

The Future of Housing Finance, the Mortgage Market and Securitization

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Future of Housing Finance

State of Housing Finance

- Pre-Crisis, the housing finance market was an \$11 trillion market
- To day that market is smaller and dominated by FNMA and FHLMC
 - At one point the GSEs were financing 95% of all new mortgage loans
- And it is a radically changed landscape from before the crisis
 - New agencies, expanded regulatory reach, sharply higher capital
- Today, we will talk about
 - How the landscape has changed
 - What is impeding the private label securities market
 - What the prospects are

State of U.S. MBS Markets

- Many issuers have been put off by the uncertainty caused by the large number of “reform” proposals resulting from the crisis.
- While there are still many uncertainties, the basic outline of the future U. S. mortgage finance market is finally emerging.
- We will review the status of a number of reforms, both adopted and proposed.
- For perspective, we will start with an overview of the agency and non-agency mortgage securitization market since 2005.

U.S. Mortgage-Related Securities Issuance (USD Billions)*

	Agency		Non Agency			Total
Year	MBS	CMO	CMBS	HEL	RMBS	Total
2005	983.3	364.4	156.7	460.2	726.0	2,691.1
2006	923.1	316.0	183.8	483.8	687.5	2,594.3
2007	1,189.0	276.6	229.2	216.9	509.5	2,421.6
2008	1,169.7	197.1	4.4	3.6	32.4	1,407.5
2009	1,734.2	288.7	8.9	0.6	9.2	2,041.7
2010	1,419.9	500.0	22.5	2.9	12.1	1,978.7
2011	1,238.6	376.7	34.3	2.2	2.8	1,662.3
2012	1,730.7	285.1	36.8	2.4	3.4	2,058.4
2013	1,596.8	261.1	79.9	8.8	8.1	1,954.7
8/14**	908.0	218.0	47.6	8.6	2.7	1,188.6

*Source: SIFMA

**Annualized

State of U.S. Private-Label RMBS Market

- Residential MBS
 - Redwood Trust
 - Post-GFC RMBS pioneer
 - Accounts for most of 2010 to 2012 U.S. RMBS Issuance
 - Other issuers entered market in 2013
 - Credit Suisse, JPMorgan, Citi, Shellpoint and more
 - Post-Crisis Deal Terms
 - Arbitration
 - Time-Limited Representations and Warranties
 - Non-traditional RMBS
 - GSE risk-sharing deals
 - Housing rental income bonds
 - Servicer advance deals

State of U.S. Private-Label RMBS Market (cont'd)

- Private-label securitizations took hold in 2013
 - 2013 started out on track to be the best year since 2008
 - At least 8 issuers were in the market in 2013, ending years of Redwood sole dominance
 - Market cooled in mid-2013 when Fed announced end of QE and rates spiked
 - Market ended 2013 with strong issuance total of \$17 billion, but less than hoped for
- PLS has cooled in 2014
 - Only \$4.5 billion of traditional prime jumbo deals closed through 9/5/14 (S&P)
 - Virtually no publicly registered deals in 2014
 - Why?

The Changed Landscape

Changed Landscape

- A very different world from the housing finance world of 2006
 - Basel III
 - CFPB
 - CFTC
 - FDIC
 - SEC
 - Volcker Rule
 - GSE legislation
 - Risk retention – QM/QRM
 - Conflicts of interest
 - Cross border conflicts of regulation
- Still changing – unfinished regulation and unresolved GSE role

Basel III

- Increased capital requirements
 - Residential mortgage loans – unchanged
 - 50% risk weighted if in accord with prudential underwriting standards; else
 - 100%
 - Securitization exposures
 - Up to 1250%; I/O strips
 - Non-cash gain on sale (e.g., I/O strips) deducted from Tier 1 equity capital
 - Servicing
 - Deduct from Tier 1 capital if exceed 10%
 - 250% risk weight
- Liquidity Coverage Ratio requirement
 - HQLA equal to total net cash outflow
 - Securitizations do not qualify as HQLA
- Net Stable Funding Ratio
 - Excludes short-term funding (except for deposits)

Basel III (cont.)

