ABS

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Margin posting: swaps increase ABS issuance costs by 1%, 3%, 7%...of deal size – ANALYSIS

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With less than 10 months until the deadline for ABS issuers that enter into new swaps to comply with daily margin requirements, the industry as a whole seems to have become increasingly quiet on the matter. For example, we have yet to hear an official word from the rating agencies that must overhaul ABS methodologies in order for deal sponsors to assess the costs of margin posting.

While margin posting is front and center in the fund world, "there is not as much anxiety in the ABS space, apart from the wailing and gnashing of teeth by SFIG and other lobbyists," said a structured finance attorney in the New York office of K&L Gates. This can be attributed in part to a lack of synthetic ABS deals and less utilization of fixed-floating swaps post-crisis, but margin posting is still an issue for deals that securitize fixed-rate assets, he said.

"No one knows what is going to happen," said the attorney. "The volume of these deals may shrink after margin posting is required. As sponsors adjust, for instance, you may see less hedging and more issuance of deals with fixed-rate coupons. In other words, the hedging obligation will be pushed on to investors."

ABS issuers that don't want to hedge by buying options or adding overcollateralization may have little choice other than to push hedging decisions to investors if rating agencies have not completed methodologies which account for SPV margin posting.

Time is running out. Beginning 1 March 2017, each ABS issuer that is party to a new swap must either post or collect variation margin so that the cumulative amount that has been exchanged will at least equal the full market value of the swap. The issuer will be either posting margin equal to the full value of the swap when the swap is out of the money or holding this amount when the swap is in the money for as long as the swap is outstanding.

As a result, the cost of issuing ABS from an SPV that is or may become party to a new swap will be significantly higher than now. Depending on the size of the swap, the additional cost

may be 1%–7% of the par of securitized assets for many types of basis and interest rate swaps that are often characterized as "plain vanilla," and considerably more for long-dated or currency swaps.

The Dodd-Frank Act that generated swap margin rules was intended to ensure that the two financial counterparties to a swap – in this case an ABS issuer and a swap provider – were fully insulated from each other's potential non-performance. But this insulation will come at a cost and one can't help but look to the industry's recent dance with risk retention rules and wonder if the hope is that the music will play on and on and never stop.

Early on, ABS industry warned that posting margin will cost real money

The two broadly similar rules for swap margin posting that the prudential regulators and the CFTC approved last year are applicable to most if not all ABS issuers. The two rules came into effect on 1 April and share a series of compliance dates that start on 1 September and are applicable to most ABS issuers beginning 1 March 2017.

The swap margin rules had a five-year gestation period during which the Structured Finance Industry Group unsuccessfully lobbied the regulators to exempt issuers of both rated and unrated ABS. SFIG argued that not exempting ABS issuers would subject them to higher costs to the detriment of many consumer and commercial sectors and the US economy as a whole.

"SPVs are not structured ... to account for the uncertainty of fluctuating daily margin requirements," wrote SFIG in a comment letter to the regulators dated 24 November 2014. "Any daily variation margin requirement imposed on securitization SPVs would have serious adverse economic consequences on the use of swaps by securitization SPV."

Standard & Poor's echoes the sentiment.

SPVs that issue rated ABS lack the assets to post margin and also repay notes with a probability that is commensurate with their ratings, according to Standard & Poor's. Its "Global Derivative Agreement Criteria," which the company uses to analyze "derivative agreements in new and existing structured finance transactions," is based in part on the assumption that an "issuer does not have the financial resources both to maintain the ratings on its obligations and post collateral to a counterparty."

Less than 10 months to margin posting; same players are surprisingly quiet

Nonetheless, neither S&P nor any of the other five agencies that are both approved by the SEC to rate ABS and do so actively have proposed a methodology to address margin posting by ABS issuers. Collectively, the six agencies publish some 20-odd methodologies and rating criteria with respect to ABS when an issuer is party to a derivative contract. These methodologies, which are generally applied globally, rest on a common assumption – ABS issuers the world over don't post margin.

In fact, some rating agencies seem to be doubling down on this global assumption despite its looming inapplicability to the US market and some overseas affiliates of US swap providers, as reported (see article, 9 November). Since the approval of the swap margin rules, S&P has introduced a new derivative methodology that supports the status quo of no margin posting by ABS issuers and Fitch has proposed an update to its existing methodology that would have the same effect.

