



The Impact of Dodd-Frank on the US Securitization Market

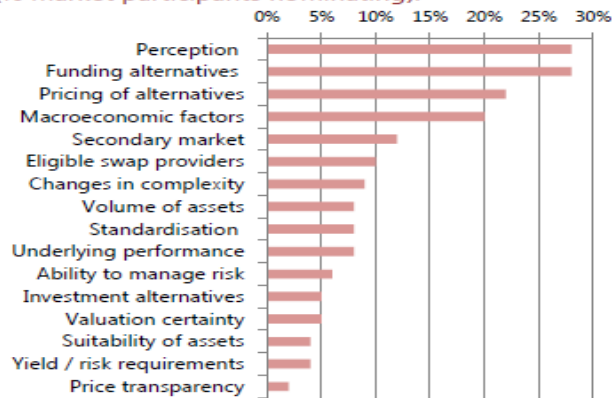
Chris DiAngelo

October 7, 2015

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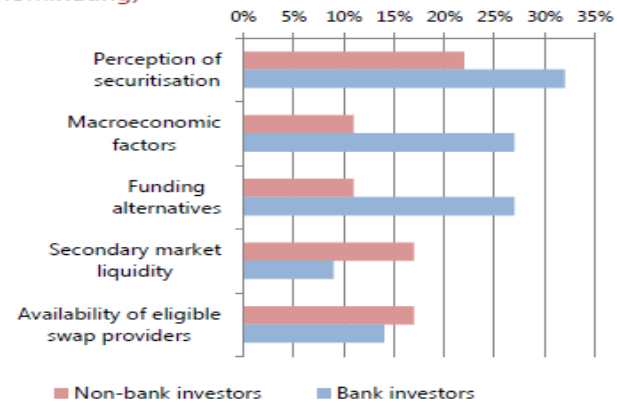
- Member of Structured Finance Industry Group (SFIG) Board of Directors and Executive Committee
- Partner at Katten Muchin Rosenman LLP, Member of Board of Directors and Executive Committee, Managing Partner of New York Office
- 31 years as a finance attorney in structured finance and mortgage finance

Chart 1: Most important market factors contributing to market developments since 2009 (% market participants nominating).



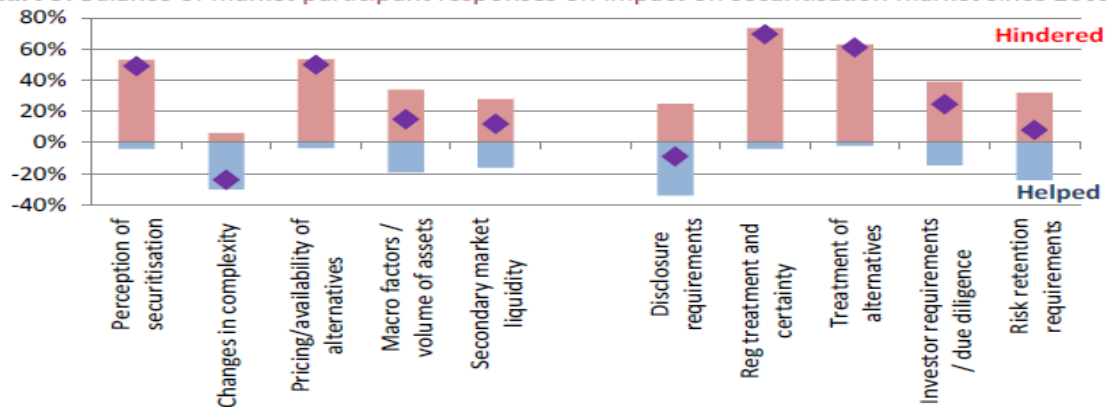
Source: Responses to the TFSM Survey.

Chart 2: Most important market factors contributing to market developments since 2009 (% investors nominating).



