-quarter deals; and borrower demand is strong, particularly in the single-asset, single-borrower (SASB) space, which increased from 26 percent of issuance in 2016 to 38 percent through the middle of the fourth quarter. The SASB deals often have *pari passu* notes that are placed in other conduits, adding a degree of complexity to servicing and reporting on those loans. The Mortgage Bankers Association reported that commercial loan borrowing increased by 17 percent year-to-date over last year, even though sale transaction volume slowed. Trepp reports that the delinquency rate on CMBS has dropped in successive months in the second half for all five property groups, which is expected to continue.

The boost in CMBS activity was a bit surprising given increases in alternative lending activity. For example, commercial real estate collateralized loan obligation issuance increased significantly this year, already double that for 2016. Several factors underlie this increase: flexibility in facilitating transitional properties, more disciplined underwriting for conduit loans reduced some of the high loan-to-value and low rate that had attracted borrowers, and the increasing complaints of borrowers about the CMBS experience led many to seek anything non-CMBS. The negative CMBS borrower experience did not go unnoticed: The Commercial Real Estate Financial Council appointed a task force to address the complaints and recently produced a report with recommendations to improve the borrower experience without jeopardizing investor credit concerns.

So, what's the outlook from a regulatory perspective? Many expected the administration to roll back regulations and facilitate market activity. While there has been relief, it has not been substantial. Treasury came out with its long-awaited report in October questioning the breadth and detail of much of risk retention and favoring a scale-back; but will it lead anywhere?

Expecting regulatory or legislative action in this political environment may not be a safe bet, but market participants have hopes for making at least some accommodating reforms. Perhaps a positive indicator is that the tax bill passed in the waning legislative calendar of 2017 did not disturb key commercial real estate provisions affecting borrowers and lenders.

Non-Mortgage Assets

Developments in the Auto Sector: The securitization pipeline for both prime and nonprime auto issuances remained steady in 2017; however, issuance volume, compared to 2016, continues to remain slightly down. At least four seasoned prime issuers closed their fourth securitization transaction as of the fourth quarter, and two bank issuers re-entered the market for the first time since 2015. While financial institutions have the ability to fund auto loan originations from their internal capital, the recent re-entry of two bank issuers into the market indicates strong investor interest and favorable market pricing conditions. However, regulatory bank capital requirements may continue to put pressure on financial institutions in the coming years, and cause smaller institutions to reduce their exposure to the prime auto securitization market or exit the market completely.

Although the prime securitization market has remained relatively concentrated with seasoned players, nonprime continues to attract a more diverse issuer base across a broad spectrum of product, ranging from near-prime to deep nonprime. Consistent with last year's numbers, nonprime securitization issuances continue to exceed prime securitization issuances, and at least one seasoned nonprime auto finance company sponsored its inaugural securitization in the fourth quarter.

Institutional and specialty finance lenders continue to provide a strong source of financing to auto finance companies through traditional warehouse credit facilities, term loans, and bespoke asset-backed financing structures. Nonprime auto paper also continues to attract more diverse investors seeking higher yields. Although the whole-loan auto secondary market has always provided a strong source of liquidity, industry participants have noted a strong uptick in secondary market trading activity this year in particular. The increase in whole-loan market trades may be attributed in part to the fact that certain originators, including smaller players, have made the strategic decision to exit the nonprime auto finance space by selling off whole-loan portfolios. This trend is anticipated to continue into 2018.

Compliance with the Dodd-Frank credit risk retention requirements (Regulation RR), which became effective Dec. 24, 2016, presented fewer implementation challenges for auto issuers as opposed to other asset classes. This is largely because pre-Regulation RR nonprime auto securitizations were typically structured to provide for some form of substantial retained economic risk. Public auto issuers have also effectively streamlined compliance with Regulation AB II's asset-level data requirements that became effective Nov. 23, 2016. The asset-level data requirements require public auto issuers to provide standardized asset-level information relating to 72 data points for each financed vehicle to be securitized. The asset-level information must

now be disclosed and filed with the SEC on the Electronic Data Gathering, Analysis, and Retrieval system (EDGAR) on Form ABS-EE in the standardized, tagged data format called Extensible Markup Language (XML), both at the timing of the offering and at or before the filing of the related Form 10-D. In 2018, several auto issuers will go through their first SEC Form SF-3 shelf registration statement renewal processes since Regulation AB II took effect Nov. 23, 2015. Because of the increased transaction costs, heightened regulatory oversight, and granular disclosure requirements, it remains to be seen if any new issuers will enter, or non-active issuers will re-enter, the public securitization market in 2018.

In another notable regulatory development that could have significant implications in the prime auto securitization markets, the Office of General Counsel of the National Credit Union Administration (NCUA) issued a legal opinion in June 2017 that held that a federal credit union (FCU) has the authority to issue and sell securities (including asset-backed securities) under the Federal Credit Union Act (FCUA). The NCUA is the independent federal agency charged with regulating, chartering, and supervising the nearly 5,700 FCUs. The opinion was issued in response to inquiries from industry participants seeking clarification on whether an FCU has the authority to issue and sell securities or whether additional regulation would need to be adopted. The opinion, although a positive outcome for the industry, only applies to FCUs and not to federally insured, state-charted credit unions.

To date, credit unions have played an active and important role in the U.S. auto finance industry, but such activities have been limited to the whole-loan market.

The NCUA legal opinion notes that the authority to issue and sell securities is not an express power granted to FCUs, but rather an activity that is authorized under the ''incidental power'' provisions of the FCUA. The opinion emphasizes, however, that before securitizing any assets, an FCU must submit an application and work closely with the NCUA to structure and onboard the securitization program.

Pursuant to the NCUA's guidance, FCUs that onboard a securitization strategy must comply with all applicable legal requirements, including the FCUA, NCUA regulations. and other federal laws and regulations that govern the issuance and sale of securities. The NCUA legal opinion also notes that the FCU must carefully develop proper internal safeguards to ensure it continues to serve the interests and needs of its members. Internal safeguards include management oversight, internal controls. and quality control, in addition to adjusting its risk management process and insurance coverage to account for the additional risk taken on by the FCU.

Although the NCUA legal opinion allows FCUs to tap into a new source of liquidity and mitigate potential interest rate risk, FCUs will have to contend with the requirements set forth under the NCUA's recently amended safe harbor requirements, which became effective July 31, 2017. The requirements impose several conditions on the availability of the safe harbor in connection with a securitization, including that the documents governing both a public and private securitization must, at a minimum, require the delivery to investors of asset-level data in line with the requirements set forth under Regulation AB II. Compliance with this requirement may prove to be a barrier to entry for smaller FCUs that lack the technology or resources to provide this granular level of reporting.

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