The US regulators purposefully chose not to harmonize the swap margin rule with evolving EU policy that may exempt many ABS issuers from margin posting, as reported. However, the rating agencies seem to be in denial on this score, and a detailed review of the 20-plus methodologies indicates the reason why. Margin posting ends a long-standing rating arbitrage that incentivizes issuers to hedge with swaps rather than by buying options or increasing overcollateralization.

Absent this rating arbitrage, the all-in costs to an ABS issuer should be broadly the same regardless of whether it enters into a swap, buys an option or overcollateralizes the deal. And therein lies a challenge that margin posting poses to rating agencies – higher costs to enter into new swaps may constrain ABS issuance in the near, medium, and long terms, as SFIG has warned.

Will the rating agencies wait out the deadline of 1 March 2017 to add pressure for regulatory or legislative relief for all or a subset of ABS issuers? One outcome may be legislation that pushes back the compliance date that is applicable to ABS issuers, as reported (see article, 13 November).

DBRS, Fitch, Kroll, Morningstar, Moody's Investors Service and S&P each declined to comment on margin posting by ABS issuers.

A reminder of what is at stake

"Regulations which impede the ability of securitization issuers to continue to use swaps can reduce the availability or increase costs of consumer and commercial funding in core segments of the economy, such as mortgage finance, vehicle finance, equipment finance, student loans and credit cards," wrote SFIG in its 2014 comment letter.

SFIG was prescient in listing vehicle and equipment finance with other ABS sectors that might be subject to the swap margin rules. In fact, auto and equipment ABS are subject to the rules, as reported (see article, 4 April).

There has been a widespread misconception that a parallel exemption in the swap margin rules that benefits "captive finance companies" such as some auto and equipment finance companies also applies to their ABS vehicles. However, no such exemption exists, at least not yet. If the captive finance companies wish to clarify whether or not their ABS vehicles will be exempted from the swap margin rule, "they can make a request" along those lines to the applicable regulator, according to a source familiar.

Exactly how much money is real money?

Given that all ABS sectors are impacted by margin posting but industry players such as SFIG, the rating agencies and deal sponsors have not published detailed projections of cost, some estimates are in order.

The private education deals of Navient – a company that has been front and center in both the news and rating world – provide real world examples of swaps that are commonly used in a major ABS sector and by a sponsor facing ongoing scrutiny of its potential earnings (see article, 5 May).

Navient has used swaps in all six of its private education deals – Navient Private Education Loan Trust (Navient) 2016-A, 2015-A, 2015-B, 2015-C, 2014-A and 2014-CT – and has based these swaps on a common template, according to the respective rating announcements for each deal from one or more agencies. The most recent deal – Navient 2016-A – closed on 4 February.

The swaps, in which the Navient private education deals pay an amount tied to the Prime rate and receive an amount tied to one-month Libor, are "basis swaps," a broad category of swaps that ostensibly have relatively low volatility and by extension, relatively low costs for margin posting. These swaps can set a lower boundary for the cash-on-hand at either the deal level or from a liquidity provider that may be needed to support margin posting.

The daily price volatility of these types of swaps can only be estimated because they rarely trade, which raises the boundary from the outset. "Prime Libor swaps are never quoted," stated a manager and former trader at a firm that makes markets in interest rate derivative contracts. "In my last two years on the desk, there wasn't even one inquiry." In fact, the former trader said, "Brokers have not seen a trade within memory, but at a price a trade could be done. The market could be re-awakened if there is a structuring need."

Pushing the risk estimate of the swaps higher still, each is also "balance guaranteed," a swap type that has been used by a range of ABS issuers. Under a balance-guaranteed swap, parameters such as the notional amount or maturity date are determined at least in part by the performance of the deal rather than solely by adherence to a set schedule that is established at closing. In other words, a balance-guaranteed swap has an embedded option that operates with respect to deal performance rather than pure cost/benefit and transforms even a widely used type of swap, let alone one in a moribund sector, into a one-off transaction.

For instance, the swaps for five of the six deals terminate "eight to ten years after closing, and the notional balance of the swap will be reduced by 50% after the swap step-down event," according to the respective Moody's rating announcements for five of the deals.

The DBRS pre-sale report for Navient 2016-A contains more information on that deal's swap:

"The trust entered into an interest rate swap to mitigate the transaction's exposure to basis risk that exists because a large portion of the underlying loans adjust based on the Prime rate, while the floating-rate notes are indexed to one-month Libor. The swap notional amount will be based on the outstanding balance of the student loans that adjust monthly and are indexed to the Prime rate, and based on the ratio of the outstanding principal balance of the floating-rate notes to the total notes. After three years from the closing date, and if the transaction has reached the 36.5% specified overcollateralization amount, the swap notional amount will decrease, or step down, to 50.0% of the student loans that adjust monthly and that are indexed to the Prime rate, as reduced by the ratio of the outstanding balance of the floating-rate notes to the total pool balance. Additionally, the maturity of the swap will decrease from ten years to eight years."

