Chambers

GLOBAL PRACTICE GUIDES

Definitive global law guides offering
comparative analysis from top-ranked lawyers

Securitisation

USA
Trends & Developments

Jeffrey R. Johnson, Matthew P. Joseph,
Steve Levitan and Charles A. Sweet
Morgan, Lewis & Bockius LLP

practiceguides.chambers.com

2021

Trends and Developments

Contributed by:
Jeffrey R. Johnson, Matthew P. Joseph, Steve Levitan and Charles A. Sweet
Morgan, Lewis & Bockius LLP ***see p.10***

During the recovery years after the financial crisis, market participants spent a large amount of time and energy responding to significant legislative and regulatory developments. These included significant revisions to Regulation AB (the regulatory framework for registered public offerings of ABS), which is commonly known as Regulation AB II, and the rule-making required under the Dodd–Frank Wall Street Reform and Consumer Protection Act (the "Dodd–Frank Act"), such as US credit risk retention rules, the Volcker Rule (which generally prohibits certain banking entities from having ownership interests in covered funds and from engaging in proprietary trading), the nationally recognised statistical rating organisation (NRSRO) due diligence rules (which impose pre-pricing filing requirements in respect of third-party due diligence reports received in connection with public and private deals rated by NRSROs) and the repurchase demand reporting rules (which require ongoing filings describing pool asset repurchase demand activity for public and private deals).

Following the 2016 election, federal rule-making momentum dissipated, with only modest changes to the regulatory framework for securitisations. It remains to be seen what direction the federal regulators will take after the transition to a new administration in January 2021.

The calendar year 2021 should see a continued strong focus on planning for the transition from the use of LIBOR to another interest rate reference index. In the USA, the Alternative Reference Rate Committee (ARRC), which was formed by the Board of Governors of the Federal Reserve System (the "Federal Reserve") and the Federal Reserve Bank of New York (the "New York Fed"), has recommended the Secured Overnight Financing Rate (SOFR) as its preferred alternative to LIBOR for many purposes, including securitisations.

The year 2020 also saw regulatory changes regarding the "valid when made" rule, guidance with respect to determining what entity should be viewed as the "true lender" in a transaction and a settlement of a much-watched and discussed marketplace lending case in Colorado. These developments will have impacts on the fintech/marketplace lending ABS market as well as structured finance transactions involving other asset classes.

Regulatory

Rule 144A and other private offering exemptions

In August 2020, the SEC adopted changes to its rules regarding the sales of securities in offerings that are exempt from the registration requirements of the Securities Act, which include Rule 144A offerings. These proposals focused on liberalising the definition of "accredited investor" under Regulation D. Among other things, the SEC added a number of categories of specific types of entities that qualify as accredited investors.

The SEC also added a new "catch-all" category of accredited investor, consisting of any "entity" owning investments in excess of USD5 million that is not formed for the specific purpose of acquiring the securities being offered. "Entity" is not defined, and is intended to encompass types of entities that currently exist but are not captured as accredited investors (such as Indian tribes and governmental entities) and new types of entities that may arise.

The SEC added another new catch-all category of "qualified institutional buyer" (QIB) under Rule 144A, which permits any institutional accredited investor of an entity type not already included within the definition to qualify if it meets the USD100 million threshold for investments in securities. This new category is intended to be co-extensive with the similar new category of accredited investor.

These rule changes became effective in December 2020.

FDIC Securitisation Safe Harbor Rule

In January 2020, the Federal Deposit Insurance Corporation (FDIC) adopted a significant change to its Securitisation Safe Harbor Rule. An investor's right to receive information relating to their securities is no longer tied to what Regulation AB would require to be disclosed. Thus, a private ABS offering does not need to comply with the requirements of Regulation AB to avail itself of the Safe Harbor Rule. However, this change did not impact the other disclosure requirements in the FDIC's rule, such as its requirement to provide loan-level information in connection with RMBS offerings.

This change became effective in May 2020.

Contributed by: *Jeffrey R. Johnson, Matthew P. Joseph, Steve Levitan and Charles A. Sweet,* ***Morgan, Lewis & Bockius LLP***

Qualified mortgage/qualified residential mortgage definitions

RMBS with an asset pool consisting entirely of performing "qualified residential mortgages" (QRMs) are exempt from the US credit risk retention rules. For these purposes, the definition of QRM is consistent with the definition of "qualified mortgage" (QM) under the Truth in Lending Act. One of the features of the QM definition required the borrower to have a total debt-to-income (DTI) ratio that is less than or equal to 43% (based on the highest payment that could occur in the first five years of the loan).

