ABS East 2020 Conference Notes

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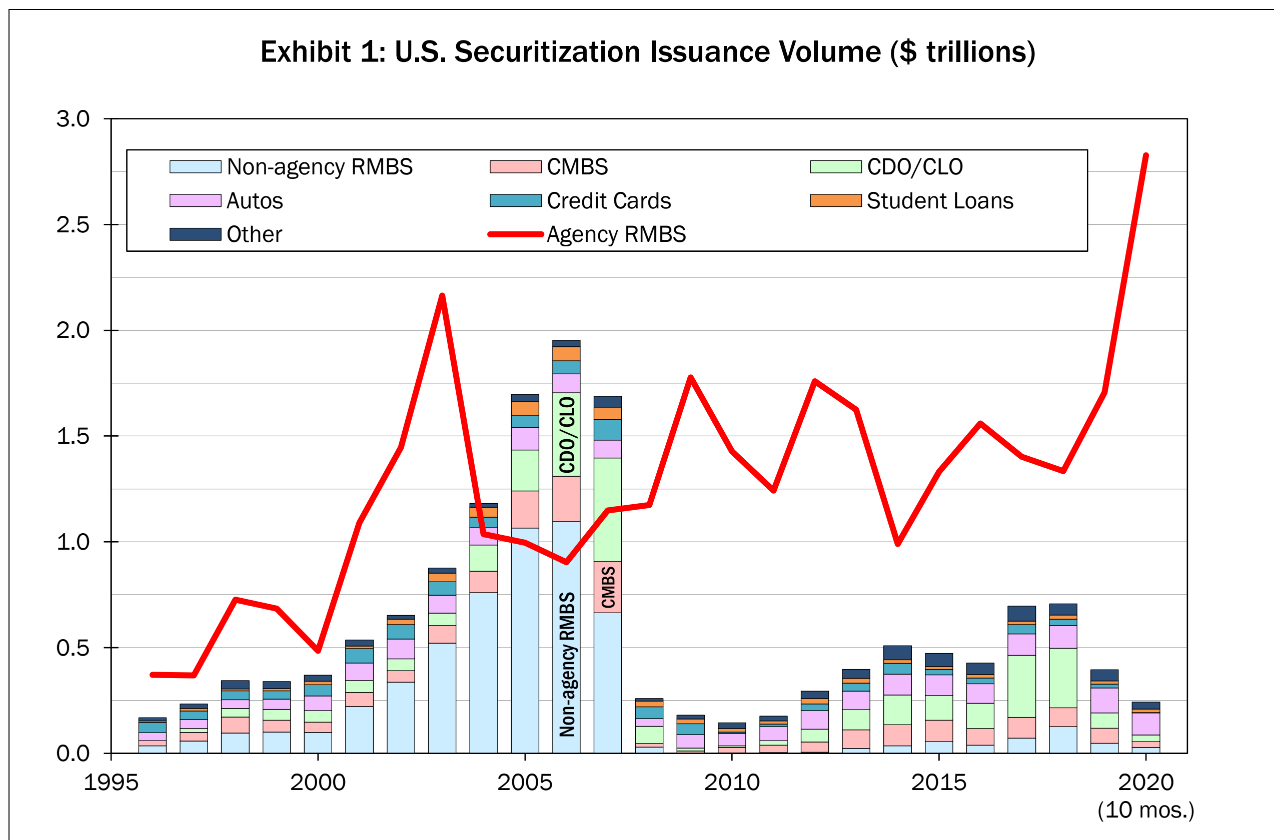
The recent **26th Annual ABS East** conference was a virtual event on December 1-2, 2020. It attracted slightly more than 4,000 registered attendees, including more than 300 investors. Speakers expressed divergent views about the outlooks for inflation, the economy, and the future investment landscape.

Agency MBS continues to dominate the U.S. securitization landscape, with 2020 issuance on track to exceed $3 trillion. The next most active sector is auto loan ABS, which has seen slightly more than $100 billion issuance through October. Other sectors have been quite slow compared to historical issuance volumes (Exhibit 1). The Covid-19 pandemic seems like an obvious explanation, but it has not slowed down agency MBS. Nor has it slowed residential mortgage loan originations, which are expected to reach a record $4 trillion for the year.

Key themes at the conference included reporting of forbearance and payment deferrals, ESG investing, the cessation of LIBOR, and the potential for policy changes following the presidential inauguration. There was somewhat less discussion of regulatory issues than at past conferences.



Source: SIFMA. Note: Non-agency RMBS includes prime jumbo, non-prime/subprime, and scratch-and-dent but excludes credit-risk transfer, resecuritizations, and single-family rental. Agency RMBS includes basic pass-through securities but excludes CMOs/REMICs. CMBS includes only non-agency CMBS.

The following summaries reflect the remarks of the panelists who participated in selected sessions at the conference. For the most part, the summaries are drawn from notes that I took during the sessions. The summaries have not been reviewed or approved by the panelists. While I have tried to capture panelists' remarks accurately, I apologize in advance for any inaccuracies and omissions. In addition, I wish to acknowledge the excellent work of Information Management Network in organizing and hosting the conference.

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Tuesday, December 1, 2020

9:10 am: Red v. Blue (or some shade of Purple): Reviewing the Outcome of the Presidential and Congressional Election and Anticipating the Impact on Capital Markets

In a poll of the audience, 68% of respondents indicated that they do not expect the Democratic candidates to win both Senate seats in Georgia. This indicates a prevailing expectation that the U.S. will have a split government. If that happens, a large portion of economic policy implementation will happen through executive action.

One speaker asserts that financial markets are the lifeblood of an economy. New sectors of the economy are driving growth and mitigating the current economic downturn. The low-interest-rate environment distorts investor behavior. Investors are hungry for yield, and they are not getting adequate compensation for taking risk. Economic policy should focus on helping small businesses.

Another panelist observes that companies may be skeptical about the longevity of policies implemented through executive action. They may perceive greater uncertainty about the future, which can hamper their ability to operate. Additionally, the leftmost elements of the Democratic Party will likely push the Biden administration to embrace policies that could hinder economic growth. A major new stimulus package is unlikely before the inauguration. Also, much of the economic stimulus authorized under the CARES Act was never deployed. A third panelist agrees that the likelihood of a major stimulus package during the lame-duck session is remote. However, a smaller stimulus package may succeed in getting through the legislative process. Infrastructure is the area that has the best chance to garner bi-partisan support as an economic initiative after the inauguration.

Monetary policy is another potential source of relief. Despite near-zero interest rates, the Fed has not exhausted its tools. It can continue to be a source of liquidity, which it has done so far to support markets. On the other hand, the prospect of greater regulatory burdens, particularly on banks, may be a drag on the recovery.

Credit spreads have been relatively tight through 2020. The likely reason is the massive fiscal stimulus earlier in the year, combined with the generous liquidity from the Fed. One panelist states that marketplace lending ABS are the best opportunity on the structured finance landscape during the tight-spread environment. The panelist also favors subprime auto ABS from select issues.

LIBOR: There was a key announcement yesterday (November 30) about LIBOR: LIBOR quotes are likely to continue until June 30, 2023, but regulators are urging banks to immediately stop using LIBOR for new deals.[1] Many market participants would favor a legislative solution to provide a permanent fix for legacy deals.[2] In contrast to the U.S. legislative approach, the European approach leans toward synthetically continuing LIBOR for use in legacy deals.

ESG Investing: One panelist expects the Biden administration to promote ESG investing. In particular, the new administration will likely address recent Labor Department regulations that prevent pension plans from pursuing ESG strategies.[3] One panelist notes, however, that ESG initiatives must come primarily from investors rather than the government.[4]

Consumer Protection: The Biden administration is likely to promote consumer protection through the CFPB, the SEC, the CFTC, and other agencies.

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[1] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, *Statement on LIBOR Transition* (30 Nov 2020) https://www.fdic.gov/news/press-releases/2020/pr20129a.pdf?source=content_type%3Areact%7Cfirst_level_url%3Anews%7Csection%3Amain_content%7Cbutton%3Abody_link.

[2] *See e.g.*, NY Senate Bill S9070 (28 Oct 2020) https://www.nysenate.gov/legislation/bills/2019/s9070.