In other words, a balance-guaranteed swap is complicated. "The balance guarantee and long maturity would make it far worse than the completely illiquid normal prime swap," said the former trader. "I guess you could approximate price variability with a two year fixed-for-floating swap?"

The "potential exposure" of a swap – the upfront estimate of the largest market value of the swap over the course its life – can be calculated using daily variability and is a good proxy for the total margin that a deal might post when the market value of a swap is substantially out of the money. And what is the potential exposure of a two-year fixed-for-floating swap when estimated to a very demanding standard, i.e., one that might be needed to assign AAA ratings to senior debt? "1.75% upfront," according to the source.

The number is...

At initiation, the swap notional amounts in the six Navient private education deals ranged in size from USD 270m to USD 900m and as a percentage of securitized assets the notional amounts ranged from 39% to 86%, according to the monthly servicing report for each deal. The six deals securitized a total of USD 4.5bn student loans.

Putting the numbers together, 1.75% of swap notional upfront indicates that, had margin posting been in place when Navient had done its six private deals, the company would have to have arranged for additional resources that ranged from 0.70% to 1.50% of securitized loans to be available to post margin.

These estimates serve as a floor for the additional resources that will be needed to support margin posting under many other types of swaps that have been used by ABS issuers, even swaps that are often characterized as "plain vanilla." For instance, the potential exposure of a fixed-for-floating interest rate swap with a three-, five- or ten-year maturity will step up from the estimate of 1.75% for a two-year swap.

Add balance-guaranteed features, such as those that were often used in pre-crisis RMBS, to a fixed-for-floating swap and the potential exposure increases. Finally, for currency swaps, which can be used in any sector and are common in re-packagings, the potential exposure

could easily be 20% or higher.

by Bill Harrington

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ANALYSIS: FFELP Downgrades - Moody's stalls, Fitch plays catch up, and S&P abstains

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One hundred and sixteen tranches of 58 FFELP ABS have languished in ratings purgatory for an average of 159 days as Moody's Investor's Service mulls changes to its methodology for the troubled asset class. The rating agency granted the industry almost four months to lobby against the updates and push for the status quo - Aaa and Aa ratings for most tranches of FFELP ABS.

Navient is urging the rating agency to consider the years spanning 2008 through 2013 as outliers to student loan performance and SFIG has requested more time for its members to conjure solutions to keep non-paying loans from triggering events of default at maturity. Downgrades aside, more stringent rating methodologies are likely to lead to higher credit enhancement levels and longer final maturity dates for new FFELP securitizations.

Meanwhile, Fitch Ratings may push Moody's hand with its own proposal to update FFELP ABS methodology earlier this week. This proposal, for which comments close on 31 December, unifies what had seemed to be a more ad-hoc approach. Earlier in the year, Fitch also placed tranches of FFELP ABS on rating watch negative, many of which have been on watch for almost as long as Moody's ratings.

S&P has been consistent. It has proposed no updates to its FFELP ABS methodology. The last time S&P dabbled in meaningful FFELP downgrades was after its controversial move to downgrade the country's sovereign debt rating to AA+ in July 2011. In that case, industry participants waited nine months for S&P to act.

What will it take for the rating agencies - of which Moody's appears to be at the forefront - to downgrade these bonds which clearly have no chance of paying off by their final maturity dates?

Navient, SFIG weigh in

Navient, the largest issuer of FFELP ABS, is perhaps the most public opposing force in its

efforts to force Moody's to scrap the proposed methodology and downgrades. The company has purchased more than USD 1bn in loans this year out of ABS deals and would face increased costs in the wake of more stringent rating methodologies. According to Navient, the failure of students to pay their loans between the years of 2008 and 2013 was simply an anomaly.

Navient's critique of Moody's proposal hinges on the weight that should be given to performance data concerning these six years, which are outliers from the true average performance that resumed in 2014 and which will continue as the economy grows and new government programs for FFELP borrowers gain traction, according to its 71-page comment letter to Moody's posted on its website on 17 October.

SFIG's own comments build on the Navient critique by adding that Moody's should ignore the prime rationale for updating its methodology and placing tranches of FFELP ABS on review for downgrade - namely, the likelihood that a tranche will extend past final maturity and incur a payment event of default. Perhaps events of default could be stopped using some combination of loan buybacks, deal amendments and note repackaging, SFIG argues.