One of the features of the QM (and therefore QRM) definition is the temporary rule defining QMs as loans that prohibit specified risky features and are eligible for purchase or guarantee by government-sponsored entities (GSEs), such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), or eligible to be insured or guaranteed by the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), the Department of Agriculture (USDA), or the Rural Housing Service. This temporary rule, which is known colloquially as the "GSE patch" or the "QM patch", was set to expire on 10 January 2021 or when the GSEs (Fannie Mae and Freddie Mac) exit conservatorship, whichever comes first. Mortgage loans that meet the requirements of the GSE patch are not required to comply with the other elements of the QM definition. In October 2020, the Bureau of Consumer Financial Protection (CFPB) extended the GSE patch until the mandatory compliance date for the other QM rule changes discussed below, which is 1 June 2021.

In December 2020, the CFPB amended the QM definition to replace the 43% DTI limit with a price-based approach. The mandatory compliance date is 1 July 2021, though lenders will be permitted to comply on or after the effective date, which will be 60 days after publication of the final rule in the Federal Register. Under the revised rule, most loans will receive a conclusive presumption that the consumer has the ability to repay if the annual percentage rate (APR) does not exceed the average prime offer rate (APOR) for a comparable transaction by 1.5 percentage points or more as of the date the interest rate is set, and a rebuttable presumption that the consumer has the ability to repay if the APR exceeds the APOR for a comparable transaction by 1.5 percentage points or more but by less than 2.25 percentage points.

The revisions will not change any other facets of the QM definition. Lenders must still verify the consumer's income and debts, but the prescriptive approach towards determining debt and income contained in Appendix Q has been eliminated. Lenders will have the flexibility to implement their own verification standards, though the CFPB also adopted a safe harbour for lenders that uses standards drawn from relevant provisions of current standards used by Fannie Mae, Freddie Mac, the FHA, the VA and the USDA. The revisions also clarify the requirements to consider and verify a consumer's income, assets, debt obligations, alimony and child support to help prevent compliance uncertainty that could otherwise result from the removal of Appendix Q.

In December 2020, the CFPB also created a new category of QM (Seasoned QM) for first-lien, fixed-rate covered transactions that have met certain performance requirements, are held in portfolio by the originating creditor or first purchaser for a 36-month seasoning period, comply with general restrictions on product features, and points and fees, and meet certain underwriting requirements. The Seasoned QM rules will take effect 60 days after publication in the Federal Register.

To be eligible to become a Seasoned QM (and to thereby receive a presumption of compliance with the ability-to-repay requirements), a loan must:

- be secured by a first lien;
- have a fixed rate, with regular, substantially equal payments that are fully amortising;
- have a loan term that does not exceed 30 years;
- not be a "high-cost" mortgage; and
- have total points and fees that do not exceed specified limits.

As under the general QM rule, the creditor must consider the consumer's DTI ratio or residual income, income or assets other than the value of the dwelling, and debts, and verify the consumer's income or assets other than the value of the dwelling and the consumer's debts.

The loan must also have no more than two delinquencies of 30 or more days and no delinquencies of 60 or more days at the end of the seasoning period. The creditor generally must hold the loan in portfolio until the end of the seasoning period, with an exception permitting loans to be transferred once during the seasoning period. In the event of such a transfer, the purchaser must thereafter hold the loan in portfolio until the end of the seasoning period.

Volcker Rule

The Volcker Rule covered fund provisions generally prohibit any "banking entity" from acquiring or holding any "ownership interest" in a "covered fund". In order not to be a covered fund, a securitisation vehicle generally must rely on an exemption from registration under the Investment Company Act of 1940, other than Section 3(c)(1) (the 100-holder rule) or Section 3(c)(7) (the qualified purchaser rule). Other approaches involve structuring the ABS so as not to constitute ownership interests,

or taking advantage of the loan securitisation exclusion provided by the rule, but these approaches have been less common because they involve interpretative difficulties.