- There are several significant other capital charges
 - Supplementary leverage ratio of 3% for advanced approaches banks
 - Enhanced supplementary leverage ratio for GSIBs of at least 2% more
 - Capital surcharge proposal for GSIBs
 - Graduated common equity risk-based capital
 - Will take into account reliance on short-term wholesale funding

Servicing

- The industry is restructuring
 - Financial institutions are selling large amounts of servicing to non-financial institutions
 - Partly for capital reason
 - Partly due to increased costs and legal exposure
- Due to the rapid growth of these servicing organizations, investigations have been started to review their capacity to service a major increase in the number loans they service
- Regulation is growing
 - CFPB servicing regulations
- Costs are increasing

Consumer Mortgage Lending Reform

- Consumer Financial Protection Bureau was established under the Dodd-Frank Act and began operation on July 21, 2011
- Jurisdiction of CFPB includes banks, credit unions, securities firms, payday lenders, mortgage-servicing operations, foreclosure relief services, debt collectors and other financial companies, and its most pressing concerns include mortgage origination & servicing
- Consolidated responsibilities from various federal regulatory bodies, including the Federal Reserve, the Federal Trade Commission, the Department of Housing and Urban Development & banking agencies
- It writes and enforces rules on consumer financial products & services, conducts examinations & monitors and reports on markets

CFPB at the Ready

- CFPB Ability-to-Repay (ATR) rule
 - Amends Regulation Z to require lenders to account for a borrower's ability to repay
 - Applies to all closed-end consumer-purpose mortgage loans secured by real estate
 - Final rule took effect on January 10, 2014
- Ability-to-Repay Requirement
 - For covered mortgages, creditors must make a “reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability to repay the loan according to its terms”
 - Liability for violation of the foregoing standard is limited for “qualified mortgages” (QM's), which today consist of Fannie Mae & Freddie Mac eligible loans & loans eligible for insurance/guaranty by FHA & VA

ATR Underwriting

- For the general ATR determination, eight enumerated underwriting factors for creditors to consider, including:
 - Borrower's income or assets (excludes assets securing the loan)
 - Borrower's employment status
 - Borrower's expected monthly payment for the loan
 - Borrower's debt obligations
 - Borrower's credit history
- For each factor, creditor must **VERIFY** and **CONSIDER** the information
- Inherently fact-specific and subjective, so creditor concerns over liability loom large
- Special liability for violating ATR rule: life-of-loan defense to foreclosure (including attorneys' fees), the ultimate in assignee liability

“Qualified Mortgages”

- Qualified Mortgage (“QM”) definition = residential mortgage loan that meets the following criteria:
 - No excess upfront points and fees (3% cap)
 - No negative amortization
 - Term not exceeding 30 years
 - Consumer cannot defer repayment of principal (no neg am)
 - No balloon payment (with a very narrow exception)
 - Income and financial resources must be verified and documented
 - Limits on debt-to-income ratios (43% back-end)
- QM underwriting (verification of DTI) may be conducted under Appendix Q
- QMs provide compliance safe harbor or rebuttable presumption that ability-to-repay requirements satisfied, based on APR of loan
 - Safe harbor for loans that are not “higher priced” based on APR formula
 - Rebuttable presumption for “higher priced” loans

CFTC

- Swaps now constitute a commodity interest under the CFA
 - If there is no exemption, the commodity pool operator is subject to registration with and regulation by the CFTC
- Clearing for swaps
 - Designated swaps are required to be centrally cleared and executed on a designated contract market (DCM) or swap execution facility (SEF)
 - Both initial and variation margin is required for swaps
 - Currently no Derivatives Clearing Organization (DCO) is clearing the types of swaps used in securitizations due to non-standard terms such as non-petition provisions and amortizing or declining balance swaps
 - Margin for non-cleared swaps is an unresolved issue
 - There are end user exemptions from clearing, but generally securitizations would not qualify

Definitional Changes

- Dodd-Frank's inclusion of swaps as commodity interests means that pooled investment vehicles trading in swaps (and their operators or advisors) must consider whether they may be subject to regulation as a Commodity Pool, a Commodity Pool Operator or a Commodity Trading Advisor

Commodity Pool Definition

- As amended by Dodd-Frank, the Commodity Exchange Act (“CEA”) now defines the term “commodity pool” to include any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any—
 - (i) commodity for future delivery, security futures product, or swap;
 - (ii) agreement, contract, or transaction described in section 2(c)(2)(C)(i) of the CEA or section 2(c)(2)(D)(i) of the CEA;
 - (iii) commodity option authorized under section 6c of the CEA; or
 - (iv) leverage transaction authorized under section 23 of the CEA
- In addition, the CFTC, by rule or regulation, may include within, or exclude from, the term “commodity pool” any investment trust, syndicate, or similar form of enterprise if the CFTC determines that the rule or regulation will effectuate the purposes of the CEA