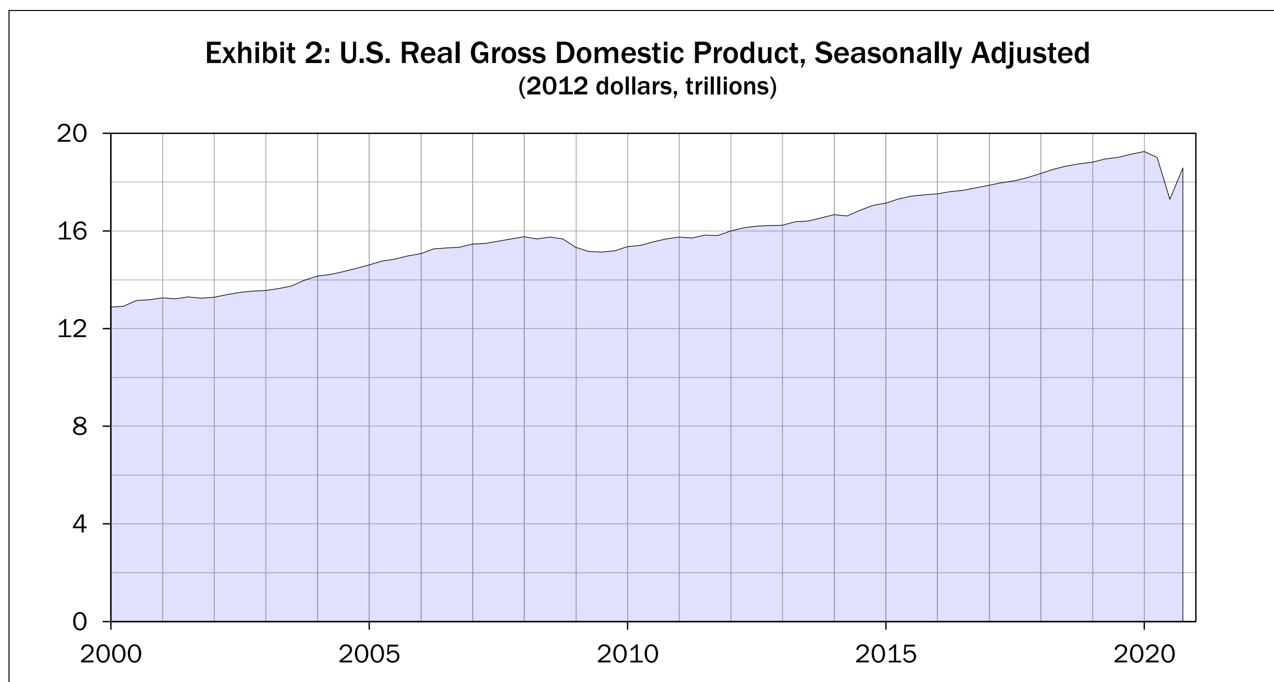
[3] Department of Labor, *Financial Factors in Selecting Plan Investments*, 85 Fed. Reg. 72846 (13 Nov 2020) https://www.govinfo.gov/content/pkg/FR-2020-11-13/pdf/2020-24515.pdf.

[4] The seemingly anodyne statement that ESG initiatives must come primarily from investors rather than the government is not universally accepted. Apart from the Dept. of Labor regulation noted above, another example is Bradford Cornell, *ESG Investing: Conceptual Issues*, J. WEALTH MGMT., Winter 2020, at 61, https://doi.org/10.3905/jwm.2020.1.117.

Student Loan Debt: One panelist asserts that forgiveness of student loan debt is unlikely under a split government because it would require legislative action. However, President Trump was able to forgive student loans for disabled veterans. Biden might be able to achieve forgiveness via executive action for limited groups, such as those in public service.

10:00 am: Tracking the State of the ABS Market throughout the Stages of COVID-19

The economic dislocations caused by the pandemic have been widespread but not evenly distributed across sectors. Some areas, such as traditional retail, travel, and entertainment, have been more severely affected. The recession in the early stages of the pandemic was severe but very short compared to prior recessions (Exhibit 2). Some businesses have flourished during the pandemic, such as delivery services, technology, and online retail.



Source: Bureau of Economic Analysis (Table 1.1.6. Real Gross Domestic Product, Chained Dollars).
Note: U.S. GDP peaked in 2019Q4 at an annual rate of $19.25 trillion (in 2012 dollars). It declined to $19.01 trillion in 2020Q1 and then dropped sharply to $17.30 trillion in 2020Q2. U.S. output recovered somewhat to an annual rate $18.58 trillion in 2020Q3.

Consumer ABS performed much better than expected during the early phases of the pandemic. However, it is unclear whether that good performance can persist through the winter. Investors currently view the ABS sector as a good value.

The tools that the Fed developed following the 2008 financial crisis allowed it to act quickly and firmly in the early stages of the pandemic.

There has been roughly $189 billion of U.S. non-mortgage ABS issuance (not including CDOs/CLOs) through the end of November (Exhibit 3). That represents a drop of 25.6% compared to the same period last year. Student loan ABS issuance increased by 10% compared to last year; issuance of student loan ABS backed by private loans increased by 27%, while the issuance of ABS backed by FFELP loans declined by 22%. Credit card ABS issuance is down by 90%, likely caused by tighter lending standards at banks combined with lower consumer spending. Banks are using deposits rather than securitization to fund credit card receivables. Issuance of prime auto loan ABS is down by 8% and issuance of auto lease-backed ABS is down 15%. Subprime auto ABS issuance is down 5%. Dealer floorplan ABS and fleet leasing ABS issuance are both down 50%. Aircraft ABS issuance is down 73%. Rental car ABS issuance is down 68%. Railcar securitization is down 70% and whole-business securitization is down 74%. By contrast, solar ABS issuance is up 20% (despite an overall decline in PACE securitizations since 2017), container lease ABS issuance is up by a factor of eight, and single-family rental securitizations are up 65%.

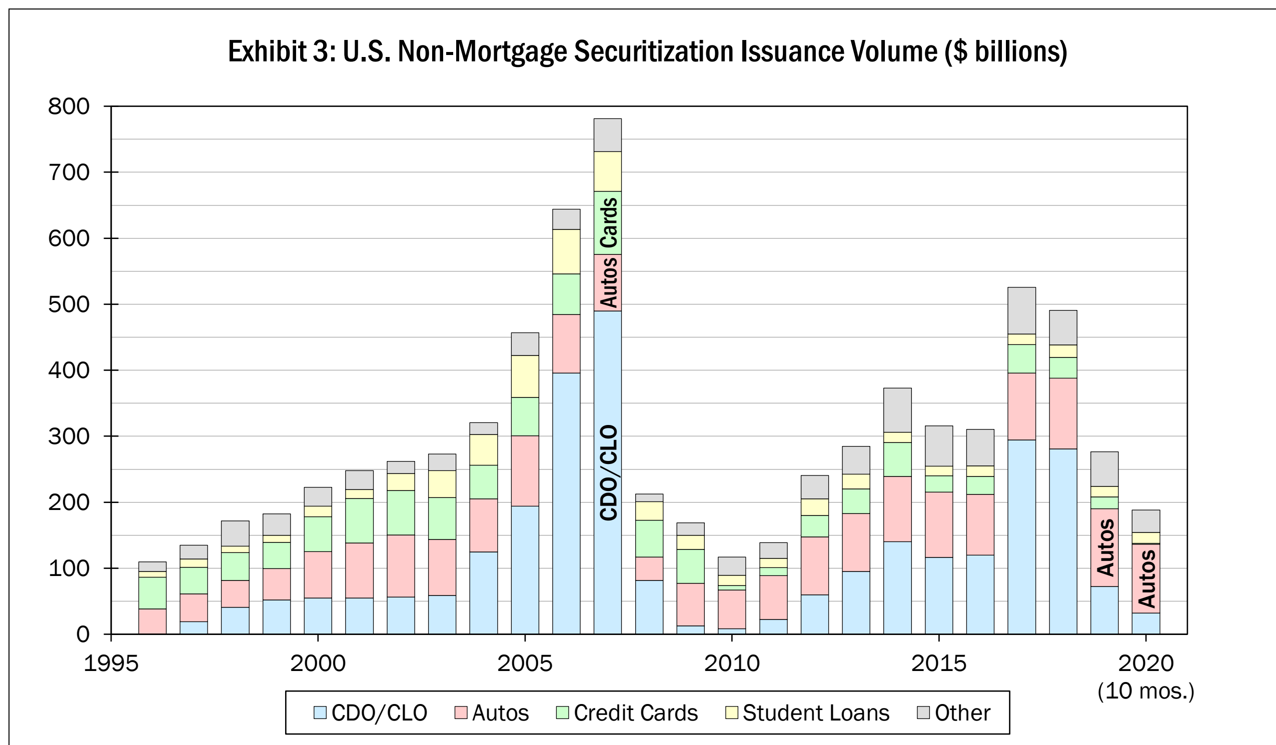


Exhibit 3: U.S. Non-Mortgage Securitization Issuance Volume ($ billions)

Source: SIFMA.