In June 2020 the agencies that adopted the Volcker Rule regulations finalised a number of changes that are intended to make it easier to conclude that typical debt ABS interests are excluded. These changes became effective in October 2020.

An "ownership interest" is any equity, partnership, or other similar interest in a covered fund. An "other similar interest" means an interest that exhibits any of a number of enumerated characteristics, including the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading adviser of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event). The new rules added an exclusion for the right to participate in the removal of an investment manager for cause or to participate in the selection of a replacement manager upon an investment manager's resignation or removal. "Cause", for these purposes, includes the following:

- bankruptcy events;
- breach by the investment manager of any material representations or material provision of the covered fund's transaction agreements;
- an act that constitutes fraud or criminal activity;
- indictment for a criminal offence;
- a change in control; or
- a key person event.

The other enumerated characteristics that can trigger a conclusion that an interest is another similar interest, and therefore an ownership interest, include:

- the right to receive a share of the income, assets or excess spread;
- if amounts payable could be reduced based on losses;
- the right to receive income on a pass-through basis; and
- any synthetic right to have, receive, or be allocated any of the foregoing rights.

Because of the difficulty of applying some of these concepts, the new rules also added a safe harbour for certain senior loans and senior debt instruments. An "ownership interest" does not include any senior loan or senior debt interest that has the following characteristics.

- The holders of such senior loan or debt interest do not have the right to receive a share of the income, gains, or profits of the covered fund, but are entitled to receive only:
  - (a) interest at a stated interest rate, as well as commitment fees or other fees, which are not determined by reference to the performance of the underlying assets of the covered fund; and
  - (b) repayment of a fixed principal amount, on or before a maturity date, in a contractually determined manner (which may include prepayment premiums intended solely to reflect, and compensate holders of the interest for, forgone income resulting from an early prepayment).
- The entitlement to payments is absolute and may not be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest.
- The holders are not entitled to receive the underlying assets of the covered fund after all other interests have been redeemed or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event).

The regulators also clarified that a debt interest in a covered fund would not be considered an ownership interest solely because interest is entitled to be received from an allocation of collections from the covered fund's underlying financial assets in accordance with a contractual priority of payments, a feature that is key to most ABS transactions.

Under the loan securitisation exclusion, a securitisation of "loans" that otherwise would be a covered fund is excluded from the definition of covered fund if the issuing entity issues ABS within the meaning of the rules and the asset pool consists solely of "loans", certain servicing assets, certain interest rate or foreign exchange derivatives, and certain special units of beneficial interests and collateral certificates. Securities generally are not permitted to be pool assets, because distinguishing between a "loan" and a "security" can be notoriously difficult and fact-dependent. The agencies adopted a change that permits a 5% "bond bucket" exception to the general prohibition on inclusion of securities as pool assets.

For debt securities to qualify for inclusion in the permitted bond bucket:

- they may not be ABS or convertible securities; and
- their aggregate value must not exceed 5% of the aggregate value of the loan, cash equivalents and debt securities in the asset pool.

The bond bucket exception was added primarily to benefit CLOs. Because the asset pool for most CLOs is actively managed, CLOs generally do not qualify for the exemption from registration as an investment company provided by Rule 3a-7 under the Investment Company Act. Since the adoption of the Volcker Rule, CLOs often have relied on Rule 3(c)(7) under the Investment Company Act (the "qualified purchaser" exemption) combined with the loan securitisation exclusion from the Volcker Rule. A small bond bucket historically was a feature of many CLOs, but had been avoided post-Volcker until the effective date of this exception.

Regulation S-K

In August 2020, the SEC adopted several changes to Regulation S-K, the set of rules that provides a unified framework for public offering disclosure and public company reporting. Most of these changes were not relevant to ABS issuers, with the exception of some changes to the risk factor disclosure that is required in public ABS offerings. The amended rules:

- require summary risk factor disclosure of no more than two pages if the risk factor section exceeds 15 pages;
- refine the current principles-based approach by requiring disclosure of "material" risk factors; and
- require risk factors to be organised under relevant headings in addition to the sub-captions currently required, with any risk factors that may generally apply to an investment in securities disclosed at the end of the risk factor section under a separate caption.

These changes became effective in November 2020.