Commodity Pool Operator Definition

- As amended by Dodd-Frank, the CEA now defines the term “commodity pool operator” to include any person:
 - **(i)** engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests, including any—
 - **(I)** commodity for future delivery, security futures product, or swap;
 - **(II)** agreement, contract, or transaction described in section 2(c)(2)(C)(i) of the CEA or section 2(c)(2)(D)(i) of the CEA;
 - **(III)** commodity option authorized under section 6c of the CEA; or
 - **(IV)** leverage transaction authorized under section 23 of the CEA; or
 - **(ii)** who is registered with the CFTC as a commodity pool operator
- In addition, the CFTC has the authority to include within, or exclude from, the CPO definition any person if such inclusion or exclusion will effectuate the purposes of the CEA

Securitizations – No-Action Relief

- CFTC No-Action Letter 12-14 (October 11, 2012) provides that a securitization vehicle will not constitute a commodity pool if it conforms to the following criteria:
 - the issuer of the asset-backed securities is operated consistent with the conditions set forth in Regulation AB, or Rule 3a-7, whether or not the issuer's security offerings are in fact regulated pursuant to either regulation;
 - the entity's activities are limited to passively owning or holding a pool of receivables or other financial assets (either fixed or revolving) that by their terms convert to cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to security holders;
 - the entity's use of derivatives is limited to the uses of derivatives permitted under the terms of Regulation AB, which include credit enhancement and the use of derivatives such as interest rate and currency swap agreements to alter the payment characteristics of the cash flows from the issuing entity;
 - the issuer makes payments to securities holders only from cash flow generated by its pool assets and other permitted rights and assets, and not from or otherwise based upon changes in the value of the entity's assets; and
 - the issuer is not permitted to acquire additional assets or dispose of assets for the primary purpose of realizing gain or minimizing loss due to changes in market value of the vehicle's assets.

Securitizations – More No-Action Relief

- CFTC No-Action Letter 12-45 (December 7, 2012) provides further detail with regard to securitization vehicles that may or may not constitute commodity pools:
 - “certain securitization vehicles that do not satisfy the operating or trading limitations contained in Regulation AB or Rule 3a-7 may be properly excluded from the definition of commodity pool, provided that the criterion with respect to the ownership of financial assets continues to be satisfied and the use of swaps is no greater than that contemplated by Regulation AB and Rule 3a-7, and such swaps are not used in any way to create an investment exposure”
 - Examples:
 - A “standard asset-backed commercial paper conduit”
 - Even if not falling within the letter of the 12-14 letter, “an investment in this securitization is not unlike an investment in a traditional securitization that satisfies Regulation AB or Rule 3a-7 in that the investment is essentially in the financial assets in the vehicle and not in the swaps”
 - A CDO using swaps to convert fixed rate assets into floating rate assets and FX swaps to convert a foreign currency into dollars
 - Similarly, such an investment “is not unlike an investment in a traditional securitization that satisfies Regulation AB or Rule 3a-7 in that the investment is essentially in the financial assets in the vehicle and not in the swaps”
 - A covered bond transaction
 - The collateral pool (and any special purpose vehicle) “would not be a commodity pool if it contains no commodity interests other than any swaps which are used only for purposes permitted by Regulation AB, and covered bond holders are only entitled to receive payments of accrued interest and repayment of principal of their covered bonds, without any condition to payment based upon any derivative exposure”

Securitizations (further cont'd)

- However, if investors in an SV have exposure to swaps which are used to create investment exposure (e.g., the payment to investors is affected by swaps in a way other than to enhance credit (within reason) or to swap interest rates or currencies, each as permitted by Regulation AB), then the securitization vehicle may be a commodity pool
 - Examples:
 - CDO holding a 5% bucket for synthetic assets consisting of swaps rather than having 100% of its holdings in financial assets
 - Repackaging vehicle that issues credit-linked or equity-linked notes where the repackaging vehicle owns high quality financial assets, but sells credit protection on a broad based index or obtains exposure to a broad based stock index through a swap (SV may be a commodity pool because investors in the SV are obtaining a significant component of their investment upside or downside from the related swaps)
 - Repackaging vehicle that acquires a three-year bond, issues a tranche of notes, and uses swaps to extend investment experience of the bond (and notes) to four years
 - “Commercially unreasonable” use of swaps as credit support in a securitization (e.g., to raise “CCC” rated underlying assets to “AA” rating level, thereby making the swap “a significant aspect of the investment”)