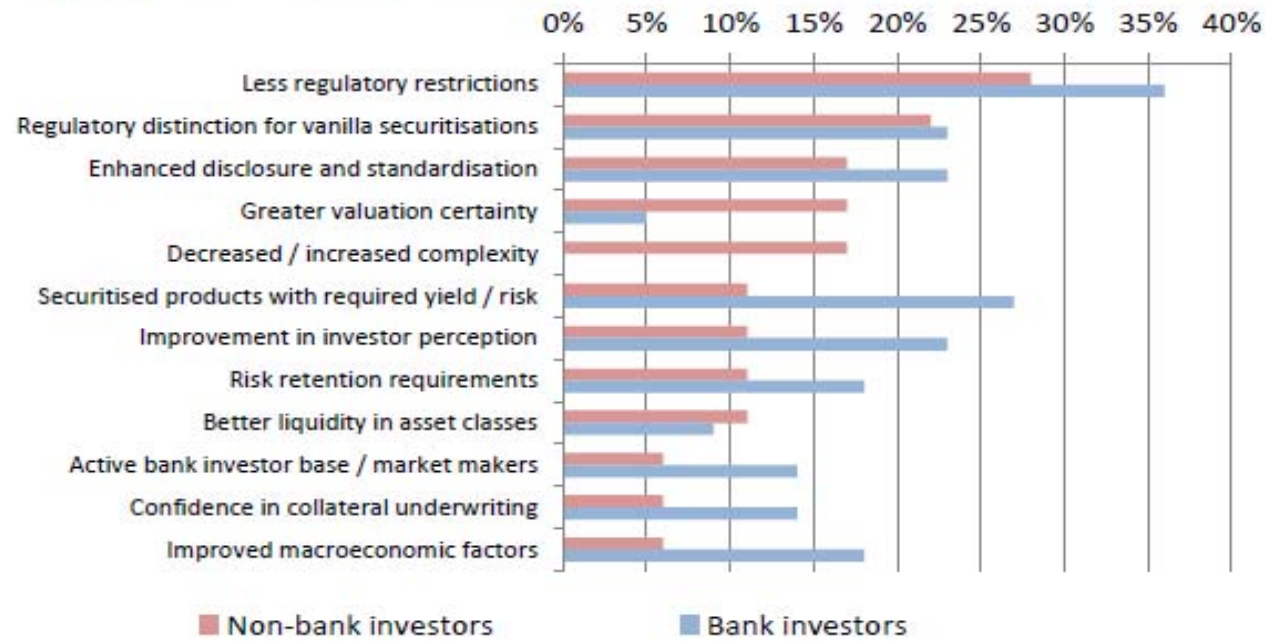
Source: Responses to the TFSM Survey.

Chart 3: Balance of market participant responses on impact on securitisation market since 2009



Regulatory treatment category includes capital and liquidity treatment. Purple markers reflect net results.
Source: Responses to the TFSM Survey.

Chart 4: Investors' view of most important factors for increasing investor participation



Source: Responses to the TFSM Survey.