Valid when made

The case Madden v Midland Funding, LLC, decided in March 2015 by the United States Court of Appeals for the Second Circuit – which encompasses the States of New York, Connecticut *and* Vermont – disrupted the securitisation industry by ruling that the purchaser of a loan was not entitled to rely on Section 85 of the National Bank Act (NBA). This affected national banks and federally chartered savings and loan institutions (and, by implication, Section 27 of the Federal Deposit Insurance Act (FDIA), which is applicable to state-chartered banks and financial institutions). This meant that third-party purchasers (including securitisation trusts) would need to comply with state usury laws (at least in the states of New York, Connecticut and Vermont) and not be able to rely on the state usury law solely in the state where the originating bank is located. No other Circuit Court issued a decision that followed this case and the US Supreme Court declined to hear an appeal. So while it was the law in those three jurisdictions, it was not universally accepted.

On 2 June 2020, the Office of the Controller of the Currency (OCC) issued a final rule to clarify the "valid when made" doctrine. This OCC final rule amends 12 CFR 7.4001 and 12 CFR 160.110 of the NBA by adding a new section that states: "Interest on a loan that is permissible under [12 USC 85 and 12 USC 1463(g)(1), respectively] shall not be affected by the sale, assignment, or other transfer of the loan" (the "OCC Valid When Made Rule"). The OCC Valid When Made Rule became effective on 3 August 2020.

The FDIC issued a substantially similar rule on 25 June 2020. The FDIC's rule may be found at 12 C.F.R. § 331.4(e) of the FDIA, and states that "[w]hether interest on a loan is permissible under [the Federal Deposit Insurance Act] is determined as of the date the loan was made" and "[i]nterest on a loan… shall not be affected by a change in State law, a change in the relevant commercial paper rate after the loan was made, or the sale, assignment, or other transfer of the loan, in whole or in part" (the "FDIC Valid When Made Rule").

It is important to note that the OCC oversees federally chartered national banks and savings institutions and the FDIC oversees state-chartered banks and savings institutions. The FDIC Valid When Made Rule became effective on 21 August 2020. Together, these two rules provide rule-making guidance in contradiction to the holding in the Madden case. However, while courts generally give great deference to the OCC and FDIC rule-making guidance, they are not required to do so. So, at least in the Second Circuit, there remains a possibility that a court may not follow the directives provided in these new regulations.

In response to these two new rules, on 29 July 2020 the Attorneys General of California, Illinois and New York filed suit against the OCC in the US District Court for the Northern District of California. The lawsuit has been named "People of the State of California, et al. v The OCC". In their complaint the Attorneys General claim that the OCC over-reached the OCC's rule-making authority in that by issuing the "valid when made" rule it:

- acted in an arbitrary and capricious manner,
- took action in excess of its statutory authority; and
- took an agency action without observance of procedure required by law.

Later, eight Attorneys General (the states of California, Illinois, Massachusetts, Minnesota, New Jersey, New York and North Carolina, plus the District of Columbia) filed suit against the FDIC in the same US District Court for the Northern District of California. This lawsuit, known as People of the State of California, et al. v FDIC, was filed on 20 August 2020. This lawsuit similarly challenges the FDIC's rule on the "valid when made"

doctrine. Both cases are ongoing and briefs have been filed on both sides (including amicus curie briefs).

True lender

The other major regulatory action by the OCC that affects the securitisation industry was its issuance of a regulation on 27 October 2020, which became effective on 29 December 2020, regarding the determination of which entity is the true lender in a bank partnership programme (the "OCC True Lender Rule").

It is commonplace in the fintech/marketplace lending space for the programme operator, an entity that typically is not itself a licensed lender, to partner with a national or state-chartered bank to make consumer loans (usually over the internet). The bank partner is most often the entity that is tasked with funding the loan and is named as the lender in the loan documentation. However, most programmes require the bank partner to sell most or all of such loans originated through the programme operator's systems to the programme operator or another third-party purchaser very soon after each such loan is originated. In addition, such loans are sometimes funded with amounts the programme operator has deposited with the bank partner. This has led to multiple legal challenges to the designation of the bank partner as the true lender in the transaction (often in the "payday lending" space, where effective interest rates charged to consumers can be in triple digits).

If the bank partner is not the true lender, then applicable state usury laws would apply to the unlicensed programme operator or third-party purchaser of each such loan that the court may determine to be the true lender. Cases have been decided for both plaintiffs and defendants, and are sometimes based largely on the public policy interests in protecting consumers.

