Katten

Structured Finance

Structured Finance Year in Review and the Outlook for 2021

Key Takeaways

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The "Securitization Disclosure and Document Updates for 2020 and 2021" panel featured Structured Finance and Securitization partners Prachi Gokhale, Christina Burgess, Josh Yablonski and Joe Topolski and was moderated by partner John Keiserman. The discussion ranged from the effects of the COVID-19 pandemic on the structured finance industry, to the eventual cessation and replacement of the London Interbank Offered Rate (LIBOR), and concluded with an outlook to recent securities law changes that will affect offerings in 2021 and beyond. Here are the top five takeaways from the panel.

Impact of COVID-19 on Risk Factors

The COVID-19 pandemic has had a far-reaching impact on the disclosure for asset-backed securities offerings and has brought about several changes throughout the year, in particular to the disclosed risk factors. Most issuers prominently featured pandemic-specific risk factors in their disclosure documents, which focused on the uncertainty brought about by the pandemic. These risk factors were both general, covering macroeconomic trends such as unprecedented unemployment and an anemic economy, and industry-specific, covering legislation adopted to offset the effects of the COVID-19 pandemic on the underlying securitized collateral and obligors. In particular, the panel discussed challenges for servicers of the underlying assets. Servicers found their ability to collect on the underlying assets impaired by legislative moratoriums preventing repossession of the securitized assets for delinquent payments, and many implemented self-imposed obligor relief programs, including voluntary loan deferrals and other hardship extensions. The risk factors covering the macroeconomic implications of the pandemic will likely remain in the disclosure documents in the near term, as the country continues to grapple with additional waves of the virus and the uncertainty surrounding further federal relief plans. However, the industry-specific risk factors remain fluid and many have been removed altogether or updated to reflect the evolving legislative requirements and obligor relief programs.

Impact of COVID-19 on Business Continuity Plans and Force Majeure Clauses

The COVID-19 pandemic also has affected disclosure with respect to business continuity plans and force majeure clauses. At the beginning of the pandemic, issuers included broad disclosures about adjustments to their business continuity policies and the transition to working from home. Insofar as these disclosures are indicative of a long-term realignment of the issuer's working arrangements, they may become a permanent "part of the furniture" as the panel suggested.

The pandemic also has affected force majeure clauses in securitization documents. Initially, the outlook was that COVID-19 was not an "act of God" but an event akin to prior, less invasive, public health emergencies, such as the Swine Flu epidemic or the Ebola outbreak. As the pandemic worsened, many financial institutions argued that the scope of COVID-19 was so encompassing that it should be considered a force majeure. Because New York courts construe force majeure clauses narrowly and require the party claiming a force majeure to show that the event was not reasonably foreseeable, we have now seen "pandemic," "epidemic" and "acts of governmental authorities" explicitly included in the laundry list of items that are considered a force majeure.

Impact of COVID-19 on CMBS Transactions

The panel further discussed the impact of the COVID-19 pandemic in the context of commercial mortgage-backed securities (CMBS) securitizations. At the onset of the pandemic, there had been discussion surrounding where exactly to put the wide-ranging COVID-related risk factors for these securitizations. Issuers eventually settled on aggregating the separate COVID-related risks into a "COVID chart" where all of the related impacts on the underlying collateral were aggregated and prominently featured in the disclosure documents, all to prevent investors from having to search throughout the disclosure documents to find the COVID-related disclosures. In the context of loan level due diligence on CMBS securitizations, there was been a shift away from including hotel and retail loans in the pools of underlying assets, as those assets have been more negatively affected by the COVID-19 pandemic relative to industrial and office building loans, which have, as a result, become larger percentages of CMBS asset pools.