Relative Value & Credit Spreads: The pandemic initially hit spreads hard. However, there was not much forced selling. Investors had staying power and expected that scientists would develop a vaccine in due course. Spreads on triple-A-rated securities recovered quickly to pre-pandemic levels, but spreads on lower-rated securities have remained wide. The spread widening for lower-rated securities is more pronounced in off-the-run asset classes and in deals from smaller issuers.

Housing Market: The housing market has weathered the pandemic better than it faired through the mortgage meltdown and the 2008 financial crisis. The U.S. housing market was on solid footing going into the pandemic. Additionally, the affordability products that were prevalent immediately before the mortgage meltdown were largely absent at the onset of the pandemic. Unemployment caused by the pandemic has been higher among non-homeowners than among homeowners. There has been slow issuance of non-agency MBS, producing a net shrinkage in outstanding non-agency supply.

Consumer Asset Performance: One panelist notes strong performance in the auto sector. Sales of new cars have been very strong. The "flight to suburbs" is a partial explanation. The auto ABS sector represents roughly half of all non-mortgage ABS (excluding CLOs). According to the US Bureau of Labor Statistics, 20%-23% of US workers can work from home, but the proportion is nearly 40% for those with college degrees, and nearly 50% for those with graduate degrees.

Commercial Real Estate: Different types of commercial properties have been affected to differing degrees by the pandemic. Lodging has been affected very badly. The future of office properties in urban areas is uncertain as workers increasingly work from home.

Corporates and Service Industries: As with commercial real estate, the pandemic has had differing impacts on different corporate sectors. Essential services are less affected than other areas, such as companies associated with leisure activities.

Despite tight spreads, structured finance securities currently offer good relative value compared to corporate fixed-income securities. There is solid demand for one-off deals.

Going forward, the base case for modeling structured deals will include the stress of a pandemic. This will produce higher credit enhancement levels

Predictions for 2021 Market Issuance: Next year will likely bring greater focus on ESG investing. Total supply of US ABS will likely be in the range of $207 billion to $228 billion, which is close to the level of 2019.

Q&A: Will the strength of suburban housing reverse after the pandemic passes? One panelist explains the suburban housing will continue to be strong because working from home will continue for many individuals.

One panelist states that the economic recovery will likely start fast and then slow down.

10:50 am: Keynote Session Emerging Global Megatrends: 2020 Investment Themes and Preparing for the Next Decade

Three key trends are shaping the investment landscape for the next decade and will drive inflation:

- genomics and health sciences surpassing physics as the dominant areas of technological advancement
- the resurgence of populism and protectionism
- climate change

Genomics & Health Sciences vs. Physics: The rising dominance of genomics and health sciences as the main areas of technological advancement creates inflationary pressure by extending longevity. By contrast, physics had a deflationary influence by making everyday objects smaller and more powerful.

Resurgence of Populism & Protectionism: People are worse-off because their wages are not rising fast enough to keep up with the rising prices of housing, healthcare, and education. Those areas are generally deemphasized or excluded from government inflation statistics. Rising prices in housing, healthcare, and education make people worse-off even while government statistics tell them that they are better-off.

Climate Change: Addressing climate change is extremely expensive and drives inflation. Replacing coal is inflationary because the substitutes are more expensive.

The combined inflationary effect of the key trends means that businesses with the ability to reprice quickly, such as hotels, will have an advantage over those that cannot do so, such as lessors of office properties.

Equity investors are benefiting from the largess of creditors. Weak covenants in credit agreements allow borrowers to give favored treatment to their equity holders.

Companies are now realizing that they have sacrificed resiliency in their quest for efficiency. They are now engaging in strategic introspection about diversifying their supply chains. Also, particularly in Japan and Europe, companies have a once-in-a-lifetime opportunity to downsize their workforces and trim underperforming operations.

Vietnam and Southeast Asia have benefited from the shift in manufacturing away from China. Diversification of supply chains has accelerated the trend of moving manufacturing away from China.

The outlook for the next decade is bleak. Negative returns are likely. The markets have priced potential upside but not potential downside. Currencies offer a potential opportunity for positive returns. Appealing candidates include the Brazilian Real (BRL) and the Chinese Yuan (CNY). Oil may be a good investment for the next decade. The demand for oil is likely to be strong, especially as urbanization accelerates in emerging markets. Declining oil production levels combined with rising production costs will likely provide an additional boost.

Gold has performed well over the past decade. However, most of its strong performance is likely behind it, at least for the near- to medium-term. Cryptocurrencies are unlikely to replace government-sponsored currencies because government sponsorship is a strong source of credibility and acceptance.

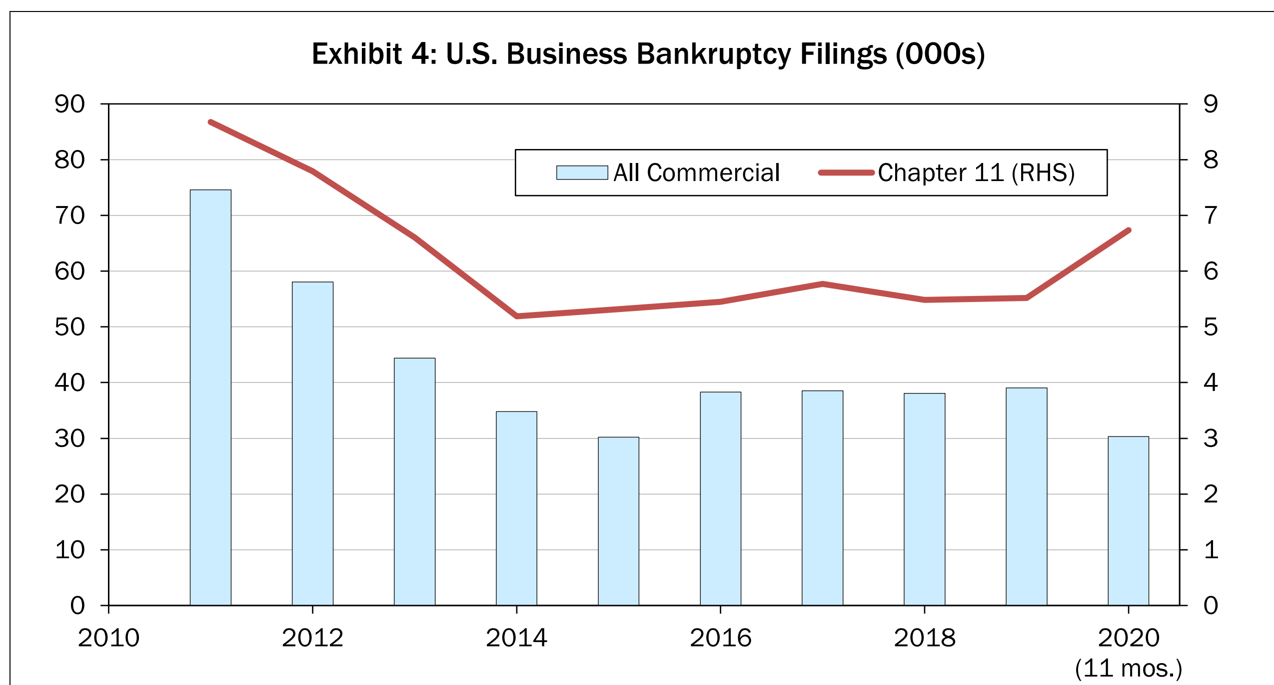
Diversity and inclusion help boost investment performance.

The conventional wisdom about emerging markets is that they are a bet on growth. However, inflation is a key cause of disappointment for investors in emerging markets. Inflation has always been an Achilles' heel of emerging markets. Over the past 15 years, emerging markets have benefited strongly from low interest rates in the developed world. That may not last. Also, corruption is a widespread problem in emerging markets. An ESG movement against holding the bonds of corrupt governments would be a significant problem for emerging markets. Broad investment in emerging markets has been a poor strategy. However, there are good opportunities in picking specific sectors and companies.

Holding a large cash position may be the wisest strategy for the next decade. Cash has a place in portfolios. It provides protection against market declines.

12:00 pm: Trends in the Leveraged Loan Sector: The Rise of Chapter 11 Filings in the High Yield and Leveraged Loan Market

One panelist explains that the total volume of commercial bankruptcy filings is down compared to last year, though the number of Chapter 11 filings is up (Exhibit 4).