The OCC True Lender Rule creates a very simple test for determining whether the bank partner is the true lender in the transaction. In short, a bank will be deemed to have made the loan when, as of the date of origination, the bank is named as the lender on the loan agreement or the bank funds the loan. In situations where more than one bank could be the true lender (eg, when one bank is the named as the lender in the loan agreement but another bank has funded the loan), the true lender will be deemed to be the bank that is named as the lender in the loan agreement. It is important to note that the OCC True Lender Rule applies only to national banks and federal savings associations. The FDIC has not yet issued any pronouncements on this subject, so it is not applicable to state-chartered banks.

On 6 January 2021, a consortium of Attorneys General from seven states (New York, California, Colorado, Massachusetts, Minnesota, New Jersey and North Carolina) and the District of Columbia filed a lawsuit in the Southern District of New York against the OCC challenging the OCC True Lender Rule. This lawsuit has been named People of the State of New York v The Office of the Comptroller of the Currency. Much as they did against both the OCC and the FDIC with respect to the OCC's and FDIC's Valid When Made Rules, the lawsuit seeks to invalidate the OCC True Lender Rule on multiple grounds, including that:

- the OCC exceeded its statutory authority by offering an "unreasonable" interpretation of federal law, and that it acted in a manner contrary to centuries of case law, the OCC's prior interpretation of the law, and the plain statutory language of the federal statutes;
- the OCC True Lender Rule is contrary to Congressional actions to rein in the OCC's ability to pre-empt state consumer protection laws; and
- its enforcement would encourage highly consumer disadvantageous "rent-a-charter" lending schemes, designed solely to evade state usury laws.

As this case has been very recently filed, proceedings are expected to continue well into 2021 and beyond.

Colorado litigation

The Colorado Attorney General's Office settled two lawsuits in August 2020 concerning Colorado's right to enforce its usury interest rate caps on consumer loans (the "Colorado Settlements"). The first lawsuit involved Avant of Colorado, LLC ("Avant") and the second lawsuit concerned Marlette Funding, LLC ("Marlette"), neither of which is a bank or a federal or state-chartered lending institution. However, Avant and Marlette had established lending partnerships with banks located outside Colorado: Avant with WebBank, and Marlette with Cross River Bank.

The Colorado Settlement provided a "safe harbour" for web-based platform operators that operated using bank partnership arrangements. If complied with, the Colorado Attorney General's office would not seek enforcement actions against such companies or their bank partners for usury violations. In brief, such companies and banks had to agree:

- to certain oversight restrictions (which could be by the OCC, FDIC or state banking regulators);
- to certain consumer disclosure and funding criteria that would need to be adhered to;
- to certain licensing criteria that would have to be met;
- that no loan could be made to a Colorado-based borrower in excess of 36% per annum; and
- that certain programmatic structural criteria would be required to be met.

In addition, Avant, Marlette, WebBank and Cross River Bank agreed to pay certain specified fees and penalties to Colorado. No other states have followed this settlement blueprint, but it would not be unexpected if future settlements among state regulators, web-based consumer loan programme operators and their bank partners are constructed to contain similar terms.

Alternatives to LIBOR

The interest rates on many ABS (and on many variable-rate loans, credit card accounts, derivatives and other financial instruments) adjust in accordance with an index based on the average of the inter-bank offered rates for US deposits of certain durations in the London market based on quotations of major banks (LIBOR). LIBOR is calculated and published for various currencies and periods by the benchmark's administrator, ICE Benchmark Administration Limited (IBA), which is regulated by the UK Financial Conduct Authority (FCA).

In November 2017, the FCA announced that the panel banks that submit information to the IBA, as administrator of LIBOR, have undertaken to continue to do so only until the end of 2021 (the LIBOR phase-out date). It is not expected that a value for LIBOR (of any duration) will be calculated or published after the LIBOR phase-out date.

The FCA's announcement followed a series of regulatory investigations dating back to 2012, in which certain financial institutions were accused of manipulating LIBOR and altering costs when reporting to regulators. In addition, lawsuits have been filed in the USA seeking damages for losses arising from alleged LIBOR manipulation. While some aspects of these lawsuits have been dismissed or settled, others continue to be litigated. These investigations and litigation may affect the use of LIBOR as a global benchmark even before the LIBOR phase-out date.

