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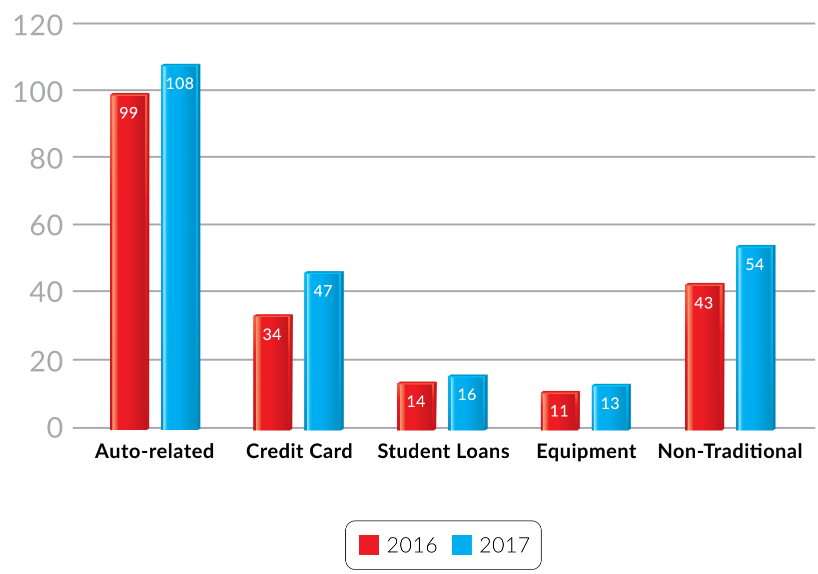
Market Trends: Structured Finance, Securitization and Derivatives

ABS Issuance Growth by Sector ($bn)



STRONG ECONOMIC GROWTH AND HISTORICALLY LOW interest rates boosted U.S. structured finance issuance to $510 billion in 2017, a 37% increase over 2016 volume. This growth occurred across a wide range of asset classes. Up and down the credit curve, spreads (i.e., the difference between what the issuer receives from the underwriter and what the underwriter receives upon resale) on asset-backed securities (ABS) were stable or grew tighter in both developed and developing markets as demand far outpaced supply. Investors continued their hunt for yield further down the capital stack as well and into the more esoteric corners of the market.

The biggest driver in 2017 was the boom in the collateralized loan obligation (CLO) market. New CLO issuances were the second highest year on record, reaching $118 billion in the United States, up 64% from the prior year. A record number of existing CLOs were refinanced or reset, which in combination with new CLO issuances resulted in total issuances of over $250 billion in 2017. Some industry commentators pointed to the recently effective risk retention requirements as part of the driving force behind such growth; more than 50% of new CLOs complied with the risk retention requirements by retaining an eligible horizontal residual interest in the issuing entity in an amount equal to at least 5% of the fair value of all ABS interest issued as part of the securitization transaction, thereby resulting in less availability for third-party investors.

Another 2017 highlight was the non-traditional ABS sector or so-called esoteric ABS market, which comprises assets other than the usual sources for ABS financing such as auto-related, credit card, student loan, or equipment assets. Overall, the esoteric ABS market was up approximately 41% year-over-year, with issuances rising to over $50 billion. Consumer loan, whole-business, aircraft lease, single-family rental, and mobile device payment ABS led in this market, representing 61% of such issuance in 2017.

Whole-business volumes notably increased 171% from the prior year with $7.6 billion of new issuance. The large increase was driven by $2.1 billion and $1.6 billion offerings from Domino's and Dunkin' Brands, respectively; however, smaller restaurant franchises were also in the market, including Jimmy John's, Five Guys, and TGI Fridays.