Source: American Bankruptcy Institute (https://abi-org-corp.s3.amazonaws.com/articles/aacer-nov-2020-commercial-bankruptcy-filings-all-chapters-ch-11-focus.xlsx)

Another panelist notes that 2020 has brought an increase in leveraged-loan defaults and downgrades, along with a very high volume of issuance. Very strong liquidity, partly from the Fed, has helped avoid an even greater level of defaults. Going into the pandemic, the population of leverage borrowers was weaker than it was going into the 2008 financial crisis. About 70% of leveraged borrowers are owned by private-equity firms. CLOs are likely to become an even greater funding source for leveraged loans. The default rate is projected to peak at 10% in March 2021. The sectors with the most defaults have been retail and energy. Recoveries on defaulted leveraged loans are projected to be around 60%, which is below the historical average of 70%. The reason is that there are lower levels of subordinated debt.

Defaulting borrowers have exploited permissive loan documentation to favor certain creditors over others. One method that the borrowers use is drop-down transactions to

move assets. Neiman-Marcus,[5] Chewy,[6] and Revlon[7] are examples of borrowers that used the technique. Another variation is up-tiering or layering, which is a restructuring transaction offered to only a portion of existing creditors. Serta Simmons Bedding used that technique.[8] There are many loans with documents that would allow similar transactions. The Serta Simmons transaction sharply disadvantaged the minority lenders. Most credit agreements do not require unanimous consent for subordination or non-pro rata treatment. The Serta Simmons credit agreement allowed open market purchases of outstanding debt, which was the loophole that allowed preferred treatment for the majority lenders. The Serta Simmons case is in court. The minority lenders sought a temporary restraining order, which the court denied. The minority lenders argued that the credit agreement required their consent for the release of collateral. However, the company's action was not a release of collateral, though it had the same effect. The judge ruled that the parties could have included anti-subordination and other provisions in the credit agreement but had not done so. Documents for a large portion of outstanding leveraged loans allow for subordination with a simple majority. Therefore, other distressed borrowers may pursue strategies like Serta's.

Hertz Bankruptcy: Hertz filed for bankruptcy in May 2020.[9] The company's rental business was slow and its ability to sell cars was diminished. Hertz sought to attack its master lease agreement. Specifically, it sought to reject the master lease with respect to

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[5] Ben Unglesbee, *Can Neiman Marcus Finally Leave Its Baggage Behind After Bankruptcy?*, Retail Dive (13 Aug 2020), https://www.retaildive.com/news/can-neiman-marcus-finally-leave-its-baggage-behind-after-bankruptcy/583331/; *Neiman Marcus Charged with Fraudulent Transfer of $1B of Assets to PE Firms*, ABL Advisor (11 Dec 2018), https://www.abladvisor.com/news/15394/neiman-marcus-charged-with-fraudulent-transfer-of-1b-of-assets-to-pe-firms.

[6] Kenny Tang, Steve Wilkinson, and Ramki Muthukrishnan, *The PetSmart Case: A Deep Dive Into Its Equity Transfer of Chewy Inc.*, S&P Global Research Report (8 Nov 2018), https://www.spratings.com/documents/20184/798011/NOVEMBER8-2018-The-Pet-Smart-Case-A-Deep-Dive-Into-Its-Equity-Transfer-Of-Chewy-Inc/162e276d-a034-c87d-ba9e-3c22b014ab52.

[7] *Revlon Accused of Fraud Over $1.8B Loan*, CFO.com (13 Aug 2020), https://www.cfo.com/legal/2020/08/revlon-accused-of-fraud-over-1-8b-loan/.

[8] North Star Debt Holdings v. Serta Simmons Bedding, No. 652243/2020 (NY Sup. Ct. 22 Jun 2020) (Doc. No. 88), https://iapps.courts.state.ny.us/fbem/DocumentDisplayServlet?documentId=NeFZms3ZlQFqW4PQVnJddA==&system=prod.

[9] *In re Hertz Corporation*, No. 20-11218 (Bankr. Del., filed 22 May 2020) (case information and filings are available at https://restructuring.primeclerk.com/hertz/Home-Index).

only a portion of the vehicles subject to the lease.[10] The master lease was governed by New York law. Hertz argued that the intent of the parties had been to create a lease that provided for fluidity in the treatment of the vehicles and that it was subject to division. ABS market participants objected.[11] They explained that the master lease covered a fleet comprising a revolving pool of vehicles. They outlined that Hertz had described the master lease as a single lease in its filings. The parties settled the matter, agreeing that the debtors would pay $650 million to the ABS investors, which amounted to a 50% loss on overdue payments. The parties agreed to defer the matter in court until at least mid-January.

Effect of Covid-19 on Covenants and Documentation: The leverage ratio on new leveraged loans declined to 3.5x or less from March through May. However, it subsequently rose to the range of 5.0x to 6.5x. Documentation requirements show a similar trend, tightening during the early phase of the pandemic but then loosening.

Restructuring has evolved over the past 15 years. Looser documentation means that restructurings give borrowers more flexibility and allow them to pursue liquidity and non-pro rata strategies.

Leveraged-loan credit agreements are likely to remain weak until investors push back. That is not likely to happen as long as yields remain low and investors continue to stretch for yield.

1:30 pm: Housing Market Trends

One panelist explains that stable home prices before the onset of the pandemic largely explain the difference between the fortunes of the housing market during the pandemic and its experience through the mortgage meltdown and 2008 financial crisis. A significant housing bubble preceded the mortgage meltdown. By contrast, there was

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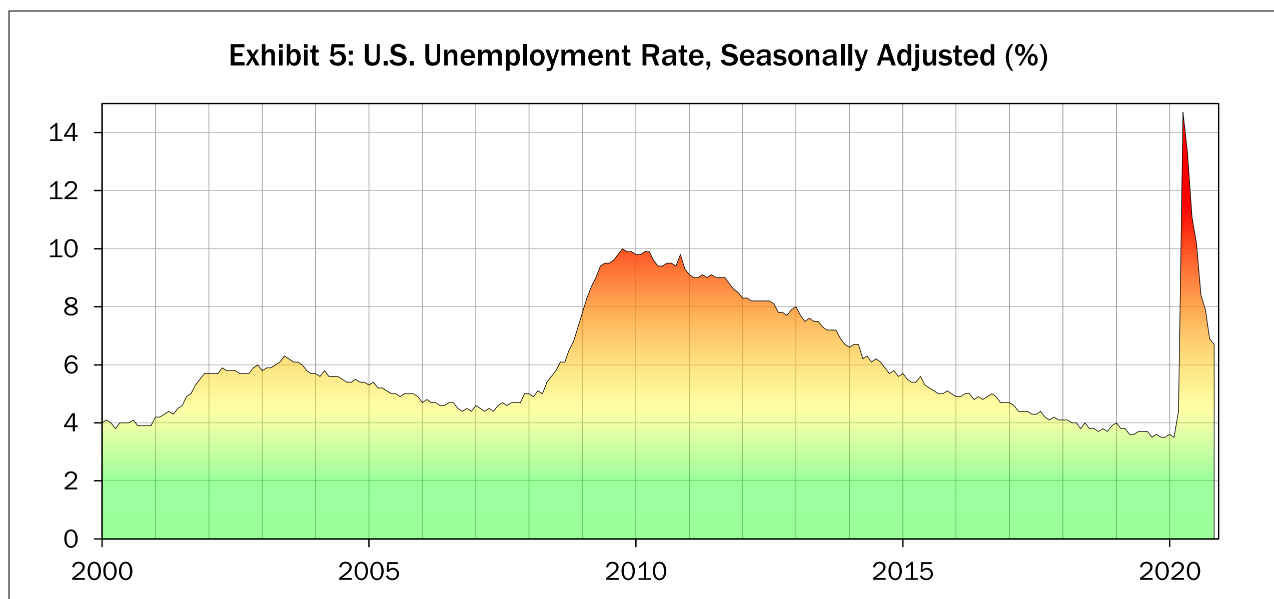
[10] Debtors' Motion for Order Rejecting Certain Unexpired Vehicle Leases Effective *Nunc Pro Tunc* to June 11, 2020 pursuant to Sections 105 and 365(a) of the Bankruptcy Code, *In re Hertz Corporation*, No. 20-11218 (Bankr. Del., 11 Jun 2020), https://restructuring.primeclerk.com/hertz/Home-DownloadPDF?id1=NDE4ODE5&id2=0.