LIBOR Replacement

While disclosures and document terms that look forward to the cessation of LIBOR and its ultimate replacement were in place well before 2020, including via prominent risk factors since its initial announcement, specific replacement has yet to be implemented in most securitizations. Many issuers have adopted the Alternative Reference Rate Committee's (ARRC) proposed fallback language as a replacement, which, in short, provides that once LIBOR is discontinued, the rate will switch to a forward-looking term Secured Overnight Financing Rate (SOFR) or to compounded SOFR, which is calculated in arrears. To date, the only issuers that have closed deals based on a SOFR rate directly, without any fallback language, are Fannie Mae and Freddie Mac. It is worth noting that the ICE Benchmark Administration has considered continuing to post LIBOR through June 2023 in order to provide more time for the wind-down of legacy transactions. In 2021, we expect that fallback language will continue to be added to those deals without such fallback language, and we may see more deals move straight to issuing SOFR-indexed floating rate securities. While there has been some discussion about federal legislation on the issue of LIBOR, there may be constitutional issues with such legislation (i.e., due process and takings issues) to consider.

Regulatory Changes

Finally, the panel concluded by discussing changes to existing securities regulations by the Securities and Exchange Commission (SEC) that impact many securities offerings. These principal changes are:

1. updates to Regulation S-K, which are intended to rein in the lengthy generic risk factors in the offering documents, require a grouping of risk factors by category, and mandate the inclusion of a summary of risk factors if the overall risk factor section is more than 15 pages in length;
2. definitional changes that modestly expand the individuals or entities that qualify as "Accredited Investors," or AIs, for placements relying on the safe harbor provided by Rule 506 of Regulation D and "Qualified Institutional Buyers," or QIBs, for resales of securities that are made in reliance on Rule 144A; and
3. revised rules that expand the use of electronic, as opposed to "wet ink," signatures on documents that are filed with the SEC.

The "The View From Across the Pond — UK/EU Updates" panel featured Financial Markets and Funds partner Neil Robson and Transactional Tax Planning partner Charlotte Sallabank and was moderated by Private Credit partner Peter Englund. The panel included discussion of rules and regulations put into place to help businesses address economic uncertainty caused by COVID-19, challenges facing the Coronavirus Business Interruption Loan Scheme (CBILS) and bounce-back loan programs that were developed to help businesses struggling with COVID-19, updates to the EU Securitization Regulation, the effects of the UK tax regime on securitization and the effects of Brexit on the securitization market. Here are the top five takeaways from the panel.

Legislative and Regulatory Uncertainty in Response to COVID-19

Certain rules and regulations put in place to help businesses cope with the economic impacts caused by COVID-19 are approaching their expiration dates, and it's unclear whether they will be extended. For example, a moratorium to prevent companies from being pushed into an insolvency process unless its creditors had reasonable grounds to believe that COVID-19 had no financial impact of that company, i.e., such company's debt would have existed even without COVID-19, is set to expire on December 31. Other protections limiting a director's liability have already expired. Even though vaccines are being administered, COVID-19 is likely to continue to have an effect on the broader economy for several more months, and it is unclear how businesses will cope if or when such protections expire.

Loan Programs Intended to Assist Businesses Uncertain as Asset Classes

Two schemes providing loans to businesses struggling with COVID-19 have faced some challenges. In the CBILS scheme, the British Business Bank (BBB) agreed to guarantee up to 80 percent of loans issued to businesses. Many origination platforms were quick to get the necessary accreditation from the BBB, but we saw that sourcing funding for such loans was made difficult due to the restrictions from the BBB in assigning the government guarantee and an insistence that funding sources were robust and of a high standard, i.e., big name banks or well-established funds.

The other scheme, bounce-back loans, have mainly been provided by traditional banks issuing small/micro business loans between £2,000 to £50,000 that are 100 percent guaranteed by the British government. According to a study, up to 40–60 percent of those bounce-back loans are likely to suffer defaults, which could present a long-term issue for the government as guarantor of those loans and of such loans remaining a viable asset class during their six-year term.