Notable Transactions

As noted above, the whole-business securitization market experienced significant growth in 2017. One deal in particular stood out: Coinstar, LLC (Coinstar). Coinstar issued a first-of-its-kind $900 million whole-business securitization of its coin exchange business. Coinstar operates automated coin-counting kiosks that enable customers to deposit coins and receive the equivalent in cash or vouchers, less a transaction fee. The $900 million of notes, rated BBB by Kroll and Morningstar, were backed by Coinstar's coin kiosks, intellectual property (including proprietary software and patents related to coin counting and sorting), contractual arrangements with retailers and stored value card providers, and international royalty payments. In contrast to a traditional securitization, where the securitized cash flows are payments by contractually obligated parties, the main securitized cash flow in this transaction was Coinstar's profit margin on the coins deposited into kiosks by the general public. The deal introduced a unique cash flow structure and cash management arrangement that allowed Coinstar to continue to operate its business as usual, but which was also acceptable to rating agencies and attractive to investors.

The Coinstar deal showed that securitization of assets other than the traditional kinds of ABS assets, when structured appropriately, can be attractive to potential investors. The innovative securitization structure may have wider application to a variety of businesses that, like Coinstar, rely on margins on individual transactions for their revenue. Commentators on the ABS industry have noted that the Coinstar type of deal may represent another active source of future ABS financing.

> Many market participants agree that structured finance can weather interest rate hikes so long as they are not sudden and steep.

In another unique securitization, Angel Oak Capital Advisors, LLC (Angel Oak) sponsored the issuance of a $90 million securitization backed by loans originated by an affiliated direct investment property lender. The notes are backed by loans known as fix-and-flip loans, which are issued to residential real estate investors. Traditionally, fix-and-flip loans, which are short-term loans to developers and speculators who buy run-down houses to quickly fix and resell, have been difficult to securitize. That is in part because the loans typically mature in 6–12 months, which can be too short to support bonds with average lives long enough to appeal to most investors.

With its 2017 issuance, however, Angel Oak created a structure using a revolving trust (which the company claimed was the first of its kind) that allows the issuer, over the course of 18 months, to acquire new loans as the original loans are paid off. This attracted the attention of the market with some seeing it as a possible roadmap for other issuers. The total dollar volume of financed home flip purchases was $16.1 billion for homes flipped in 2017, up 27% from 2016 and the highest level since 2007.

Deal Terms

Impact of Credit Risk Retention on ABS Deal Terms in 2017

The credit risk retention rule for ABS (the Risk Retention Rule) promulgated pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] became effective for all securitizations as of December 24, 2016.[2] The Risk Retention Rule requires any securitizer of ABS to retain an economic interest equal to at least 5% of the aggregate credit risk of the assets collateralizing the issuance. Taking its cues from the residential mortgage-backed securities (RMBS) and CLO markets (which were initially subject to the Risk Retention Rule

1. 111 P.L. 203, 124 Stat. 1376. 2. *See* 17 C.F.R. §§ 246.1 - 246.22.

as of December 24, 2015), issuers of other ABS adapted well to the new requirements. Some of the notable changes to deal terms are summarized later in this article.

Indemnification Tied to Risk Retention

Underwriters, initial purchasers, and other market participants now require securitization sponsors to provide certain representations, warranties, and indemnifications related to risk retention including:

- Confirmation that the sponsor, as such term is defined in the Risk Retention Rule, has been selected appropriately
- Confirmation that the sponsor or a majority-owned affiliate thereof will hold an amount equal to at least 5% of the fair value of all ABS interest (as such terms are defined in the Risk Retention Rule)
- Confirmation that the sponsor has complied with (and was solely responsible for) the disclosure requirements under the Risk Retention Rule
- General indemnification for any liability related to the Risk Retention Rule

Disclosure Trends

Generally, the Risk Retention Rule requires a list of specific disclosures be provided to prospective investors a reasonable period of time prior to the sale of the ABS. Additionally, in certain circumstances, additional disclosures are required to be provided a reasonable time after closing.

Furthermore, the rule requires the sponsor to retain all information regarding the investor disclosure (including descriptions of methodology used to calculate fair values, key inputs, and assumptions) until three years after all ABS interest is no longer outstanding and disclose such information to the Securities and Exchange Commission (SEC) and other regulators upon request.