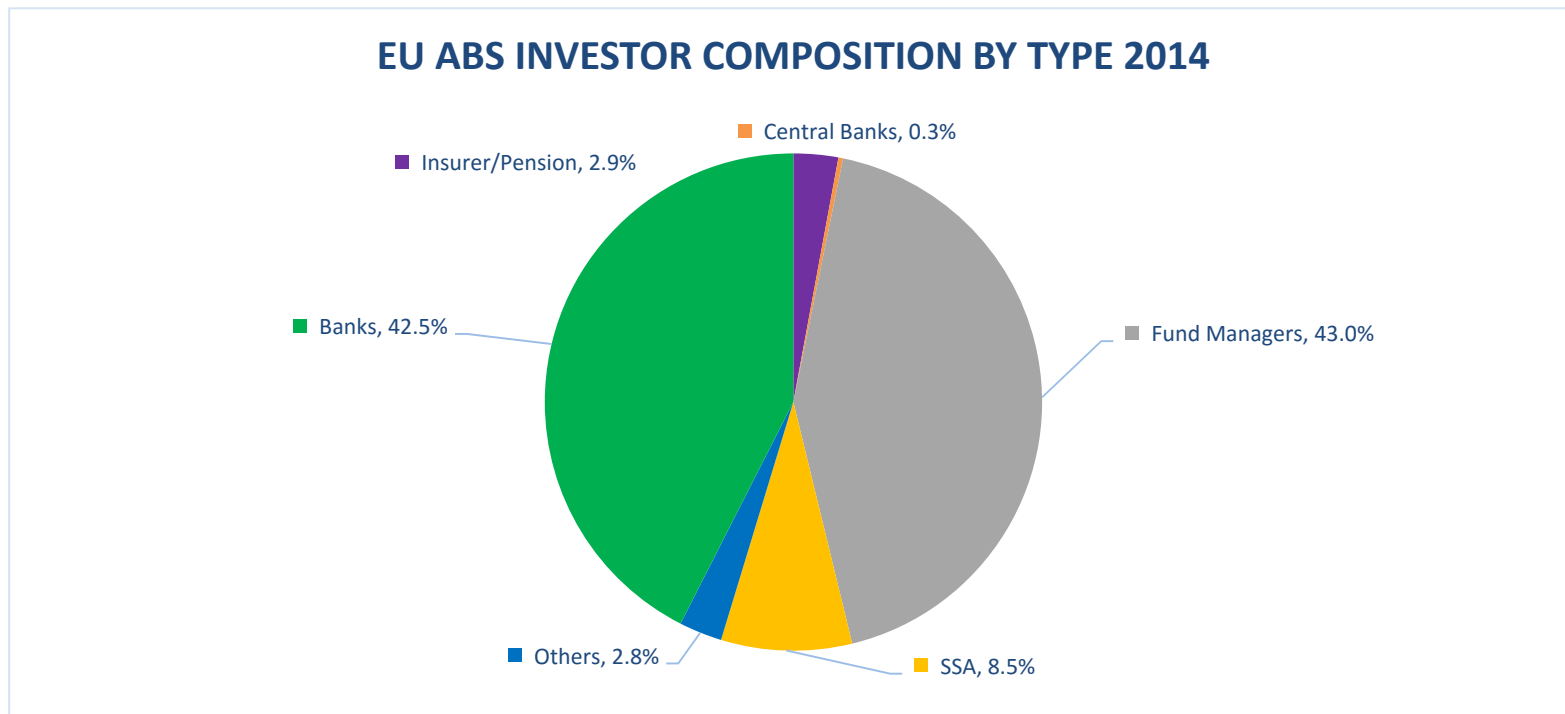
Regulatory Matters

“Perception” of Securitization

- Alignment of Interests
- Disclosure at the Security Level
- Integrity of the Underlying Assets

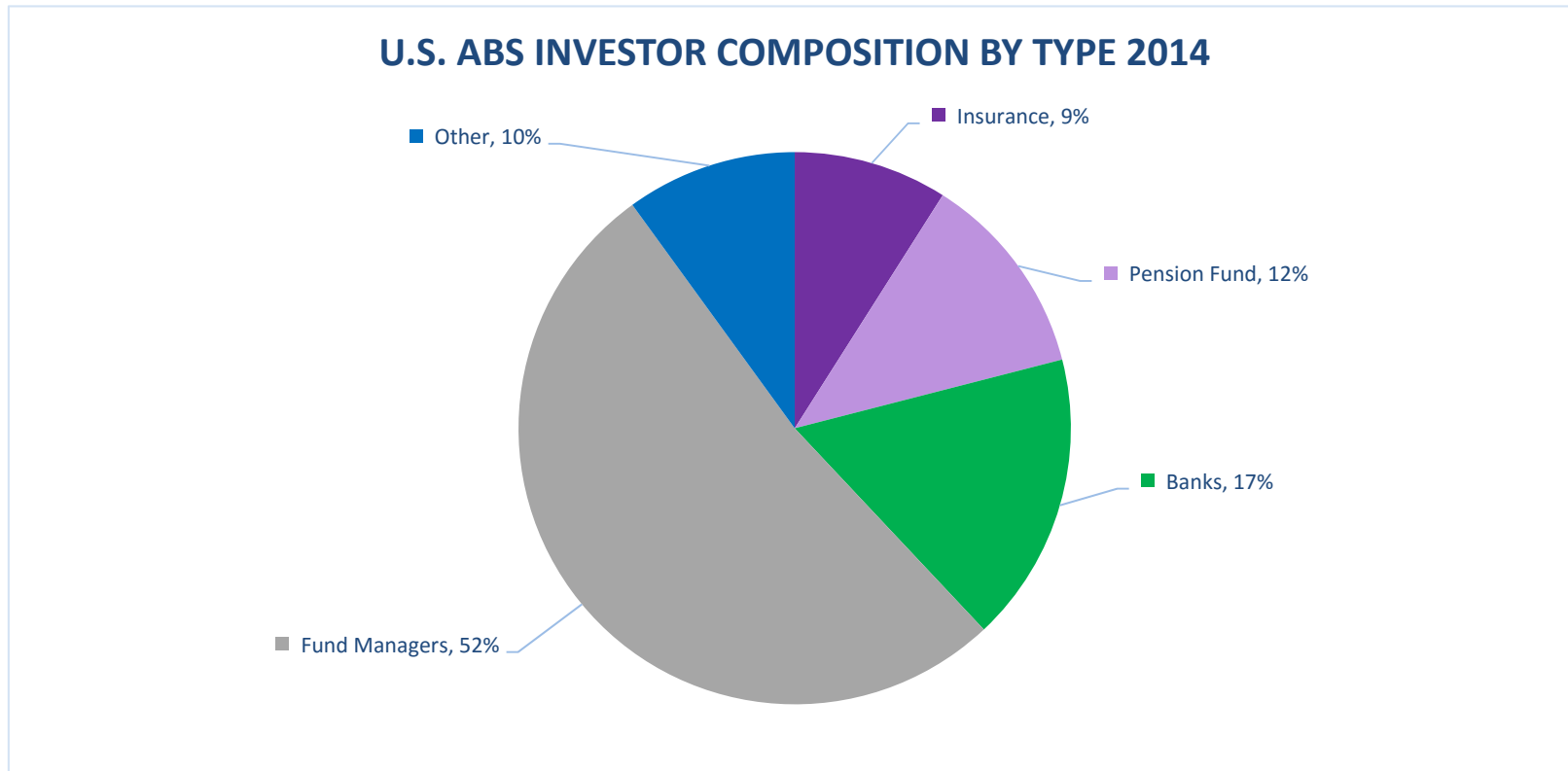
Beyond Dodd-Frank: Desire for International Regulatory Convergence/Substituted Compliance