[11] Corrected Exhibit A to Motion of Proposed *Amicus Curiae* Structured Finance Association for Leave to File Brief as *Amicus Curiae* in Support of Preliminary Objection of Deutsche Bank AG, New York Branch, The MTN Steering Committee and the Bank of New York Mellon Trust Company, N.A. to Debtors' Motion for Order Rejecting Certain Unexpired Vehicle Leases Effective *Nunc Pro Tunc* to June 11, 2020 pursuant to Sections 105 and 365(a) of the Bankruptcy Code, *In re Hertz Corporation*, No. 20-11218 (Bankr. Del., 26 Jun 2020), https://structuredfinance.org/wp-content/uploads/2020/07/Dkt-606-2-Corrected-Amicus-Brief-00215847xB5CB3.pdf.

no such bubble preceding the pandemic. Also, consumer balance sheets were stronger going into the pandemic, and the aggregate level of home mortgage debt was lower relative to U.S. GDP.

Another panelist adds that the government response to the pandemic has been different from its response to the mortgage meltdown and the financial crisis. The government response to the mortgage meltdown and the financial crisis started after those events were in full swing. The measures and reforms implemented then were still in effect when the pandemic arrived. Additionally, credit enhancement levels for mortgage securitizations increased following the mortgage meltdown, and those higher enhancement levels have remained in place, including through the start of the pandemic. Another key difference is that unemployment increased very quickly around the start of the pandemic but has been recovering (Exhibit 5). By contrast, it took two years for unemployment to peak in the last crisis. Government response has also been quicker in the pandemic than it was before. The CARES Act[12] and other measures were implemented very quickly.



Source: Bureau of Labor Statistics

A third panelist adds that the economy was generally strong before the start of the pandemic. Indeed, the pandemic has had no adverse effect on many homeowners; the

[12] CARES Act, Pub. L. No. 116-36, 134 Stat. 281 (27 Mar 2020), https://www.govinfo.gov/content/pkg/PLAW-116publ136/pdf/PLAW-116publ136.pdf.

value of their homes has not declined. At the same time, mortgage borrowers have had the opportunity to refinance their loans at historically low interest rates.

A fourth panelist adds that today's borrowers are stronger than those at the inception of the mortgage meltdown because of both ability-to-repay regulations[13] and the reduced prevalence of mortgage affordability products such as negatively amortizing loans. Lending standards were tighter going into the pandemic than they were preceding the mortgage meltdown.

Despite the recent population shift toward suburbs, New York and other large cities are expected to recover after the pandemic. Businesses change their locations only slowly because most office leases have 10-year terms. Working from home is likely to continue as a trend, but it is not expected to strongly affect the demand for office space.

Over the long term, home price appreciation cannot exceed the rate of inflation because the price of shelter would outstrip the prices of other goods and services in the economy.

There is a dichotomy between the financially stronger end of the homeowner population spectrum and the weaker end. The stronger end has been able to take advantage of refinancing at record-low interest rates. Borrowers at the weaker end of the spectrum have had to use forbearance, which generally disqualifies them from refinancing. Self-employed homeowners have been hard hit.

Delinquency figures are currently distorted because of differing treatment of forbearance by servicers. The more useful performance metric is the proportion of loans that are not cash-flowing. Prepayments are running 40% on prime jumbo MBS and about 35% on Fannie Mae and Freddie Mac credit-risk-transfer transactions. The rapid speed of prepayments reflects strong refinancing incentives.

Policy changes by the Biden administration, particularly those relating to the conservatorship or status of Fannie Mae and Freddie Mac, could have amplified effects on the non-agency MBS market.

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[13] Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) § 1411, Pub. Law No. 111-203, 124 Stat. 1376, 2142 (2010), https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf, 15 U.S.C. § 1639c(a) (2018) https://www.govinfo.gov/content/pkg/USCODE-2018-title15/pdf/USCODE-2018-title15-chap41-subchapI-partB-sec1639c.pdf; 12 C.F.R. § 1026.43(c) (2020), https://www.govinfo.gov/content/pkg/CFR-2020-title12-vol9/pdf/CFR-2020-title12-vol9-sec1026-43.pdf.

2:30 pm: Private-Label RMBS including Non-QM

One panelist observes that a borrower's ability to get a forbearance may depend on who owns his loan. The CARES Act covers only federally-related loans.[14]

Another panelist explains that there was an initial wave of forbearance that spanned all mortgage sectors in May and June. Government relief programs have kept delinquencies from rising across the residential mortgage sector in general. However, delinquencies have been higher on non-QM loans. Delinquencies are now declining, partly driven by deferral plans that bring borrowers current and give them the ability to stay current. Significantly, there is no housing crisis—home prices remain strong. This means that borrowers have not lost the equity in their homes and, therefore, they have incentives to avoid defaulting.

A third panelist explains that there is inconsistent treatment of delinquencies and forbearance in non-agency MBS deals. There is no standardization of non-agency MBS documentation and each non-agency MBS sponsor/issuer has the ability to craft its documents as it sees fit. Forbearance is a temporary suspension of the obligation to make principal and interest payments.

Forbearance vs. Deferral: One panelist explains that a "forbearance" can be whatever a servicer and a loan owner allow. A borrower under a forbearance plan is delinquent. As such, a loan in forbearance generally triggers an MBS servicer's obligation to advance principal and interest. A forbearance can end in many ways, including with a realized loss. By contrast, a "deferral" is a type of modification to a loan. A deferral does not constitute a delinquency and, therefore, does not trigger a servicer's obligation to make advances.

Recent non-agency MBS deals generally provide that the majority holder of the most subordinate class (i.e., the "controlling holder") can direct the servicer with respect to handling distressed loans. One panelist suggests that future deals may include a servicing administrator to make those decisions.

Servicer practices with respect to forbearances and deferrals vary widely. Approval mechanisms also vary widely. Some servicers convert the prior month's forbearance to a deferral every month. Some MBS deals limit a servicer's ability to grant forbearances. A key issue is how to handle forbearance amounts at the end of a forbearance period.

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[14] CARES Act § 4022, Pub. L. No. 116-136, 134 Stat. 281, 490 (27 Mar 2020), https://www.govinfo.gov/content/pkg/PLAW-116publ136/pdf/PLAW-116publ136.pdf.

Many MBS transactions require reviews of loans that become delinquent by 120 days or more for possible breaches of representations and warranties. The most recent deals provide that breach reviews are not required if the delinquencies are associated with pandemics or natural disasters. Some newer deals use realized losses rather than delinquencies as the trigger for breach reviews.

One panelist argues that including an unaffiliated "deal agent" in a transaction would improve the governance of MBS deals.[15] Most RMBS 2.0 deals call for mandatory breach reviews when trigger events occur. Some of the newest deals give the controlling holder discretion about whether to have breach reviews. The controlling holder might act in its own interest, which could be contrary to the interests of other investors. Having an independent deal agent to decide on whether to conduct breach reviews is arguably a better approach than allow the controlling holder to decide.

Many of the borrowers on loans securitized in non-QM MBS are weaker-than-average. Many of those now using forbearance will ultimately not recover.

3:30 pm: LIBOR Cessation: Is the Loan Market Ready?

Regulators have released a proposal to continue LIBOR quotes for use in legacy transactions until June 30, 2023.[16] They are also urging banks to stop using LIBOR for new deals. The proposal would delay the timing of the trigger to fallback mechanisms in legacy deals by 18 months. Panelists generally agree that firms should continue to transition away from LIBOR in all new transactions. The new proposed relief should be used only for the purpose of administering legacy transaction.

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[15] *See generally*, Association of Institutional Investors, *Deal Agent Key Principles* (25 Feb 2016). https://association.institutionalinvestors.org/Files/20160225_Deal_Agent_Agreement_Key_Principles.pdf; Structured Finance Industry Group. *RMBS 3.0, A Comprehensive Set of Proposed Industry Standards to Promote Growth in the Private Label Securities Market*, 6th edition, at 244, 265-269 (9 Nov 2017) https://structuredfinance.org/wp-content/uploads/2019/05/RMBS-3.0-Sixth-Edition-Final-1109.pdf; *see also* 17 C.F.R. § 239.45(b)(ii) (2020), https://www.govinfo.gov/content/pkg/CFR-2020-title17-vol3/pdf/CFR-2020-title17-vol3-sec239-45.pdf (S.E.C. requirements for using shelf registration call for breach reviews by an "asset representation reviewer" that has a role analogous to a deal agent.).