Legacy Securitizations

- CFTC No-Action Letter 12-45 also contains no-action relief for certain legacy securitization issuers of fixed-income securities
- The relief applies if:
 - the issuer issued fixed income securities before October 12, 2012 that are backed by and structured to be paid from payments on or proceeds received in respect of, and whose creditworthiness primarily depends upon, cash or synthetic assets owned by the issuer;
 - the issuer has not issued and will not issue new securities on or after October 12, 2012; and
 - issuer agrees, upon request, to provide disclosure documents and other information

FDIC

- 12 CFR 360.6 – FDIC Sale rule
 - No more than six credit tranches
 - Allows senior tranche sequential pay or planned amortization classes
 - No unfunded or synthetic transactions
 - Minimum 5% retained interest, except if the risk retention rule is finalized
 - 5% reserve fund for one year for reps and warranties
 - Reg AB disclosure for public OR private offerings
 - Disclosure of compensation to originator, sponsor, rating agency or third party advisor, any mortgage or other broker and the servicer(s)
 - Compensation to rating agencies spread over 5 years
 - Must meet GAAP sales accounting treatment other than “legal isolation”
- Failure to comply subjects transaction to repudiation by FDIC in the event of the failure of the transferring bank

SEC

- Dodd-Frank rulemaking
- Reg AB II
 - Single prospectuses
 - Delays in offering
 - Loan-level disclosure requirements
 - Review for breach of reps and warranties
 - Remedy for breach of reps and warranties
 - CEO certification
- Rating agencies

Dodd-Frank Section 943: Reps and Warranties Rule

- Reason for Section 943:
 - High percentage of rep and warranty breaches claimed in post-financial crisis securitization litigation (including related disclosure claims made in securities litigation)
 - Party enforcing repurchase requirement often same entity or affiliate of sponsor and/or loan originator who made the reps and warranties
- 34 Act Rule 15Ga-1 – Replacement and repurchase history
 - Form ABS-15G – ongoing disclosure requirement on a quarterly basis of certain repurchase activity
 - Items 1104 and 1121 of Reg AB – requires similar information required under Rule 15Ga-1 to be disclosed in the prospectus
- 34 Act Rule 17g-7 – Rating agency disclosure of reps, warranties and enforcement mechanisms
- Applies to both registered and unregistered ABS
- The Final Rule was issued on January 20, 2011 and became effective on March 28, 2011. There is a series of compliance dates listed in the final rules, including February 14, 2012 for the initial Form 15Ga-1 filing and Reg AB prospectus disclosure.
- NRSROs were required to become compliant with the requirements of Rule 17g-7 by September 26, 2011.

Dodd-Frank Section 945: Issuer Diligence Rule

Rule 193 – requires issuers to perform a review of the assets that is designed and effected to provide reasonable assurance that the disclosure regarding pool assets in prospectus is accurate in all material respects

- No specific type of review required
- Sampling may be used when appropriate
- Third-party may be hired to perform review
- If hired for review, third party either has to be named in prospectus and consent to be deemed an “expert” under Section 7 of the '33 Act and Rule 436 and subjected to Section 11 liability, or the issuer has to attribute to itself the findings and conclusions of the independent third party review

Item 1111 of Reg AB – prospectus disclosure of Rule 193 review

- Identity of party that performed review; whether sampling was used, and if so, what sampling technique was employed; findings and conclusions of review; whether any assets in pool deviate from underwriting criteria; and provide data on assets for which compensating or other factors were used

Final Rule was issued on January 20, 2011, and became effective on March 28, 2011 for issuances after December 31, 2011.

Dodd-Frank Section 942(a): Elimination of Automatic Suspension of SEC Reporting

- Section 15(d) of '34 Act suspends reporting requirements for issuers of registered offerings for any fiscal year, other than the fiscal year within which the registration statement became effective, if, at the beginning of such fiscal year, there were less than 300 holders of the class that were sold in a registered transaction.
- Section 942(a) eliminated automatic suspension for ABS issuers

Dodd-Frank Section 942(a): Elimination of Automatic Suspension of SEC Reporting (cont'd)