EU ABS Investor Composition by Type: 2014



Source: Aggregated SFIG Member Data

U.S. ABS Investor Composition by Type: 2014



Source: Aggregated SFIG Member Data

Driving Business Away From Big Banks

- Mortgage Settlements – GSEs and PLS
- False Claims Act Cases – submitting non-compliant mortgage loans to FHA/VA for insurance
- Risk-based pricing
 - Inconsistent with a “utility” view of banks
 - Credit decisions become more binary – bank either makes the loan or turns it down
- Effect on the composition of mortgage originations and growth of marketplace lending

Regulatory Capital and Liquidity

- Thrust of regulations is to favor sovereign exposures at the expense of private debt: often not subject to diversification requirements and stipulated to be liquid
- Treasures and Agencies exempt from Volcker Rule

HQS

- “High-Quality” Securitizations in EU
 - Securitizations that have three characteristics: simplicity; standardization and comparability (STC)
 - HQS – eligible securities do show lower risk (less volatility) and higher liquidity (narrower bid-ask), so perhaps merit lower capital charges
 - One proposal is to have a third party designate securitizations as HQS
- As written, U.S. ABS would generally not qualify as HQS under the proposed Basel or EU criteria –
 - EU banks may invest only in EU ABS
 - US banks may invest relatively more in EU ABS
 - Stigma of ABS that doesn’t receive “HQS” status
 - Drive more product to the relatively illiquid EU Market

Liquidity Coverage Ratio

- International initiative – US bank regulators published Final Rule September 2014
- Banks must have enough high quality liquid assets (HQLA) that can convert to cash immediately during stress periods
- Only Fannie and Freddie quality for HQLA treatment; no PLS or ABS
- EU does allow some RMBS and ABS, although with haricuts

A Quick Look at Three Asset Classes

Residential Mortgage

CLO

ABCP

Qualified Mortgage and Qualified Residential Mortgage

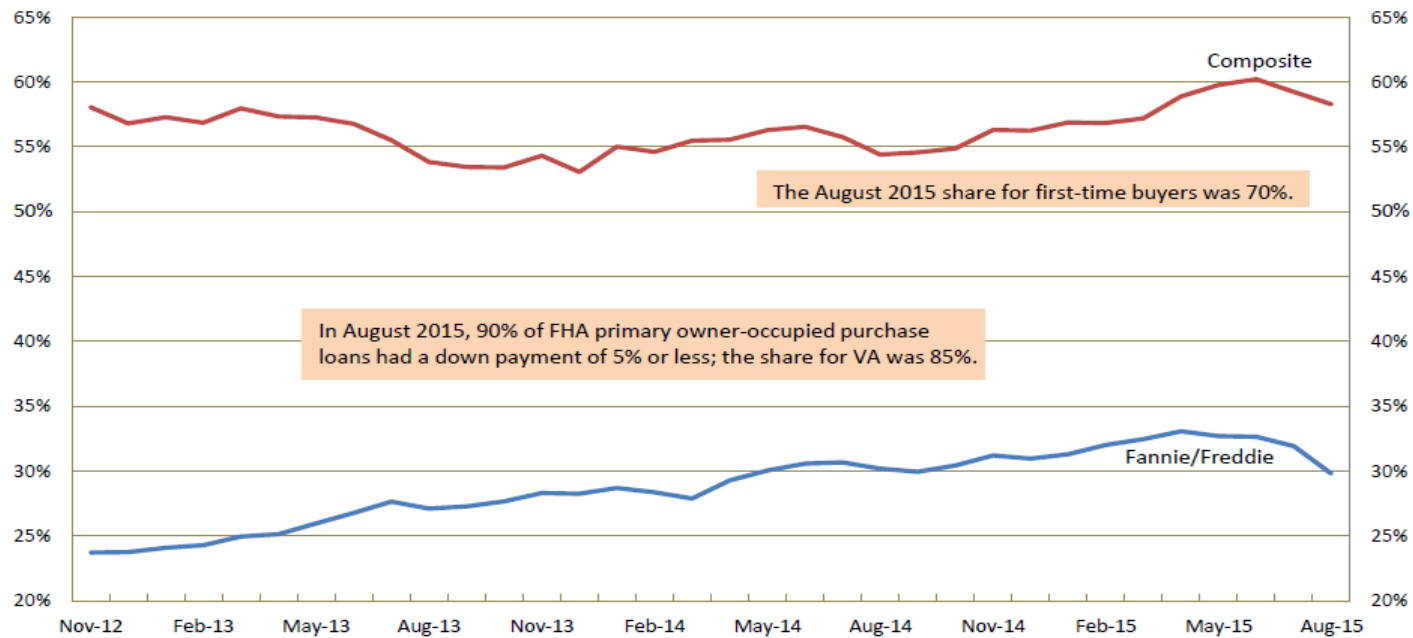
- “QM” is under the CFPB’s ability-to-repay regulation
- “QRM” is under the six joint regulators “risk retention” rule
- A QM is a QRM, not subject to the risk retention rules
- Temporary exemption for federal loans, including Fannie and Freddie