[16] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, *Statement on LIBOR Transition* (30 Nov 2020) https://www.fdic.gov/news/press-releases/2020/pr20129a.pdf?source=content_type%3Areact%7Cfirst_level_url%3Anews%7Csection%3Amain_content%7Cbutton%3Abody_link.

ISDA is producing spread adjustments for converting LIBOR to SOFR and they are available on Bloomberg.[17] The ARRC appears to support ISDA's spread adjustment levels.

There are a number of proposals for adding a dynamic credit spread adjustment to SOFR in order to produce something that would resemble LIBOR more closely.

Some new loans and new securities are already using SOFR as a floating rate index. Fannie Mae and Freddie Mac are using SOFR compounded in advance.[18] However, leveraged loans and CLOs are not yet using SOFR because the LSTA, lenders, and vendors are still building the systems and documentation for SOFR-based leveraged loans. Loans are likely to use daily simple SOFR, and CLO notes are likely to use compound simple SOFR in arrears.

The toughest legacy deals are ones that require unanimous investor consent to change the interest rate. A legislative solution could eliminate the issue of needing investor consent. However, if a legislative solution does not happen, the 18-month extension of the LIBOR cessation may provide the necessary additional time to implement other solutions.

3:30 pm: The CRT Market

A past criticism of the GSE credit risk transfer (CRT) market was that it had not been tested by adverse conditions. That has now changed. The experience of the pandemic has provided a test for the sector.

One panelist explains that the key parameters defining the CRT sector are issuance, delinquencies, prepayments, liquidity, and spreads. CRT issuance in 2019 was roughly $29 billion, but will be only about $20 billion for 2020. Issuance will likely recover in 2021. Delinquencies of 60 days or more are running in the range of 4% to 6%, with many of the loans in forbearance. Assuming that economic conditions improve next year,

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[17] Bloomberg, *IBOR Fallback Rate Adjustments* (29 Sep 2020), https://assets.isda.org/media/ddcb20e0/76dd3ab8-pdf/; International Swaps and Derivatives Association (ISDA), *Benchmark Reform and Transition from LIBOR* (undated), https://www.isda.org/2020/05/11/benchmark-reform-and-transition-from-libor/; ISDA, *Bloomberg Begins Publishing Calculations Related to IBOR Fallbacks* (21 Jul 2020), https://www.isda.org/2020/07/21/bloomberg-begins-publishing-calculations-related-to-ibor-fallbacks/.

[18] Fannie Mae and Freddie Mac CMO SOFR Index Framework (11 Jun 2020), http://www.freddiemac.com/mbs/docs/cmo_sofr_index_framework.pdf.

delinquencies are expected to drop to around 1½% by 2022. If economic conditions do not improve, then delinquencies could stay at elevated levels. Prepayments are low, around 40% CPR across all vintages. Prepayments are unlikely to increase given the current low level of interest rates. CRT secondary trading volume increased sharply in March and April, reaching roughly $5 billion. The dealer community seems willing to position substantial amounts of non-investment grade MBS. Spreads widened significantly in the early stages of the pandemic, but active participation by dealers (and their willingness to hold inventory) has helped spreads to somewhat recover.

Freddie Mac's STACR program has had 10 deals in 2020, compared to 13 in 2019. Moody's started rating STACR deals in 2020.

The Coronavirus pandemic has been the big story for the CRT sector in 2020. Forbearance has been a key element in mitigating pressure on credit performance. Steady home prices also have provided support. Forbearance was a successful strategy for preventing defaults in the aftermath of the 2017 hurricanes. This year it seems to be working again. About 9% of Fannie Mae borrowers in CRT pools are using forbearance. Of that 9%, about 20% never missed a payment. Using forbearance does not mean that a borrower is on the verge of default; it may mean that they are prudently preserving their financial flexibility. Additionally, more than half of the borrowers who entered forbearance plans between March and September have since exited. About 27% of the borrowers who exited forbearance got deferrals (their missed payments are due at the end of their loans or when they refinance). Around 22% have reinstatement plans to catch-up on the missed payments. Only about 1.3% exited forbearance with a credit modification (which counts as a loss to the CRT pools) and only 3.2% exited by liquidation of their loans.

Freddie Mac provides granular reporting on the types of payment relief provided to each borrower. Freddie Mac allows a Covid-19 payment deferral of up to 12 months, which it does not classify as a loan modification. Freddie Mac also has relaxed its requirement for full appraisals during the pandemic. It allows greater use of exterior-only appraisals and desk appraisals. Delinquencies peaked at 6.7% in June for loans in Freddie Mac CRT pools, but have since declined to around 4.7% in November.

One approach for analyzing mortgage loan credit risk while dealing with forbearance is to focus on whether loans are cash-flowing, regardless of whether they are technically in a forbearance plan. Loans that are cash-flowing are less risky than those that are not.

CRT deals are performing slightly worse than non-agency prime MBS, with older vintages slightly outperforming newer ones. CRT deals are performing much better

than "expanded prime" and non-QM MBS. Loans in CRT pools have full documentation of borrower income and assets, which many loans in "expanded prime" and non-QM deals do not. CRT pools have strong geographic diversification.

Freddie Mac has issued floating-rate securities indexed to SOFR.

Wednesday, December 2, 2020

9:30 am: Keynote Session: The Rising Importance of ESG Principles in Investing

ESG stands for "environmental, social, and governance."[19] One panelist explains that some firms focus on the environmental aspect under the rubric of "sustainability." The term "responsible investing" is often used in Europe. An ESG investment approach considers data items other than the traditional metrics used in securities analysis.

In the context of structured finance, an investor pursuing an ESG strategy might focus on the ESG aspects of originators and servicers. The "social" dimension might entail consideration of how a servicer deals with borrowers experiencing financial distress. It may entail consideration of how an originator serves underserved (e.g., lower-income) communities. The environmental dimension might entail consideration

[19] ESG investing considers the environmental, social impact, and governance activities of investee companies. Environmental criteria evaluate a company's sustainability activities (e.g., emissions, water, and waste). Social impact criteria assess a company's management of social relationships (e.g., employees, consumers, surrounding communities). Governance criteria cover the rights and responsibilities of the management of a company (e.g., board, shareholders, and stakeholders). ESG investing is sometimes defined more narrowly to strictly mean considerations of how a company's governance and its environmental and social impact affect its financial performance. In the narrower sense, ESG investing is distinguished from "socially responsible investing," which seeks to promote social and environmental good by avoiding investment in disfavored products or services (i.e., the application of negative screens), and "impact investing," which seeks to achieve positive social or environmental impact by investing in favored industries or activities (i.e., the application of positive screens).

"Engagement" is the practice by an investor of interacting with an investee firm to influence the firm's ESG policies and goals for the future.

"Negative screening" seeks to promote social and environmental good by avoiding investment in disfavored products or services, such as cigarettes or coal mining. Negative screening disqualifies specified activities but allows all others. An investment process that uses negative screening seeks to achieve the best financial returns subject to the constraint of the negative screen.

of how an originator or servicer deals with flood risk. The pandemic has highlighted the need for servicers to properly serve—and care about—customers, beyond simply the revenue that they produce. Investors can ask companies about their policies and practices that reflect caring about society and the environment. Investors can look beyond a company's advertising and focus on concrete actions.

The strong growth of ESG-themed funds is partly explained by their strong financial performance. In addition, ESG investors interact directly with companies' managements to encourage and promote environmentally responsible and socially conscious activities.

The Department of Labor has ruled that pension funds should focus purely on maximizing returns without regard to ESG considerations.[20] Even under such a framework, ESG considerations can matter, such as when a company's ESG-adverse activities negatively affect its financial performance. Examples are Volkswagen[21] and coal mining companies.

A large proportion of senior ESG roles are held by women. This may be because many of them have multi-disciplinary backgrounds, which are valuable in those roles. A purely financial background—which characterizes the backgrounds of many men in the financial industry—is not broad enough for the ESG space.

One panelist asserts that ESG investing is not merely a passing fad. It will be a permanent feature of the investment landscape. At a minimum, it offers a new viewpoint for considering how a company's activities along the ESG dimensions can affect its financial performance. However, a challenge for investors that want to pursue ESG-themed strategies is quantifying and measuring companies' ESG performance.

Another panelist adds that the Biden administration may promote standardization and metrics in the ESG space. This is particularly likely with respect to carbon emissions

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[20] Department of Labor, *Financial Factors in Selecting Plan Investments*, 85 Fed. Reg. 72846 (13 Nov 2020) https://www.govinfo.gov/content/pkg/FR-2020-11-13/pdf/2020-24515.pdf.