Legal and Regulatory Trends

The Risk Retention Rule was implemented with relative calm; however, regulation remains a hot topic. Significant regulatory items of note include (1) the United States Court of Appeals for the District of Columbia (the D.C. Court) risk retention ruling in February 2018 with respect to open-market CLOs, (2) the potential impact of the December 2017 tax reform bill on structured finance and the securitization market, and (3) the October 2017 U.S. Treasury Department report on capital markets.

Related Content

To learn more about asset-backed securities (ABS) and other securitization transactions, see

> SECURITIZATION

RESEARCH PATH: *Capital Markets & Corporate Governance > Structured Finance and Securitization > Securitization > Practice Notes*

For details on the methods that are available to enhance the credit of securitized assets, see

> CREDIT ENHANCEMENT IN SECURITIZATIONS

RESEARCH PATH: *Capital Markets & Corporate Governance > Structured Finance and Securitization > Securitization > Practice Notes*

For an explanation of the primary types of structured securities issued by aircraft leasing companies, see

> AVIATION INDUSTRY PRACTICE GUIDE

RESEARCH PATH: *Capital Markets & Corporate Governance > Industry Practice Guides > Aviation & Aerospace > Practice Notes*

For a discussion on ABS for commercial paper financing, see

> ASSET-BACKED COMMERCIAL PAPER FACILITIES

RESEARCH PATH: *Capital Markets & Corporate Governance > Structured Finance and Securitization > Securitization > Practice Notes*

For guidance on shelf registration for offerings of investment grade ABS and the application of Regulations AB and AB II, see

> LEGAL FRAMEWORK OF SECURITIZATION TRANSACTIONS

RESEARCH PATH: *Capital Markets & Corporate Governance > Structured Finance and Securitization > Securitization > Practice Notes*

D.C. Court Ruling on Risk Retention

Under the current Risk Retention Rule applicable to CLOs, CLO collateral managers are required to purchase notes representing at least 5% of the credit risk associated with each CLO that they structure. The Loan Syndications and Trading Association (LSTA) challenged this requirement as applied to

3. Loan Syndications & Trading Ass'n v. SEC, 223 F. Supp. 3d 37 (D.D.C. 2016).

managers of open-market CLOs and brought action against the SEC and the Board of Governors of the Federal Reserve System. In 2016, in response to this lawsuit, a District of Columbia district court held that the Risk Retention Rule was a valid exercise of federal agency authority deferring to the agencies' interpretation of the term securitizer to include open-market CLO managers.[3]

On February 9, 2018, a three-judge panel of the D.C. Court disagreed with the district court's ruling and invalidated the Risk Retention Rule, as it applies to the collateral managers of open-market CLOs.[4] Specifically, the court ruled that collateral managers of open-market CLOs are not securitizers under the Dodd-Frank Act and, accordingly, are not subject to the requirements of the Risk Retention Rule. Given that the rule defines a securitizer as, among other things, an entity that transfers assets to an issuer of ABS, the court explained that managers of open-market CLOs characteristically never own the assets that collateralize a CLO, and therefore cannot transfer them to the issuer. Instead, the managers act as agents of the issuers in selecting the assets to be purchased by the issuers from third parties. After the March 26 deadline for appeal by regulators had passed, the D.C. Court ordered summary judgment for the LSTA. With the deadline for seeking review by the U.S. Supreme Court having passed, the D.C. Court's ruling is the final word: the Risk Retention Rule will no longer apply to open-market CLO managers.

While there are many theories as to how this decision will impact the market, the implications of the ruling are not yet clear. Some open questions include:

- How will new CLOs be structured?
- How will managers of open-market CLOs approach their contractual obligations to comply with risk retention?
- Can the D.C. Court's ruling be applied to other structured asset classes?
- Will the market demand that managers still hold risk or will investors be willing to buy securities from issuers who do not hold any risk?