Updates to EU Securitization Regulations

In 2020, the European Union largely completed the implementation of its new Securitization Regulation, which establishes the first true pan-EU framework regulating issuers of, and investors in, securitizations. The new rules

cover more than traditional risk retention: potential investors in securitizations must conduct an initial diligence assessment of the securitization to evaluate all risk characteristics of the deal, including reviewing underlying exposures and structural features, e.g., the priority of payments, and ensuring that certain ongoing disclosure obligations are met. The application of this regime to EU investors in non-EU issuances remains unclear and generally depends on the risk appetite of the specific EU investors. Finally, the Securitization Regulation will be reviewed by 2022, which provides an opportunity for investors, issuers/originators and European policymakers to address certain shortcomings in the regime that have acted as a drag on the relaunch of the EU securitization market. Following Brexit, the United Kingdom will onshore the Securitization Regulation and implementing secondary legislation into domestic law, meaning that the two frameworks will be nearly identical in the immediate near term, however the United Kingdom may ultimately determine to diverge from the EU framework where it is justified based on the specificities of the UK market.

UK Tax Regime and Its Effects on Securitization

A UK tax regime was introduced in 2005 to address the adverse effect that the introduction of International Accounting Standards had on the taxation of UK securitization vehicles. The introduction of IAS 32 and IAS 39 resulted in potentially large annual fluctuations in securitization companies' accounting profits, which in turn led to fluctuations in tax liabilities year on year, as accounting profits are the basis for the computation of taxable profits. This variation in annual tax charge created unique problems for securitizations. The large fluctuations were hard for rating agencies to rate and, in the event the profits unexpectedly increased, the securitization SPV issuer may not have enough cash on hand to pay the necessary taxes. Consequently, the 2005 tax regime for securitization vehicles was introduced in the United Kingdom to flatten out the fluctuations. However, these regulations only apply to securitization vehicles that are part of a capital markets arrangement, which essentially requires there to be a fund raising through an issue of securities to third parties which are rated by internationally recognized rating agencies and are traded on a recognised exchange. These regulations were a step in the right direction, but many securitizations do not fall within the definition of capital markets arrangement and so the regulations cannot apply to them, or originators do not want to have to comply with the stringent requirements of the regulations, and so many UK-sourced securitizations have non-UK issuers in jurisdictions where the securitization regime is easier to comply with, such as Ireland and Luxemburg.

Effects of Brexit on the Securitization Market

Under the EU Withdrawal Act, all EU rules and regulations as of December 31, the end of the transition period, shall become UK law for purposes of financial market regulation. Thus, the rules will be identical between the United Kingdom and the European Union on January 1, 2021. As time passes, though, we expect the rules to deviate as the United Kingdom and European Union have no obligations to follow changes in each other's laws and regulations and are free to, and have already expressed interest in, diverging from one another. This will inevitably lead to new structuring and tax issues for future securitizations. However, there is also an opportunity for either the United Kingdom or European Union to implement a regulatory scheme that attracts increased securitization activity.

The "Fintech Update and the Road Ahead" panel was moderated by partner and co-chair of the Structured Finance and Securitization department, Howard Schickler, joined by partner Jonathan Evans and Roxy Bargoz, general counsel of Avant, Inc. The discussion focused on challenges to the bank and financial technology company (fintech) partnership models in consumer lending, including the recent settlement reached among the Colorado Administrator of the Uniform Consumer Credit Code (the Colorado Administrator), Avant, Inc. (Avant), Avant's bank partner, WebBank, Marlette Funding, LLC (Marlette) and Marlette's bank partner, Cross River Bank. Here are the top five takeaways from the panel.

Basics of the Bank-Fintech Partnership Model

A fintech can lend to borrowers in two ways (1) directly; or (2) through a national bank partnership. When a fintech lends directly to borrowers, it must satisfy certain state licensing requirements and comply with the maximum interest rate rules in each state in which it lends. Under a bank-fintech partnership structure, however, a fintech is generally not required to abide by the licensing and interest rate rules of each state, relying instead on its bank partner's federal pre-emption of state laws. Under federal law, a national bank can charge interest at the maximum rate permitted in the state where such national bank is located, regardless of where the related borrower is located.

State Interest Rate and True Lender Challenges vs. Valid-When-Made

State regulators and private plaintiffs have challenged bank-fintech partnerships in two main ways: (1) alleging violations of state interest rate limits; and (2) bringing "true lender" challenges. Under the first theory, plaintiffs and regulators have challenged whether a loan's interest rate is permissible once the originating bank transfers the loan to the fintech if such loan's interest rate is above the legal limit in that state. The Valid-When-Made doctrine, however, provides that a loan that is valid at origination cannot become invalid or unenforceable according to its original terms upon a subsequent transfer. Under the second theory, "true lender" challenges assert that the fintech — not the national bank — is the "true lender" because the bank is not engaged in the lending program and does not take on the typical risks of a lender as it sells the loans to the fintech after origination.