- No down payment requirement to be a QM
- Maximum 43% “back-end” debt-to-income ratio

So, what has happened?

Purchase Loans with Down Payment of 5% or Less*

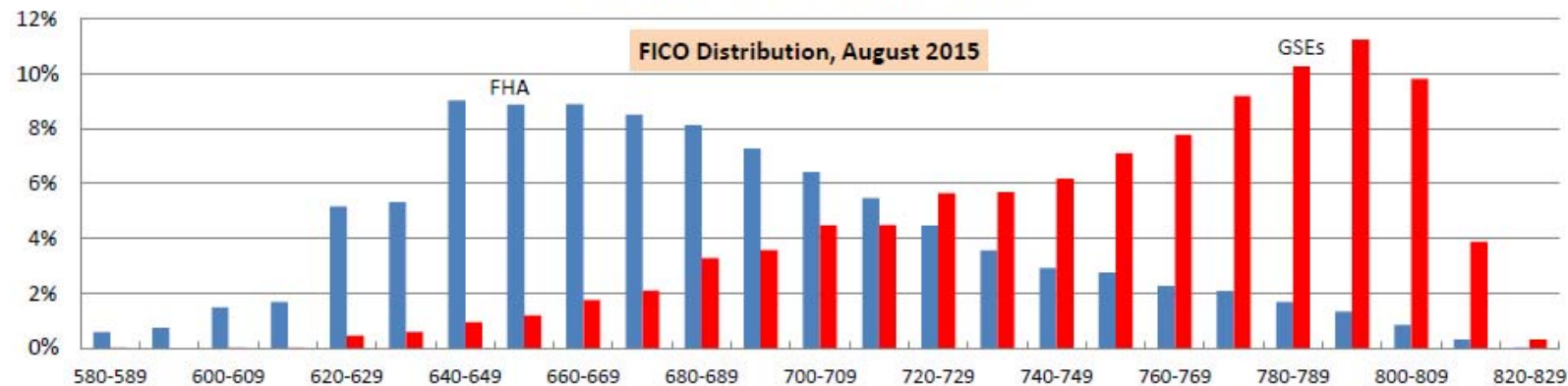
58% of all primary purchase loans and 30% of such Fannie/Freddie loans have a minimal down payment. With QM silent on down payments, lots of room for these shares to rise. In current seller's market, this will drive up home prices more than income.



*Data pertain to purchase loans for primary owner-occupied properties.
Source: AEI International Center on Housing Risk, www.HousingRisk.org

FICO Distributions and MRIs, Purchase Loans

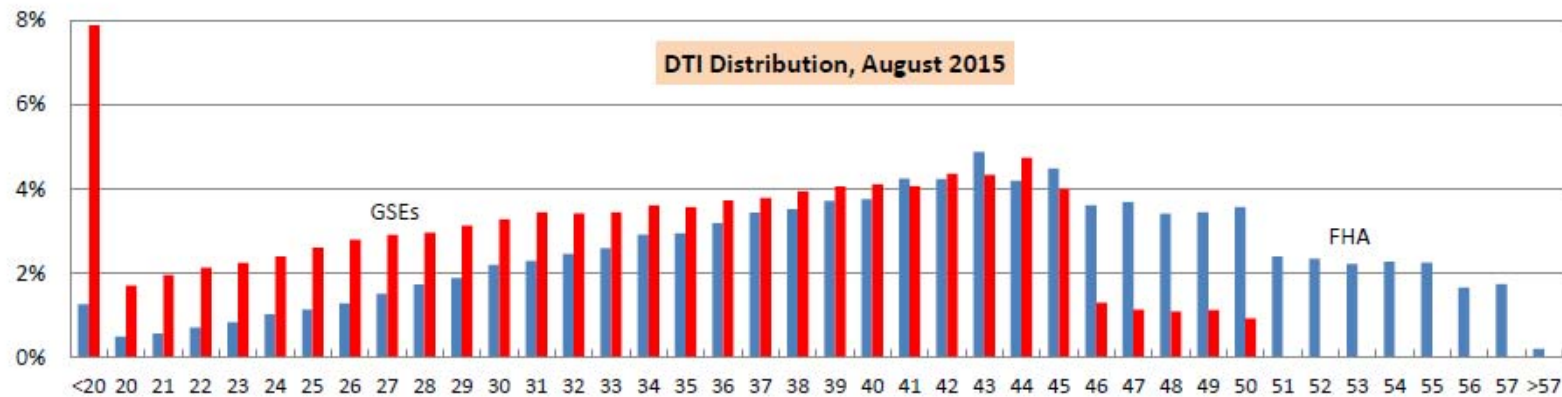
Stark contrast between FICO distributions for FHA and GSE borrowers. About 75% of FHA's FICOs are below the U.S. median score of 713; for the GSEs, 80% are above the U.S. median.