- Rule 15d-22(b) – suspends or terminates ABS reporting for registered deals (i) as to any semi-annual fiscal period, if, at the beginning of the semi-annual fiscal period, other than a period in the fiscal year within which the registration statement became effective or, for shelf offerings, the takedown occurred, there are no ABS of such class that were sold in a registered transaction held by non-affiliates of the depositor and a certification on Form 15 has been filed, or (ii) when there are no ABS of such class that were sold in a registered transaction still outstanding, immediately upon the filing with the Commission of a certification on Form 15 if the issuer has filed all required reports for the most recent three fiscal years

Regulation AB

- Originally adopted in December 2004
- Governs disclosure and reporting requirements for SEC-registered securitization transactions
- Proposed and adopted on the view that the securitization market had become so significant that additional regulatory attention was warranted

Regulation AB II – History

- In April 2010, the SEC proposed substantial revisions in the wake of the financial crisis, attempting to provide greater investor protection and restore investor confidence
- The SEC re-proposed its revisions in July 2011 following Dodd-Frank Act provisions concerning asset-level disclosure, broker and originator compensation and risk retention
- Partial re-opening of comment period – February 2014
 - SEC re-opened comment period on certain aspects of asset-level disclosure to address privacy concerns
 - SEC memo proposed issuers be responsible for assuring borrower privacy, including possible use of secure websites
- Final rules adopted by SEC on August 27, 2014

Regulation AB II – Significant Provisions

- The most significant changes adopted by the SEC are:
 - a requirement to file a complete preliminary prospectus at least three days prior to sales of any securities (this is referred to as the “speed bump” provision)
 - Any material change requires the filing of a prospectus supplement at least 48 hours before the first sale of securities
 - a requirement to appoint an “asset representations reviewer” to review assets for compliance with representations and warranties
 - a requirement to provide in machine readable form asset-level information for securitizations involving residential mortgage loans, commercial mortgage loans, auto loans and leases, debt securities and resecuritizations of these assets
 - report periodically demands by the trustee to repurchase assets for breach of representations and warranties and any such assets not repurchased
 - dispute resolution – the transaction documents must contain provisions for repurchase claims unsatisfied after 180 days to be referred to mediation or arbitration

Regulation AB II – Significant Provisions

- The most significant changes (cont.):
 - investor communications – the transaction documents must include a provision requiring the party responsible for distribution date Form 10-D filings to include a request from any investor with any other investor
 - for each offering, a certification by the CEO
 - that the securitization as described in the prospectus is designed to produce cash flows from the assets in amounts sufficient to service expected payments on the securities, and
 - that the prospectus does not contain an untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they are made, not misleading
 - new Forms SF-1 and SF-3 for the registration of asset-backed securities

Regulation AB II – Significant Provisions (cont'd)

- The following significant items from the 2010 proposal were not adopted by the SEC:
 - a requirement to file a computer program for the cash flow waterfall – in the 2011 re-proposal, the Commission stated that it would address the requirement separately
 - a requirement for the sponsor or an affiliate to retain an interest in the assets securitized – this is the subject of a separate multi-agency rulemaking as required by the Dodd-Frank Act
 - the extension of the disclosure requirements of Forms SF-1 to private placements under Rule 506 or Rule 144A
 - filing of transaction agreements in substantially final form with the preliminary prospectus
 - asset-level information for other assets, including student loans and equipment leases and loans.

Regulation AB II – Loan Level Disclosure

- RMBS has by far the most extensive asset-level disclosure requirements of any asset class
- For RMBS, there are 270 prescribed data points for each loan to be disclosed in the prospectus and in ongoing reporting
- Data must be filed on Edgar in machine-readable form
- Privacy concerns/Re-identification risk
 - 2-digit zip code (instead of MSA)
 - Some proposed fields removed, including sales price, origination date and borrower bankruptcy and foreclosure history
 - Exact credit score, LTV and DTI still required

Regulation AB II – Compliance Dates

- Regulation AB as amended is effective 60 days after publication in the Federal Register
- Offerings of RMBS, CMBS, Auto ABS, and debt securities (including resecuritizations) must comply with asset-level disclosure requirements not later than two years after the effective date
- Any Form 10-D or 10-K filed after one year after the effective date must comply with all requirements except asset-level disclosure.