The elimination or effective unavailability of LIBOR has implications not just for floating-rate ABS but also for pool assets that have floating interest rates. This could lead to disconnected floating rates between the ABS and the related collateral if the reference rate is not addressed in both.

Transition to SOFR

As noted above, the ARRC was established in 2014 to identify possible alternative reference rates for US dollar LIBOR and to identify best practices for implementation of a new reference rate. In June 2017, the ARRC identified the SOFR, which is a secured rate derived from borrowing and lending activities on US treasuries, as its preferred alternative reference rate. Based on the work of the ARRC's Securitization Working Group (chaired by the SFA and the Commercial Real Estate Financial Council, or CREFC), in December 2018 the ARRC posted a consultative document that provides proposed fall-back language for contracts to address the possibility that LIBOR ceases to be available or is discontinued. Also in December 2018, the SFA released the first edition of a Green Paper setting forth recommended best practices for LIBOR benchmark transition. More recently, on 31 May 2019, the ARRC recommended fall-back language for securitisations to facilitate a benchmark transition from LIBOR to SOFR. As with the ARRC's consultative document and the Green Paper, the ARRC Securitization Release suggests the use of "waterfalls" of fall-back language to deal with the potential discontinuance or effective unavailability of LIBOR.

The ARRC Securitization Release provides that a transition from LIBOR to SOFR in a securitisation would be triggered upon the declaration of a specific benchmark transition event:

- a public statement by the IBA or FCA that the actual cessation of LIBOR has occurred or is expected;
- a public statement or publication of information by the IBA that LIBOR is no longer "representative" as an index (known as a "pre-cessation trigger"); or
- with respect to transactions where the underlying pool assets bear floating rates, a transition of a specified percentage of those assets from LIBOR based to adjusting using an alternative index.

Upon determination that a benchmark replacement event has occurred, the applicable benchmark replacement index would be substituted for LIBOR. Under the waterfall for determining the appropriate replacement index, the default choice if only some LIBOR tenors become available would be an interpolated benchmark (ie, a linear interpolation between the longest available LIBOR that is shorter than the corresponding tenor and the shortest available LIBOR that is longer than the corresponding tenor). However, if an interpolated benchmark cannot be produced, the ARRC set forth the following alternatives, the first available of which would become the replacement benchmark:

- the sum of forward-looking term SOFR for the corresponding tenor (as selected or recommended by the Federal Reserve, the New York Fed or other official committee of the foregoing, the "relevant governmental body") and the applicable benchmark replacement adjustment;
- the sum of daily SOFR, compounded in arrears, and the applicable benchmark replacement adjustment;
- the sum of the alternative rate of interest selected or recommended by the relevant governmental body and the applicable benchmark replacement adjustment;
- the sum of the rate that would apply for derivatives referencing International Swaps and Derivatives Association (ISDA) definitions as the fall-back rate (less the ISDA fall-back adjustment) and the applicable benchmark replacement adjustment; and

Contributed by: *Jeffrey R. Johnson, Matthew P. Joseph, Steve Levitan and Charles A. Sweet,* ***Morgan, Lewis & Bockius LLP***

- optionally, the rate selected by a designated transaction representative, giving due consideration to any industry-accepted rate of interest as a replacement for LIBOR in US dollar-denominated securitisations and an applicable benchmark replacement adjustment.

The ARRC provisions also include a waterfall for the determination of the benchmark replacement adjustment:

- first, the spread adjustment (or method for calculating the spread adjustment) that has been selected by the relevant governmental body or the relevant unadjusted benchmark replacement;
- second, if the unadjusted benchmark replacement is the ISDA fall-back rate, the spread adjustment that would apply for derivatives transactions referencing the ISDA definitions for the applicable tenor; or
- third, and optionally, the spread adjustment selected by the designated transaction representative, giving due consideration to any industry-accepted spread adjustment (or method for calculating the spread adjustment), for the relevant unadjusted benchmark replacement.

The ARRC Securitization Release sets forth that a contractually "designated transaction representative" would be responsible for making most related LIBOR transition decisions, including declaring that a benchmark replacement event has occurred, the selection of the applicable benchmark replacement, and the ability to amend all required transaction agreements to effect those determinations. In the absence of manifest error, the decisions of the designated transaction representative would be conclusive. A number of securitisations in the USA have incorporated the ARRC Securitization Release recommended language, either in whole or in part.