Source: AEI International Center on Housing Risk, www.HousingRisk.org.

DTI Distributions and MRIs, Purchase Loans

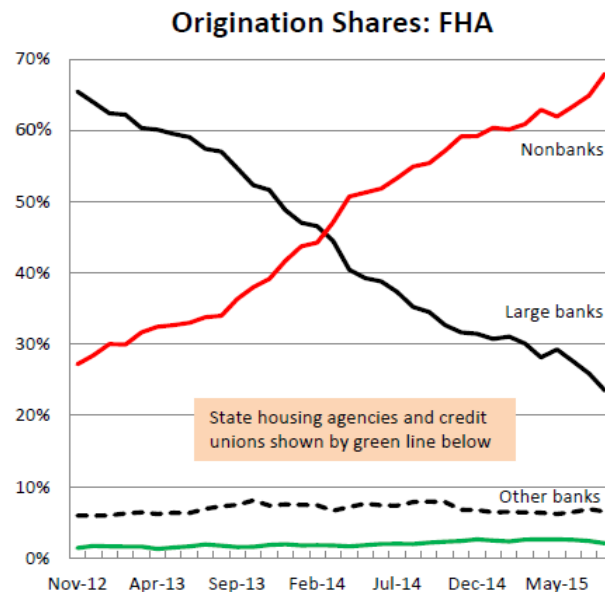
FHA's distribution of DTIs is fairly symmetric around 43%, with numerous DTIs as high as 57%. GSE distribution is more uniform up to DTI of 45% and then tails off.



Source: AEI International Center on Housing Risk, www.HousingRisk.org.

Focus on FHA: Origination Shares and MRIs by Lender Type, Purchase Loans

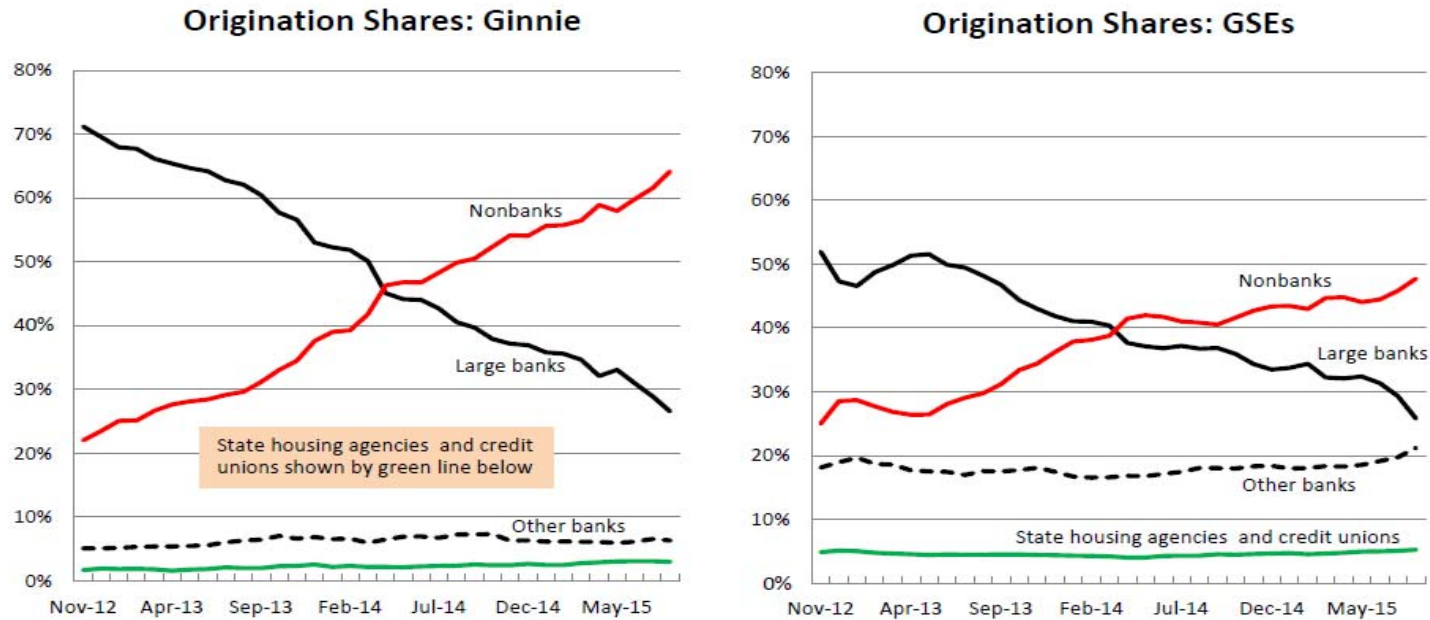
Dramatic market shift from large banks to nonbanks continued in August. Nonbanks originate riskier FHA loans than large banks and have been receptive to HUD's push to expand the credit box.