Volcker Rule

- Proprietary trading limitations
 - Market making
 - Underwriting
- Covered fund limitations
 - Will include Re-remics and resecuritizations
 - Many tiered structures will not work
- Changing the shape of banking

Volcker Rule

- On December 10, 2013, the federal banking agencies, the SEC and the CFTC approved the final version of the Volcker Rule
- Very detailed release of almost 900 pages
- The rule, based on section 619 of Dodd-Frank, will substantially limit the circumstances in which many banking entities may enter into derivatives
- The rule also prohibits proprietary trading, which could substantially reduce market liquidity
- The rule will prohibit sponsorship or ownership of some securitizations
- The rule applies to a very broad range of banking entities, including insured depository institutions, companies controlling an insured depository institution, and companies treated as bank holding companies, and any affiliate or subsidiary of any of the foregoing

Volcker Rule (cont'd)

- The general rule —
 - a banking entity may not engage in “proprietary trading” except as permitted by the rule.
 - a banking entity may not acquire or retain any “ownership interest” in or sponsor a “covered fund” except as permitted by the rule
- Proprietary trading – “engaging as principal for” its own “trading account” in a “purchase or sale of one or more financial instruments,” including derivatives
 - Definition of “trading account” incorporates concept of “short-term” resales, price movements or arbitrage profits
 - Definition of “financial instrument” includes most derivatives
- There is a rebuttable presumption that if a banking entity holds in its trading account a financial instrument for less than 60 days, the purchase or sale of such instrument is for the banking entity’s trading account
- Certain types of trading are excluded from the definition of proprietary trading
- No exclusion for interaffiliate trades

Securitization Overview

- Banking entities involved as investors in, sponsors of, or transaction parties (e.g., credit or liquidity providers) with, securitization issuers are subject to severe restrictions or divestiture if the securitization issuer is a covered fund.
- Congress stated in the Dodd-Frank Act its intention that the Volcker Rule not limit or restrict the ability of banking entities to sell or securitize loans.
- In the Final Rule, the Agencies generally followed Congressional intent by making clear that most securitizations of traditional loan products (e.g., mortgage loans, auto loans, student loans and credit card receivables) are not covered funds.
- However, the Final Rule creates the possibility that certain securitization vehicles whose assets include securities or derivatives (as opposed to loans) may be covered funds.

Covered funds

- The rule prohibits a banking entity, as principal, directly or indirectly from acquiring or retaining an ownership interest in, or sponsoring, a “covered fund”
 - Does not apply to banking entity: solely acting as agent, broker or custodian and the activity is conducted for the account of or on behalf of a customer and the banking entity does not retain an interest; the banking entity’s ownership interest is held/controlled by it as trustee in connection with a deferred comp or similar plan; owns interest in the ordinary course of collecting a debt; or holds as trustee or on behalf of a customer that is not itself a covered fund
- A “covered fund” is an issuer:
 - that would be a 40 Act entity but for 3(c)(1) or 3(c)(7)
 - any commodity pool
 - CPO relies on exemption or
 - units sold to QEPs and not publicly offered

Covered funds (cont'd)

- exemptions; certain CPOs; foreign funds that have no connection to the U.S.
- For any banking entity that is, or is controlled by a banking entity that is, located in or organized under the laws of the U.S., any entity —
 - organized outside the U.S. whose ownership interests are offered and sold solely outside the U.S.
 - organized primarily for the purpose of trading in securities
 - the banking entity sponsors or holds an ownership interest in the entity
- Various entities are excluded from the definition of a covered fund, including, among others: foreign public funds; wholly owned subs; joint ventures; acquisition vehicles; certain qualifying securitization vehicles; registered 40 Act entities

Covered funds (cont'd)

- Scope of prohibition
 - The basic prohibition is that banking entities are not permitted to “sponsor” or acquire an “ownership interest” in a covered fund, subject to certain exceptions
 - Sponsorship means
 - To serve as a general partner, managing member, trustee or CPO of a covered fund
 - To select or control selection of a majority of directors, trustees or management of a covered fund
 - To share with the covered fund the same name or a variation of the name
 - Ownership interest
 - Means any equity, partnership or other similar interest
 - Other similar interest includes an interest in or security issued by a covered fund that exhibits certain characteristics on a current, future or contingency basis
 - Definition of ownership interest may include interests in a covered fund that might not be considered an ownership interest or an equity interest in other contexts

Covered Fund Problem Areas

- Most covered fund problems arise for Section 3(c)(1) or Section 3(c)(7) funds whose assets include securities or derivatives:
 - CDOs backed by securities or derivatives (including CDOs backed by trust-preferred securities (“TruPS”))
 - CLOs that hold debt securities
 - Certain CMOs backed by mortgage securities
 - Auction rate preferred securities
 - Resecuritizations
 - Bond Repackagings
 - Synthetic ABS
 - Synthetic structured products
 - Funding vehicles