Key differences

SOFR differs from LIBOR in several key respects. First, SOFR is an overnight rate, while LIBOR is available in many different tenors (eg, one month, three months) and is forward-looking. While consensus reflected in the ARRC Securitization Release suggests that the first alternative should be a forward-looking term SOFR with a matching term to LIBOR, no such rates are currently available and some industry participants have expressed concern as to whether they will be by the LIBOR phase-out date.

Second, SOFR is a secured rate derived from borrowing and lending activities on US treasuries, while LIBOR is based on a survey of quotations from participating banks regarding what they believed the going-forward unsecured interest rate should be. Because SOFR is effectively a risk-free rate, it will require a spread adjustment – known as the "applicable benchmark replacement adjustment" in ARRC parlance – to match LIBOR's unsecured and riskier calculation. While the waterfall provisions suggested by the ARRC Securitization Release acknowledge that need, there is no consensus as to what an appropriate spread adjustment should be or how it should be calculated.

Finally, because SOFR is an overnight rate, the market must reach a consensus as to how to calculate properly a rate for use with consumer products and other contracts that provide for an interest rate to be set at the beginning of each interest accrual period. Because SOFR currently is an overnight rate only, calculating forward-looking rates based on spot rates or over a past period will be based on stale information. In combination, these factors may represent significant risk if not addressed in a neutral manner. The market will be watching closely to judge whether any new rate structures that are adopted have unintended consequences.

Problems of LIBOR transition for existing securitisations

While new securitisation documents can provide for an effective alternative reference rate, LIBOR transition poses more difficult problems for many existing ABS and their underlying pool assets.

Many existing securitisations provide that if LIBOR is terminated or ceases to function, the applicable interest rates may become fixed based on the last LIBOR available. A large number of these deals present no readily apparent amendment mechanism to incorporate the ARRC's recommended fall-back provisions. Also, there is likely to be basis risk between the cash flows on ABS and the underlying pool assets if floating interest rates on both do not adjust simultaneously and based on the same reference rate.

To address some of the difficulties involved in the transition for legacy assets, the IBA has announced that it will consult on when to end the publication of various USD LIBOR tenors. These proposed plans would extend the cessation date for most USD LIBOR tenors until mid-2023, including overnight, one month, three months, six months and twelve months. Two little-used USD LIBOR tenors (one week and two months) would retain their cessation date of the end of 2021. This consultation is open for feedback until 25 January 2021. The proposed extension would only apply to legacy contracts – in the USA, the Federal Reserve, the FDIC and the Office of the Comptroller of the Currency have made it clear that issuances in 2021 should use an alternative reference rate or contain robust fall-back provisions, and that issuances post-2021 should not reference LIBOR.

To address some of the legacy deal issues, the ARRC has been advocating that the New York State legislature (because New York law governs the vast majority of LIBOR-utilising contracts)

pass new legislation that would provide a statutory remedy to these problems. Such a legislative fix would:

- provide that any deals that are silent on the matter would, by statute, default to the use of the ARRC waterfall and a SOFR-based replacement;
- mandate that transactions where the documents fix the interest rate at the last known LIBOR instead make use of the ARRC waterfall and default to a SOFR-based replacement;
- wherever transaction documents provide for a designated party to have discretion in choosing an alternative mandate to instead make use of the ARRC waterfall and default to a SOFR-based replacement; and
- provide a safe harbour from liabilities and lawsuits for any transaction parties that acted in accordance with the legislation.

All these provisions would be superseded if the affected parties agree to opt out of the legislative default choices. Similar legislation, which would pre-empt state law regarding LIBOR transition (and therefore would apply more broadly than the proposed New York legislation), is being pursued by some market participants at the federal level.

Even where securitisation documents or legislation provide for an effective alternative reference rate for legacy LIBOR-based ABS, the interest rate provisions for the underlying pool assets will likely have been determined prior to the securitisation and may have been drafted by entities unaffiliated with the sponsor. Therefore, close co-ordination between securitisation sponsors and the originators of financial assets that are likely to be securitised is recommended.