Source: AEI International Center on Housing Risk, www.HousingRisk.org.

Agency Origination Shares by Lender Type, Purchase Loans

Shift in Ginnie and GSE market share from large banks to nonbanks continued in August. Cumulatively, the shift for Ginnie loans has been especially large and helps explain why the large bank composite MRI has declined.



Source: AEI International Center on Housing Risk, www.HousingRisk.org.

CLOs

Dodd-Frank had two major impacts on CLOs

- Volcker Rule resulted in the elimination of the “bond bucket”, now can only include loans
 - Precipitated sales of legacy CLOs containing bonds before the July 21, 2015 effective date
- Risk retention requirement essentially was imposed on the collateral manager, which thought of itself as a fee earner not an investor
 - Industry trying to work through having the risk retained by a “majority owned affiliate” – this may involve as little as a 20% economic interest in the affiliate



ABCP

Volcker – generally ABCP conduit is owned by a third party and would be a covered fund vis-à-vis the bank managing the conduit due to reliance on 3(c)(i) exemption from Investment Company Act

Solutions:

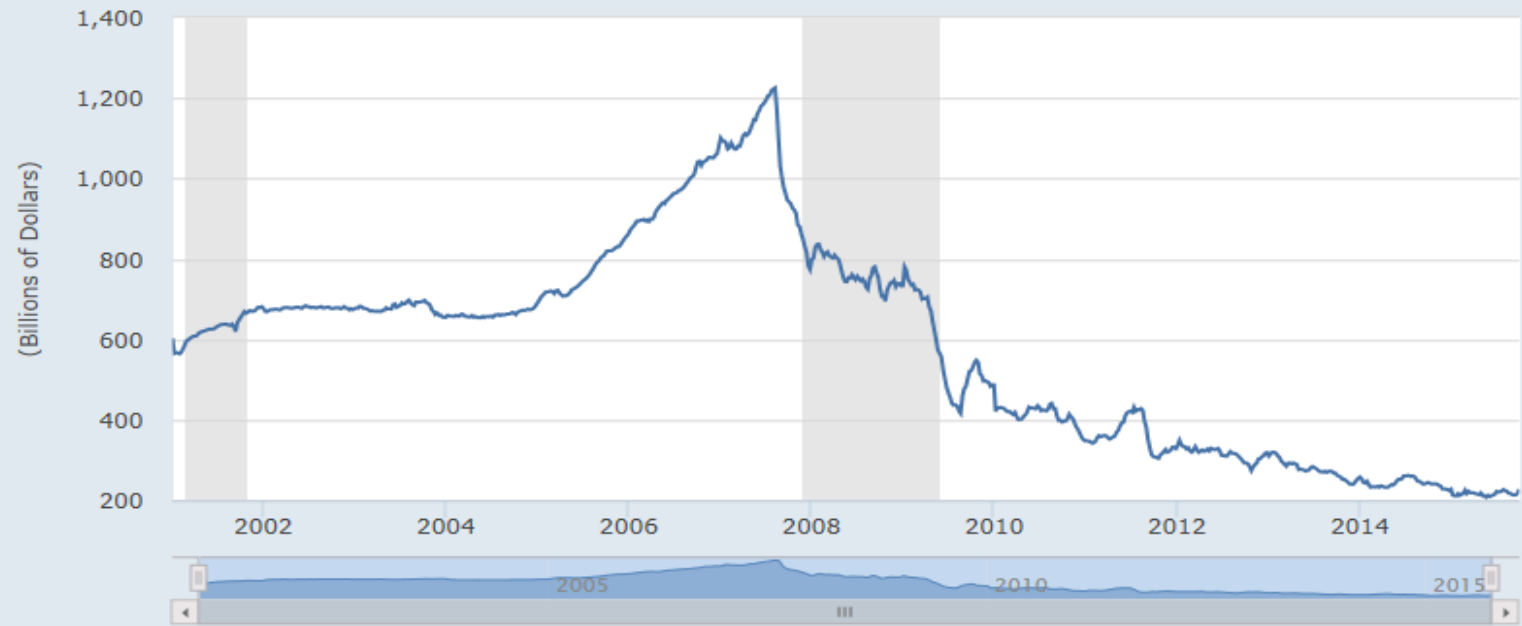
- Turn conduit into a wholly-owned subsidiary of the bank
 - Subject conduit directly to Volcker
 - Still risk retention problem
- Turn conduit into a Rule 3a-7 issuer (rated bonds)
 - Makes trading assets difficult
 - Still risk retention problem
 - Need to fix all the documents