GSE Reform

- Several bills introduced over the past year or so, including Corker-Warner reform bill of 2013, Hensarling house bill, Waters house bill and Johnson-Crapo (“expanded” version of Corker-Warner)
- More activity so far on the Senate side, with Johnson-Crapo reported out of the Senate Banking Committee
- The house bills are “outliers” compared to Senate bills, demonstrating sharp differences of opinion between “free market” approach (Hensarling) and “consumer subsidy”/community development thrust (Waters)

Why GSE Reform Matters

- Per third amended preferred stock agreement with Treasury, Treasury support scheduled to burn off (2018)
- GSE's continue to unwind portfolio loans and per HERA law (conservatorship) Congress built in GSE shrinkage
- Much of GSE's earnings 2012-2013 (and payments to Treasury) premised on buybacks and settlements – one-time sources of funds
- In a steady-state, earnings are not spectacular
- Recent stress test demonstrated that adverse market conditions could necessitate another “bailout” of the GSE's

GSE Reform Matters – cont'd

- Uncertainty over future of market generally, e.g., at what point could uncertainty itself drive up interest rates or cause other market dislocation?
- Congress believes that the US gov't should make way for private capital to return to mortgage market
- The conservatorships were not designed to be perpetual

Risk Retention – Re-Proposal

- **Issued in August 2013**
- **Changes in risk retention methods**
 - Eliminates representative sample method
 - L-shape in any percentage combination
 - Eligible horizontal retained interests (EHRIs) may be multiple first lost classes
- **Eliminates PCCRA**
- **Fair value replaces par in measuring retention**
 - Disclosure of FV calculation
- **Retention may be held by majority owned subsidiary**
- **Blended pools for qualifying commercial real estate loans, commercial loans and auto loans**
- **For most ABS types, hedging and transfer restrictions expire upon latest of**
 - 2 years
 - Assets pay down to 33% of initial UPB
 - ABS pay down to 33% of original balance
- **For RMBS, hedging and transfer restrictions expire upon latest of**
 - 5 years
 - Mortgages pay down to 25% of initial UPB
 - Outside limit of 7 years

Risk Retention – Re-Proposal (cont'd)

- QRM definition linked to TILA/CFPB “qualified mortgage” (QM) definition
 - Eliminates down payment requirement
 - Requests comment on “QM-Plus”
- CMBS B-piece option
 - Up to 2 pari passu interests
 - Operating advisor, disclosure and transfer requirements
 - 5-year sunset on B-piece retention
- Rejects industry comments that a CLO manager is not a securitizer
- Qualifying auto loan securitizations
 - All loans must be current at closing date
 - 10% minimum down payment
- Foreign safe harbor
 - Rejects mutual recognition framework approach
 - Requests comments on increasing safe harbor percentage

Risk Retention – Major Issues

- Fair value
 - Calculation
 - Disclosure
- Representative sample
- Treatment of participations
- CMBS B-piece option
- CLO securitizer definition
- Foreign safe harbor
- Regulatory interpretation process

Dodd-Frank Section 621: Conflicts of Interest Rules

- Dodd-Frank section 621 adds section 27B to 33 Act – proposed Rule 127B prohibits certain persons involved in structuring, creating and distributing ABS from engaging in transactions within 1 year after date of first closing of sale of such ABS that would involve or result in a material conflict of interest with respect to any investor in such ABS
- SEC proposed Rule 127B in September 2011
- Comment period was extended to, and expired in, February 2012
- Final rule expected in 2014 or 2015
- Conditions: ABS transaction that involves covered persons, covered products, a covered timeframe, a covered conflict, and a “material conflict of interest” would be covered by the 1-year prohibition

Dodd-Frank Section 621: Conflicts of Interest Rules (cont'd)

- Covered persons include underwriters, placement agents, initial purchasers, sponsors, and any affiliate or subsidiary of any such entity
- Covered product is any ABS as defined in section 3 of the '34 Act and covers both private and registered deals, as well as synthetic ABS
- Covered timeframe is any transaction engaged in prior to the date that is 1 year after the closing of the sale of the ABS
- Covered conflict is any material conflict of interest between an entity that is a securitization participant and an investor in such ABS that arises as a result of or in connection with such ABS transaction

Dodd-Frank Section 621: Conflicts of Interest Rules (cont'd)