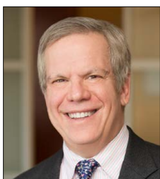
Contributed by: *Jeffrey R. Johnson, Matthew P. Joseph, Steve Levitan and Charles A. Sweet,* ***Morgan, Lewis & Bockius LLP***

Morgan, Lewis & Bockius LLP is a global law firm with approximately 2,200 legal professionals in 31 offices across North America, Europe, Asia and the Middle East. The firm's structured transactions practice serves the financing needs of the world's most sophisticated businesses. The team is a recognised global leader in the structured finance industry, domestically and internationally. Its clients, both issuers and underwriters, are among the most highly respected global financial services institutions and the practice understands the evolution of structures because it was involved in many of the industry's significant firsts. In addition to a robust, dedicated structured transactions practice, it offers key practice area expertise to support transactions, including tax, the Employee Retirement Security Act (ERISA), litigation, broker-dealer, real estate and investment company practice lawyers. Morgan Lewis lawyers wrote the books that structured finance lawyers rely on: "Offerings of Asset-Backed Securities" and "The Federal Securities Law of Asset-Backed Securities".

Authors

Jeffrey R. Johnson focuses his practice on structured finance and securitisation. He counsels large financial institutions, finance companies, government agencies, government-sponsored entities and leading investment banking firms on numerous transactions, including asset-backed and mortgage-backed securities issuances, resecuritisation of financial assets, net interest margin transactions, whole loan and asset sales, financing facilities and related regulatory matters. Jeff additionally advises issuers and underwriters on various other structured transactions involving numerous asset types and receivables, including single-family and multi-family residential mortgage loans, commercial mortgage loans and automobile and recreational vehicle loans and leases. Jeff can be reached at +1 202 739 5645 or at Jeffrey.johnson@morganlewis.com.

Matthew P. Joseph focuses primarily on structured finance transactions. He regularly represents issuers and underwriters in public offerings and private placements of ABS, and he is often involved in structuring innovative transactions with new asset types or unique tax and cash-flow structures, utilising various forms of credit enhancement and derivatives. He also represents large financial institutions in structured lending transactions both on balance sheet and in commercial paper conduit transactions, as well as in acquisition financing transactions. Matthew's practice has focused most recently on the asset-backed space and specifically on transactions backed by marketplace loans, auto loans and leases, student loans and esoteric assets. Matthew can be reached at +1 212 309 6770 or at Matthew.Joseph@MorganLewis.com.



Steve Levitan has extensive experience in structuring highly complex securitisation transactions backed by collateral encompassing a broad range of asset types, including student loans, auto loans, marketplace (peer-to-peer) loans, debt consolidation loans, residential solar panel loans and leases, Australian mortgage loans, commercial equipment receivables and leases, automobile receivables and leases, trade receivables, credit card account receivables, residential mortgage loans, home equity loans, financed insurance premiums, residual interests in pre-existing special-purpose entities and the resecuritisation of previously issued asset and mortgage-backed securities. Steve has represented sponsors/issuers and underwriters in public offerings, private placements, direct-lending/warehouse financings, offshore transactions and asset-backed commercial paper offerings. He has also represented clients in connection with acquisitions and sales of whole-loan assets and servicing operations. Steve can be reached at +1 212 309 6910 or at Steve.Levitan@MorganLewis.com.

Charles A. Sweet serves as the practice development leader of the structured transactions group. His securitisation experience encompasses a wide variety of asset classes, including automobile loans and leases, student loans, marketplace loans and residential mortgages. Charlie has worked on many innovative transactions and structures, with sponsors ranging from finance arms of Fortune 500 companies to technology-driven emerging growth companies. Charlie advises clients on the federal laws and regulations affecting ABS and other structured finance products, and is a co-chair of the Structured Finance Association's Legal Counsel Committee. He is the co-author of the fourth edition of the leading industry treatise, "Offerings of Asset-Backed Securities", and was the original author of "The Federal Securities Law of Asset-Backed Securities". Charlie can be reached at +1 202 739 5635 or at Charles.Sweet@MorganLewis.com.

Morgan, Lewis & Bockius LLP

101 Park Ave.
New York, NY 10178-0060
United States

Tel: +1 212 309 6000
Fax: +1 212 309 6001
Email: Steve.Levitan@MorganLewis.com
Web: www.morganlewis.com