Tax Reform Bill

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act of 2017 (TCJA). The law includes several changes that may have an impact on structured finance and securitization markets. Of note, the TCJA reduced the cap on principal balances entitled to take mortgage interest deductions from $1 million to $750,000 for mortgage loans originated (or subject to a written binding contract) after December 15, 2017. The new law also appeared to suspend the ability of borrowers to deduct interest for existing and future home equity lines of credit (HELOCs) for the taxable years beginning on or after January 1, 2019, with such suspension ending for taxable years beginning after December 31, 2025. However, the Internal Revenue Service clarified in a bulletin on February 21, 2018, that HELOC interest would continue to be deductible under the TCJA to the extent that the loan was used to "buy, build or substantially improve the taxpayer's home that secures the loan." The implications of the new law are still unclear but could have a negative effect on the market for higher balance mortgage loans and HELOCs used for purposes other than to make home improvements. In particular, it could have a downward effect on the value of related mortgaged properties and prevent or delay borrowers from selling or refinancing their mortgaged properties in the future.

4. Loan Syndications & Trading Ass'n v. SEC, 882 F.3d 220 (D.C. Cir. 2018).

Treasury Report on Capital Markets

On February 3, 2017, President Trump issued Executive Order 13722, which, among other things, directed the Secretary of Treasury to examine the existing laws, treaties, regulations, guidance, reporting, and recordkeeping requirements to ensure they promoted the core principles for regulating the U.S. financial system. In response, in October 2017, the Treasury Department released a paper on capital markets that included a chapter on securitizations. Among the most notable recommendations, the paper questioned the breadth of the risk retention requirement and recommended that the "federal banking regulators expand qualifying risk retention exemptions across eligible asset classes based on the unique characteristics of each securitized asset class . . . "[5] It is too early to predict the exact scope or long-term impact of this report on the risk retention requirements or the securitization and structured finance markets.

Related Content

For a review of the roles that the key parties play in packaging, servicing, selling, and administrating ABS, see

> PARTIES AND DOCUMENTS IN SECURITIZATION TRANSACTIONS

RESEARCH PATH: *Capital Markets & Corporate Governance > Structured Finance and Securitization > Securitization > Practice Notes*

For a description of the various items that are prepared in anticipation of the closing of a securitization transaction, see

> CLOSINGS IN SECURITIZATION TRANSACTIONS

RESEARCH PATH: *Capital Markets & Corporate Governance > Structured Finance and Securitization > Securitization > Practice Notes*

For information on the legal opinions that are commonly required to be delivered by counsel in most securitization transactions, see

> LEGAL OPINIONS IN SECURITIZATIONS

RESEARCH PATH: *Capital Markets & Corporate Governance > Structured Finance and Securitization > Securitization > Practice Notes*

For an overview of the major provisions of the Dodd-Frank Act, see

> DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT KEY PROVISIONS

RESEARCH PATH: *Capital Markets & Corporate Governance > Corporate Governance and Compliance Requirements for Public Companies > Corporate Governance > Practice Notes*

Market Outlook

Market views remain positive going into 2018 with many forecasting continued growth. Standard & Poor's stated in January 2018 that since securitization still represented a relatively low percentage of the total U.S. loans outstanding, there appeared to be significant opportunity for expansion in most U.S. loan sectors. Several sectors in particular are expected to play an outsized role in 2018. The CLO, RMBS, and consumer lending markets are all areas to keep an eye on in 2018.

Nonetheless, the 2018 outlook for structured financing is not without risks. Many expect interest rates to rise in 2018 (albeit gradually) with the appointment of a new chairman of the Federal Reserve Board, and questions linger regarding the effect that such anticipated interest rate hikes will have on the structured finance market. Many market participants, however, agree that structured finance can weather interest rate hikes so long as they are not sudden and steep. L

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RESEARCH PATH: *Capital Markets & Corporate Governance > Market Trends > Structured Finance > Practice Notes*

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5. See U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities: Capital Markets (October 2017) at 103, https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.