- Material conflict is a two-prong test:
 - (1) securitization participant would benefit directly or indirectly from actual, anticipated, or potential
 - (a) adverse performance of the asset pool,
 - (b) loss of principal, monetary default or early amortization event on the ABS, or
 - (c) decline in market value of the ABS; or
 - (2) securitization participant who directly or indirectly controls the structure of the ABS or selection of assets in ABS would benefit directly or indirectly from fees or other forms of remuneration as a result of allowing a third party, directly or indirectly, to structure the relevant ABS; and there is a “substantial likelihood” that a “reasonable” investor would consider the resulting conflict important to his or her investment decision

What is impeding a PLS Market

What is impeding a PLS Market

- The uncertainty of a new landscape and unfinished regulation are impeding development of a new PLS market
- We are going to cover:
 - Treasury request for comment
 - Unfinished regulation
 - GSE scope
 - QRM/QM debate
 - Effect of QM – funding non-QM loans
 - Capital requirements
 - Unfinished market developments
 - Loan-level data analysis
 - \$200 billion of enforcement settlements
 - Threatened eminent domain by some municipalities

Treasury Request

- On June 27, 2014, The Department of the Treasury called for comments on what steps could be take to restore a private label securities (PLS) market
- The comment period closed August 8
- Treasury asked what the key obstacles were to the growth of the PLS market and what the necessary conditions are for securitizers and investors to return at scale
- Scaling down the GSEs is dependent on the existence of a viable PLS market

Unfinished Regulation

- Risk retention
- Conflicts of interest

GSE Scope

- Still a belief that raising GSE g-fees will encourage private capital re-entry, though FHFA head Mel Watt not as interested in this as former head Ed Demarco was
- Shrinking commitment to GSE US gov't backstop (see above) coupled with market uncertainty – just what role does US gov't foresee for private capital and how will it be valued and deployed as GSE reform unfolds?
- When will reform legislation be enacted and how will the transition work?

Risk Retention

- QM/QRM debate
 - Under the proposal, there would be no risk retention for a Qualified Residential Mortgage loan (QRM)
 - In the most recent proposal for risk retention, QRM was equated to QM
 - This would mean that for any loan satisfying the CFPB definition of QM, there would be no risk retention
 - There is a concern that some investors may avoid offerings where there is no significant “skin-in-the-game” by the sponsor
 - Some investors favor including a minimum down payment requirement for QRM
- Accounting sale treatment
 - Higher levels of risk retention may increase the likelihood that accounting sale treatment will not be available

Effect of QM

- Conservative underwriting and staying within the QM box – under CFPB ATR rule, Fannie Mae, Freddie Mac, FHA & VA loans are QM
- Non-GSE and non-govi mortgage loans must be underwritten to Appendix Q, so limitation of liability not as clear and demonstrable as with GSE and govi mortgages
- Risk related to non-QM loans is being rationalized, but a significant market for non-jumbo, non-QM has not yet emerged
- Democrats & President Obama will not support legislative “fixes,” which would be in the form of amendments to Dodd-Frank Act

Capital requirements

- Basel III implementation
- Securitization is more expensive from a capital perspective
- Realizing a “gain-on-sale” more unlikely
- No eligibility of securitizations as HQLA
- NSFR requires term funding of securitization exposures

Unfinished Market Developments

- RMBS 3.0
- Sunset provisions on reps and warranties?
- Extent of pool due diligence for reps and warranties – re-underwrite 100% of loans? Need scalable diligence.

Loan-Level Information

- Will be provided both at the time of the offering and in periodic reports for the life of the securities
- Failure to review is likely to be viewed as negligence
- Will require building significant capacity both by issuers and by investors
 - Will the investment be made if there is no PLS market?

\$200 billion in settlements

- More to come
- Impact on investor confidence
- Affecting loans in securitizations

Eminent Domain

- Some municipalities threaten to exercise a right of eminent domain on underwater mortgage loans and pay market value for the loans
- Market value would be significantly lower than the principal balance on the loans
- Thus losses would be imposed on the holder of the mortgage loan; in a securitization, the loss would fall on investors

What are the prospects

What are the Prospects

- GSEs – Reform – 2017
- GSEs – fee increases – 2015
- Regulations – 2015
 - Risk retention
 - Conflicts of interest



Keep track of the latest mortgage market updates and stay abreast of regulatory and enforcement developments, emerging trends and mortgage news using our mortgage finance resource, [MoFoMoFi](#).

Thank You!