[21] Department of Justice, *Volkswagen AG Agrees to Plead Guilty and Pay $4.3 Billion in Criminal and Civil Penalties; Six Volkswagen Executives and Employees are Indicted in Connection with Conspiracy to Cheat U.S. Emissions Tests* (11 Jan 2017), https://www.justice.gov/opa/pr/volkswagen-ag-agrees-plead-guilty-and-pay-43-billion-criminal-and-civil-penalties-six.

and energy usage. IFRS,[22] IOSCO,[23] NGFS,[24] SASB,[25] and others are in the process of setting ESG standards, including disclosure standards.

Another panelist adds that the U.S. is one or two years behind Europe in embracing ESG.

10:15 am: Road to Recovery: Investment Implications in a Post Pandemic, Low-Yield World

One panelist asserts that a consequence of the pandemic will be low interest rates for a long time, both in the US and globally. Another panelist adds that reduced travel, combined with technological changes (e.g., widespread use of Zoom, Webex, and MS Teams), are likely to support a low-rate environment for at least the next year. A third panelist states that rates will need to stay low in order to spur economic activity and allow companies to survive. A fourth panelist expresses a contrary view: interest rates will rise and that the yield curve will steepen during 2021 and continue to move higher into 2022. A globally-synchronized economic recovery will be boosted by the introduction of vaccines to suppress the pandemic. GDP will grow in 2021 and the Fed will allow rates to rise during the recovery.

One panelist asserts that a danger of a low rate environment is that it causes some investors to reset their return targets and to underprice risk. Smart money will move to the sidelines when risk is mispriced. Another panelist observes that there is uncertainty about whether the high levels of government debt are sustainable indefinitely. Both benign and extremely adverse outcomes are possible. A third panelist adds that an

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[22] IFRS Foundation, *Consultation Paper on Sustainability Reporting* (Sep 2020), https://cdn.ifrs.org/-/media/project/sustainability-reporting/consultation-paper-on-sustainability-reporting.pdf?la=en.

[23] International Organisation of Securities Commissions, *Sustainable Finance and the Role of Securities Regulators and IOSCO* (Apr 2020), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD652.pdf.

[24] NGFS stands for the Central Banks and Supervisors Network for Greening the Financial System (https://www.ngfs.net/en). According to the organization's charter, it seeks to "contribute to the development of environment and climate risk management in the financial sector, and to mobilize mainstream finance to support the transition toward a sustainable economy." https://www.ngfs.net/sites/default/files/media/2020/09/03/ngfs_charter_final.pdf.

[25] SASB stands for the Sustainability Accounting Standards Board (https://www.sasb.org/). SASB is a private, non-profit organization based in San Francisco. According to its Form 990 tax filing for 2018, it is not affiliated with any other accounting standards boards, including the FASB, the GASB, and the IASB. Its mission "is to establish and maintain disclosure standards regarding sustainability matters that facilitate communication by companies to investors of decision-useful information…"

excessively accommodative monetary policy by central banks leads to mis-pricing risk. A fourth panelist states that the Fed will likely start tapering its balance sheet in 2021. Another panelist adds that the ABS market is well positioned to withstand higher rates.

The low-yield environment is a big problem for life insurance companies. Yields are too low for life insurance companies to cover the costs of their legacy portfolios of annuities and life insurance policies. Life companies can use hedges and alternative investments to try to close the yield gap, but the solutions are expensive or risky.

One panelist favors private-credit transactions as a good strategy in a low-rate environment. Another panelist states that total-return managers can use agency MBS to generate significant excess return during a low-rate environment. A third panelist states that there are opportunities in high-yield corporate credit and in CLOs. Triple-B-rated CMBS are also attractive.

How will the Fed exit the path of massive accommodation? One panelist states that the Fed is unlikely to withdraw its accommodative policy in 2021. GDP is likely to recover to pre-pandemic levels by mid-2021 but unemployment will remain elevated, at roughly 5%, through 2022. The Fed will start to raise rates in 2023 and then also start to shrink its bloated balance sheet. Two other panelists largely agree, noting that the Fed's balance sheet is too big for the long-term. A fourth panelist states that the Fed should be able to manage increasing rates and downsizing its balance sheet without causing an economic disruption.

11:00 am: Assessing the Liquidity of the Structured Credit Market in a Time of Crisis and the Future of Trading

Liquidity in General: One panelist states that liquidity means the ability to get the price that you want within the time that you want when you are selling a security. Another panelist states that liquidity is simply a reflection of whether a Bloomberg terminal shows that dealers are making a market in a security. The ABS market is obsessed with trading volume data from FINRA's TRACE system. CLOs are strictly over-the-counter. CLO liquidity is more complicated than liquidity of other credit products.

One panelist explains that data from the TRACE system provided valuable information to the market during periods of stress. However, market participants should not overemphasize TRACE data, especially when market conditions are changing quickly. A third panelist asserts that the availability of TRACE data increases volatility in both directions.

One panelist notes that there is a close relationship between the liquidity of a given CLO and the availability of its governing agreements. Intex and KopenTech provide access to some CLO documents through their systems.

One panelist observes that Mondays used to be busy trading days but now they are slower than the middle of the week. Another panelist observes that many traders emphasize buying early in the day and selling later in the day. However, a third panelist notes that CLO trading spreads have tended to be tighter on Thursdays and Fridays. A fourth panelist adds that agency MBS trading is very quiet on Mondays and Fridays but extremely busy on the other days. Traders suffer BWIC overload during the other days.

The best approach for getting the best execution when selling a security has not changed. A selling trader should reach out to a large number of potential buyers and should avoid overemphasizing TRACE data. Another panelist notes the importance of having a consistent process that meets the expectations of trading counterparties. Three other panelists emphasize the importance of relationships.

Liquidity in the Pandemic: Normal trading practices were largely abandoned with the onset of the pandemic. March 13 was a crazy trading day because many firms sought to raise cash by selling ABS. There was also massive selling of agency MBS, which caused the mortgage basis to widen significantly. On the other hand, the widespread selling in March (and to a lesser extent in July) was an environment for opportunistic buying by investors who had dry powder or who could raise new funds.

Securitizations tend to be less liquid than investment-grade unsecured corporate bonds. There are more investors in the unsecured corporate bond market and there are fewer issuers. By contrast, there are fewer investors in the structured market and a vastly larger number of distinct CUSIPs. One panelist notes that traditional investors in distressed corporate debt have been able to adapt easily to investing in securitizations.

Future of Liquidity: One panelist asserts that technology is likely to enhance liquidity by allowing traders to devote their time to the activities that create the most value. Electronic trading is here to stay and it will enhance the environment for investors. Another panelist expresses a contrary view, noting that investors perform extensive analysis and use diverse analytic tools that are suited to their current workflow. A third panelist expects traders to embrace electronic trading systems to operate more effectively and efficiently. Electronic trading systems will likely have a greater role in trading triple-A-rated CLO tranches than in trading CLO tranches with lower ratings.

12:15 pm: Trends in the CLO Sector: Sector Opportunities and Risks

Audience Survey Questions: In response to an audience survey question, a majority of respondents indicated that they expect CLO issuance in 2021 to exceed $90 billion. In response to a second question, a majority of respondents indicated that they expect the dominant structure for CLOs issued in 2021 to be a two-year non-call period with a five-year reinvestment period. In response to third survey question, a majority of respondents indicated that they expect the default rate on leveraged loans to be in the range of 4% to 6% in 2021.

One panelist states that the relative outlook for most sectors remains unchanged, even with the announcement of vaccines. The vaccines have been anticipated for some time and their expected effects have already been incorporated into security prices. Cruise ships, airlines, and movie theaters will remain tough sectors. Outdoor activities and some restaurants will fare better. Another panelist states that within the airline sector, Delta has brighter prospects, followed by United and then American. Amusement parks and gaming may offer potential upside. People like to gamble. Within restaurants, fast food has more upside than casual dining.

Even though vaccines have been announced, some leveraged-loan borrowers may not be able to survive until the economy rebounds in the latter part of next year. Some borrowers will become zombie companies if they cannot grow into their capital structures (i.e., if they cannot generate sufficient revenue to service their high levels of debt).

The speed of corporate downgrades in the early stages of the pandemic was unprecedented. One panelist asserts that the downgrades were overdone, as reflected in the fact that the rating agencies are now upgrading some of the companies that they had downgraded earlier in the year. More upgrades are likely to come.