Madden Ruling Complicates Matters

In *Madden v. Midland Funding, LLC, No. 14-2131 (2d Cir. 2015)*, the plaintiff argued that the purchaser of loans originated by a national bank could not charge the same interest rate under New York state law as the national bank was able to otherwise charge, which constituted a major challenge to the underpinnings of the bank-fintech partnership model. Although the Second Circuit did not address the Valid-When-Made doctrine in its opinion, it reversed the district court's ruling and held that a non-bank purchaser of a loan could not inherit from the national bank its immunity from state usury caps; instead, the purchaser must adhere to the state interest rate limits. The Supreme Court denied *certiorari* in June of 2016 and since then, not only has the Court's decision in *Madden* made it

much harder for national banks to sell loans to non-bank entities in the Second Circuit states of Connecticut, New York and Vermont, it has caused uncertainty for bank programs across the United States as well.

FDIC and OCC Attempt Fixes, Solicit Challenges

This year, the Office of the Comptroller of the Currency (OCC), the primary regulator of federally chartered banks and savings banks, and the Federal Deposit Insurance Corporation (FDIC), a regulator of state-chartered banks, have each attempted to address the uncertainty caused by the *Madden* decision. The OCC amended the relevant portion of the Code of Federal Regulations (CFR) so that "interest on a loan that is permissible [under the CFR] shall not be affected by the sale, assignment or transfer of the loan." Accordingly, the interest rate that a federally chartered bank or savings association can charge in the state where it is located, continues to be permissible following any sale, assignment or transfer, including a sale to a fintech. Similarly, the FDIC confirmed the Valid-When-Made doctrine by ruling a loan made by a state-chartered bank that is valid at origination may be enforced by any subsequent buyer of that loan, in accordance with the loan's stated terms. While neither rule overturns the *Madden* decision, both rules may be influential to regulators or other courts faced with similar disputes in the future. Several states have brought challenges against the OCC's and FDIC's new rules for allowing non-bank entities to charge interest rates above state limits.

Colorado Establishes a Safe Harbor, but Stormy Seas Elsewhere

Following an audit in 2016, the Colorado Administrator filed a complaint against Avant and Marlette alleging (1) under a *Madden* theory, even though Avant and Marlette purchased the loans in question from their respective national bank partners, holding such loans with interest rates above state usury cap was a violation of Colorado law; and (2) under a "true lender" theory, Avant and Marlette, not their national bank partners, were the "true lenders" of the loans in question, and thus neither Avant nor Marlette were able to claim federal preemption of Colorado's usury laws. Ultimately, the Colorado Administrator, Avant, Marlette and their bank partners reached a settlement finding utility in both the bank-fintech partnership model's ability to extend credit to borrowers that are often underbanked, and the state's interest in protecting consumers from potential bad actors and predatory lenders. The settlement allows for fintechs like Avant and Marlette to continue servicing loans in Colorado above the state's usury cap, so long as each company continues to meet certain criteria. While the Colorado settlement may certainly provide a framework for other states to draft similar rules, for now, no other state has adopted such a framework and regulatory uncertainty remains, despite the new rules issued by the OCC and the FDIC this year.

The "The View From DC — Transition 2021" panel featured Rob Ellsworth, co-founder of The Majority Group, and Mike Flood, senior vice president of Mortgage Bankers Association, and was moderated by Structured Finance and Securitization partner and New York office managing partner Chris DiAngelo. The panel discussed what the upcoming year and presidential administration could look like and what affects it could have on financial markets. Here are the top four takeaways from the panel.

The Senate is the Linchpin

Mike Flood is bearish on the possibility of another stimulus bill passing this year. If any stimulus does pass, he believes it will likely exclude the controversial state and local support package supported by many Democrats and the business/employer liability protections supported by many Republicans.