- Restructure conduit into a Qualifying ABCP exclusion
 - Need 100% liquidity facility support
 - All assets must be acquired at initial issuance
 - Most restrictive
 - Conduit could only issue “ABS”

Risk Retention

5% risk retention requirement must be satisfied at the customer transaction level while also maintaining 100% unfunded risk retention at the program level

FRED — Asset-backed Commercial Paper Outstanding



Source: Board of Governors of the Federal Reserve System (US)

Shaded areas indicate US recessions - 2015 research.stlouisfed.org

Volcker Rule Generally

- Other than CLOs and ABCP, no huge impact on deal structures in other asset classes
- Lingering notion of a broadly negative impact on liquidity in the bond markets
 - Lack of consensus as to what “liquidity” means:
 - Ease and speed of execution?
 - Creation/existence/maintenance of a deep pool of end investors?
 - If the latter, was that ever something anybody thought the “market-making” banks were there for?

Is There Even a Consensus on Whether Liquidity is Desirable?

Furthermore, while it is essential, liquidity might not be an unadulterated good. As former Federal Reserve Chairman Volcker stated on liquidity before the financial crisis: “traders’ and investors’ sense of an ability to sell anything instantaneously contributed to the excessive leveraging and risk-taking that led up to the crisis.” Clearly, as we look at corporate bond markets, we should be focused on authentic or real liquidity. Arguably, this is liquidity that allows investors to exit investments in an orderly way and allows market-makers to help them do so. But liquidity is not real if it gives investors a sense of false comfort while making investment decisions.

-Remarks of SEC
Commissioner Kara Stein
in February

Unfinished Business Under Dodd-Frank

Extension of Reg AB to 144A?

Section 621 – Conflicts of Interest

GSE Reform and Mortgage Market

Revisit CFPB?

Regulation of Marketplace Lending

Extension of Reg AB to 144A

SEC keeps saying they are “thinking about it”

Biggest impact would be requirement to provide loan level detail

Dodd-Frank Section 621 – Securitization Conflicts of Interest

Biggest remaining securitization-related Rule

Proposed Rule released for public comment on September 19, 2011 (under Dodd-Frank, the Rule was supposed to have been finalized with 270 days of passage (April 15, 2011))

Added Section 27B to the 1933 Act – not effective until the adoption of a final rule by the SEC implementing that Section

Proposed Rule

- [a]n underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), which for the purposes of this rule shall include a synthetic asset-backed security) shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.

Conflicts of Interest

- Uses the broader definition of “asset-backed security” from the 1934 Act, and also specifically applies to “synthetic” asset-backed securities
- Applies to public, private and exempt transactions
- Major exceptions are
 - risk-mitigating hedging activities
 - liquidity commitments
 - bona fide market-making activities

Overlap with Volcker Rule

SEC stated informally that it wanted to finish the Volcker Rule before revisiting Securitization Conflicts of Interest (Final Volcker Rule was released on December 10, 2013).

Volcker Rules prohibition on proprietary trading does not apply to

- “risk mitigating hedging activities”
 - GSE Credit Risk Transfer Deals

- certain market-making activities
 - “liquidity” issues

Mortgage Finance

- Have we seen all the “GSE Reform” that we are going to see?
- “Private capital” entering the space as much through GSE risk transfer deals as through new issue PLS RMBS
- GSEs as a more credible counterparty
- RMBS 3.0 initiative “bells and whistles’ – there’s a cost to each bell and whistle
- Maybe we are looking in the wrong place for private capital opportunities

Consumer Financial Protection Bureau

- Creation of Dodd-Frank
- Impact on securitization through impact on underlying consumer assets
- Over-reliance on “guidance” and enforcement actions rather than “notice and comment” rule making?
- Unusual governance and funding structure

Marketplace Lending

- Treasury Department recently issued a “request for information” regarding marketplace lending
- “Tech companies not finance companies”
- Not part of the business model to have assets on the balance sheet
- “Culture of transparency” perhaps more in keeping with the times
- Hard for banks to innovate