One panelist explains that CLO manager tiering always widens during periods of stress. The currently pronounced tiering is simply a byproduct of the pandemic, but it is diminishing, especially for senior notes. Manager tiering remains more pronounced for CLO subordinate securities. Some amount of tiering is justified based on the performance differences among managers. Another panelist asserts that manager tiering was overdone, especially based on coarse statistics. Taking a more nuanced view of differing strategies among managers suggests that the market significantly over-penalized some managers who were adhering to their core strategies and producing

successful results. Manager tiering is likely to diminish as overcollateralization levels and triple-C exposures both improve.

CLO equity has performed well. Early in the pandemic, the market had expected poor performance for CLO equity, but the asset class has outperformed expectations. One panelist asserts that double-B-rated CLO notes and CLO equity are nearly equally attractive (though the double-Bs may have a slight edge). CLO equity offers a median IRR of 20%, which is wider than before the pandemic. Another panelist favors double-B-rated CLO notes.

One panelist observes that CLO investors should want CLOs not to be disadvantaged relative to other lenders. Therefore, CLOs should be allowed to participate in workouts. The other panelists agree.

CLO managers generally prefer loans with longer tenors.

One panelist asserts that the biggest concerns going into 2021 are the pandemic and loan documentation that allows non-pro rata treatment of creditors. Another panelist asserts that the biggest concerns are wide bid-ask spreads and outdated trading practices.

2:00 pm: Sector Snapshot Auto ABS

One panelist explains that the auto ABS sector has displayed surprising resiliency through the pandemic. The sector has maintained good performance. Servicers have offered borrowers extensions and deferrals. And there has been hefty government stimulus. These factors, together with the necessity of having a car (for most households) and the diminished use of public transportation during the pandemic, have combined to provide both the means and the motivation for consumers to stay in good standing on their auto loans. Another factor is a population shift from urban centers to the suburbs. Used vehicle values have remained strong, buoyed by low inventory levels.

Another panelist observes that the strong performance of the auto sector is somewhat surprising given that the rate of unemployment briefly reached 14.7% in the spring (see Exhibit 5, page 13 above).

Performance: Losses on prime auto loans are at an eight-year low. Performance has benefited from a high level of extensions, which allow a borrower to skip payments by adding them to the end of the contract. Extensions peaked at 5.75% in April and have declined every month since then. Recoveries on defaulted prime loans were very low in

April at 36.8% but have since improved, reaching an eight-year high of nearly 80% for August and September. Losses on prime auto loans dropped to an eight-year low of 0.22%. High rates of extensions had an even bigger effect on subprime auto loans. Extensions on subprime auto loans peaked at 15.75% in April. Although extensions on subprime auto loans have declines since April, they had the effect of bring losses down from a level of 9.32% in April to an all-time low of 2.93% in August. The overall effect of the extensions may be to delay rather than actually reduce lifetime losses. Even so, the level of delinquencies is rising only slightly as payment holidays are expiring.

Prepayments on auto loans were surprisingly strong through September.

A majority of previously extended auto loans that have exited forbearance are performing. Of prime auto loans that received extensions since March, only 6.16% remained in forbearance at the end of September. Only 0.67% had been charged-off, and just 1.4% were delinquent by more than 60 days. For subprime auto loans, 14.2% remained in forbearance at the end of September, with 1.71% charged-off and 4.0% delinquent by more than 60 days. However, there is significant uncertainty about future performance. Unemployment benefits for many individuals are scheduled to expire at the end of the year.

For auto leases, residual values declined sharply in the spring but have since recovered strongly, partly driven by low inventories of new vehicles. Dealers are increasingly relying on online sales. Lenders were discouraging lease returns in the spring because there was insufficient demand for returned vehicles at that time. More recently there have been residual value gains of 20%, a level not seen since 2011.

Subprime Borrowers: One panelist explains that job loss generally causes quicker defaults for subprime borrowers than for prime borrowers because subprime borrowers generally have lower income and higher debt levels. However, in the early phases of the pandemic, stimulus and relief programs allowed many subprime borrowers to avoid default despite losing their jobs. Now that the stimulus and relief programs are expiring, defaults by subprime borrowers are likely to increase. Subprime auto ABS have very high credit enhancement levels. Servicing is very important for subprime auto loans. S&P requires a deep subprime auto deal to withstand 84% gross losses with a 30% recovery. Fitch is also quite selective and strict in rating subprime auto ABS.

The Biden administration’s anticipated focus on electric vehicles may eventually dampen demand for gasoline-powered vehicles, but the effect will not be apparent for some time.

The increasing prevalence of loans with longer tenors is likely to lead to higher losses. Ford, GM, and Toyota are originating such loans. Loans with tenors of 84 months have losses four times as great as 60-month loans.

Chase did two credit-risk-transfer transactions linked to the performance of the bank's auto loan portfolio (and also linked to the bank's ratings).[26]

Outlook: Panelists agree that a moderate increase in delinquencies and defaults is likely. The effect will be greater for non-prime loans. Delinquencies are greatest on subprime loans, and a new economic relief package would be very helpful. Performance is likely to follow the general trend of the economy. Issuance next year is likely to increase slightly, as the volume of auto sales is expected to increase by 15%

Most outstanding deals have performed better than expected. However, conditions remained stressed and borrowers could be pushed into default as stimulus and relief programs expire.

Investors should be wary of issuers that issue auto ABS down to the single-B rating level because such issuers may be undercapitalized.

3:00 pm: Volcker Rule Update

The Volcker Rule[27] prohibits banks from investing in "covered funds," which generally include investment companies and entities that would be investment companies but for certain exemptions.[28]

The rules were changed in August (effective Oct. 1) to add new exclusions to the covered fund definition.[29] The key change was to the loan securitization exclusion.

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[26] Chase Auto Credit Linked Notes, Series 2020-1 was backed by a portfolio of nearly 83,000 auto loans, totaling roughly $1.8 billion. The transaction closed in September with ratings from Fitch. Chase Auto Credit Linked Notes, Series 2020-2 was a November deal, backed by roughly 86,000 loans totaling more than $2 billion.

[27] DFA § 619, 12 U.S.C. § 1851 (2018), https://www.govinfo.gov/content/pkg/USCODE-2018-title12/pdf/USCODE-2018-title12-chap17-sec1851.pdf; *see e.g.*, 12 C.F.R. Part 44 (2020), https://www.govinfo.gov/content/pkg/CFR-2020-title12-vol1/pdf/CFR-2020-title12-vol1-part44.pdf.

[28] *See e.g.*, 12 C.F.R. § 44.10(b)(1) (2020).

[29] Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Commodity Futures Trading Commission, and Securities and Exchange Commission,

Before the rule change, bonds were not part of the exclusion. The rule change allows for up to 5% of non-loan assets. This allows CLOs to include a 5% bond bucket.[30] The rule change also provides safe-harbor treatment for senior loan interest so that they will not be characterized as prohibited ownership interests.[31] The rule change also permits a holder to participate in a decision to terminate a manager, which otherwise could have caused a CLO note to be characterized as an "ownership interest" that banks would not have been allowed to hold.[32]

Unless the loan securitization exception applies, a bank CLO investor needs to remain mindful that CLO notes below the most senior class might be classified as ownership interests, which it is not allowed to hold.

The rule changes are subject to the Congressional Review Act. Under that act, Congress can nullify a regulation with a bare majority. There is no Senate filibuster in the process. If the Senate remains under Republican control, there will be no nullification of the rule changes. If the Senate comes under Democratic control, then it is possible that it could nullify the changes. However, depending on how days are counted, the time limit for Congressional action may have already expired. Overall, it is unlikely that the rule change will be nullified.

If a bank is found to have violated the rule, it would be required to sell the security. It would probably not face other penalties.

The 5% threshold for the bond bucket under the rule change applies at the acquisition of bonds. It is not a maintenance requirement.

— END —

Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. 46422 (31 Jul 2020), https://www.govinfo.gov/content/pkg/FR-2020-07-31/pdf/2020-15525.pdf; Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Commodity Futures Trading Commission, and Securities and Exchange Commission, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 85 Fed. Reg. 60355 (25 Sep 2020) (notice of correction), https://www.govinfo.gov/content/pkg/FR-2020-09-25/pdf/2020-21100.pdf.

[30] *See* 85 Fed. Reg. at 46432-33, 46497, 46503-04, 46510, 46517, 46523.

[31] *See e.g.*, 85 Fed. Reg. at 46460-61.

[32] *See e.g.*, 85 Fed. Reg. at 46460.