If Republicans control the Senate, Rob Ellsworth expects the Biden administration's appointees, including cabinet appointees that have traditionally received substantial Senate deference, to experience long and drawn-out confirmation proceedings that will hamper the administration's ability to "hit-the-ground-running" with respect to any of its priorities.

Both panelists believe that it is unlikely that the Democrats will win both Georgia seats, and therefore the Republicans will retain control of the Senate in 2021.

Biden 2021 Agenda — Financial Markets and Regulatory Changes

Neither Rob Ellsworth nor Michael Flood expect the new administration to bring sweeping regulatory changes to the financial industry for at least three reasons:

1. The administration's primary initial focus will be on pandemic relief and economic stimulus;
2. Republicans are very likely to control the Senate after the Georgia run-off elections, significantly limiting the administration's ability to pass any legislation that does not have bipartisan support; and
3. The administration does not seem to be particularly hostile to big banks or the financial industry generally.

The panelists expect the administration to devote some regulatory resources on promoting affordable housing and greater homeownership. They also expect the Administration to expand certain securitization disclosure requirements that currently only apply to public transactions to similar private transactions, especially in the CMBS space.

Our panelists also expect to see a continuing, if not an accelerated, push by fintech companies into the consumer lending space. How successful this effort is during the next administration remains to be seen but the administration may see some potential benefits to such fintech lending, such as reducing the cost of certain types of consumer borrowing by taking market share from payday lenders and other high interest rate lenders.

Biden 2021 Agenda — Big Tech

Rob Ellsworth believes that the Biden administration has concerns that Google and Facebook may be the next domineering Standard Oil and not the next benign Microsoft. 48 attorney generals and the Department of Justice are now going after Facebook for monopolistic practices, and Ellsworth believes a similar initiative is likely to be commenced against Google sometime in early 2021. The catalyst for the push to break up “Big Tech” stems from Section 230 of the Communications Decency Act, which gives Facebook and Google protection from liability as an online publisher for content generated by users. Although this liability shield was critical to promoting the growth and development of the early internet, Republicans and Democrats alike are increasingly concerned by the degree to which these companies now control the landscape of information. Although both parties share concerns over the growing influence of Big Tech, the impetus for such concerns differs. Democrats are focused on imposing greater government oversight on Big Tech operations and practices, while many Republicans believe that Big Tech’s liability shield should be modified to address the perceived bias of certain social media companies against conservative viewpoints. When push comes to shove, however, the panelists do not believe many Republicans will support legislation imposing any additional regulatory oversight beyond what is allowed by current law even though some Republicans have recently expressed public dissatisfaction with certain Big Tech practices. While legislation modifying the Section 230 liability shield is a greater possibility, our panelists believe any such proposed legislation is unlikely to garner sufficient bipartisan support to become law.

Will GSE Reform Happen in 2021?

Another issue our panelists will be following during the next administration is whether Fannie Mae and Freddie Mac come out of their conservatorships and, if so, how a return to the private sector impacts their role and housing markets going forward. On November 18, their regulator and conservator, the Federal Housing Finance Agency (FHFA), finalized a rule imposing higher capital requirements on Fannie Mae and Freddie Mac to further promote safety and soundness. The new capital requirements are a prelude to steps FHFA is expected to negotiate with the US Treasury Department towards releasing the Government-Sponsored Enterprises (GSEs) from their conservatorships and reducing the government’s control and ownership of the enterprises. However, our panelists believe any process that suggests the GSE’s lack unqualified Treasury support is likely to have a substantial negative impact on mortgage lending rates, at least in the short term. This issue is likely to turn in part on whether the US Supreme Court holds in a pending case (where a decision is expected by June 2021) that the president has the authority to fire Mark Calabria, the current head of the FHFA, at will. Mr. Calabria was appointed in 2019 by President Trump and is seeking to return to the GSEs to the private sector as soon as possible. He is not viewed as sharing the new administration’s preferred approach for ending the conservatorships. Given that the FHFA will need the Treasury’s cooperation to end the conservatorships, the course of GSE reform in 2021 remains murky at best.

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