The industry group asked for additional time to find the means to prevent classes of notes from reaching final maturity with an outstanding principal balance. It further requested that Moody's withhold downgrades on notes for which the industry is attempting such mitigating strategies. SFIG also requested that Moody's confirm that amendments which extend trust final maturity dates will not constitute a distressed exchange, "which is an improvement for noteholders that will maintain the current rating and interest rate on the notes and increase their value."

Final maturity matters

A typical FFELP ABS issued multiple tranches of a senior class, all rated Aaa, and a very small junior class rated Aa1. The final maturities of the senior tranches were often staggered and have ranged from as short as 4 years to as long as 30 years. Typically, a junior class has a final maturity either equal to or after the longest-dated senior class. Payment in full by final maturity is a bedrock assumption for all ABS investors but is a particularly acute concern for investors in senior tranches of FFELP ABS with shorter-dated final maturities.

Payment in full by final maturity is also the bedrock assumption of an Aaa or Aa rating. Each ABS differs in its remedies for an event of default for nonpayment by final maturity, but a rating agency assigns a remote probability to these remedies being activated because it assigns a remote probability to the underlying event of default ever occurring. In other words, structures for ABS with tranches rated Aaa or Aa are supposed to be sufficiently robust to prevent payment events of default, full stop. As a second firewall, remedies for events of default are robust enough to facilitate repayment of the impacted tranche even at the expense of other tranches.

For instance, if the holders of a defaulted tranche have a right to liquidate collateral and

they exercise this right, the issuer may have to sell FFELP loans, reducing overcollateralization for remaining tranches. Even if FFELP loans are not liquidated, the extension of the tranche in default will draw funds that had been earmarked for other tranches.

Moody's FFELP reviews are a company outlier

Moody's published its initial comment request "Proposed Changes to Moody's Approach to Rating Securitizations Backed by FFELP Student Loans" on 9 July with a 7 September deadline for responses and a clear rationale.
"Low prepayment rates and persistently high rates of deferment, forbearance and [income-backed repayment] usage among FFELP loan borrowers have slowed the repayment speed of the loan pools and extended their weighted-average remaining term, thus increasing the risk that some tranches will not pay off by their final maturity."

Moody's set a comparatively tight deadline for comment responses because it had already articulated the rationale on multiple occasions in conjunction with having placed 121 tranches of 61 FFELPS ABS on review for downgrade in three batches: 14 tranches on 8 April, 106 tranches on 22 June and a lone tranche on 10 July.

On 2 September, Moody's extended the period for submission of comment responses until 30 October and released a spreadsheet that with cash flow modeling to provide "clarity and transparency on how we plan to apply the proposed assumptions." The rating agency received "close to 20" responses to its comment request, according to spokesman Thomas Lemmon.

As of 10 November, the 58 FFELP deals represented 45% of all issuers listed in Moody's "Update on Credit Ratings Remaining on Review", a monthly compilation of issuers with ratings that "have been on review for more than 90 days". Eighty-nine of the FFELP tranches at issue are rated Aaa, 14 are rated Aa1, and 4 are rated Aa2, and 3 are rated Aa3.

Clock is ticking

Moody's anticipates that most of the FFELP tranches that extend past final maturity will eventually payoff in full thanks to the government guarantee "of at least 97% of the defaulted loans and accrued interest," in addition to credit enhancement and excess spread. But the event of default projected to hit such deals suffering from non-payment could result in downgrades to low or below investment grade, according to Moody's.

The "extent of any downgrades ... will depend on the ability and willingness of the securitization sponsors to repurchase loans from the transactions, the amount of time until the final maturity dates, and the tranche balance that we project will remain unpaid at the time of default," Moody's wrote. There may also be an impact to tranches not currently on review, according to Moody's.

Fitch has advised on the scale of its downgrades for AAA. "Based on preliminary sample testing using proposed assumptions, approximately: 55%-60% of current 'AAA' rated senior tranches could remain 'AAA'; 30%-35% of current 'AAA' rated senior tranches could be lowered to 'AA' or 'A' rating categories; and 10%-15% of current 'AAA' rated senior tranches could be lowered to non-investment- grade rating categories."

Bigger point about rating models

Returning to Navient's argument, why is the six-year period of 2008 through 2013 an historical outlier? Because "repayment rates began to increase in 2014" || "rates of the use of deferment and forbearance have been declining since 2008" and || "data on the impacts of the [Income-Driven Repayment] program enrollment on long-term repayment activity is not yet mature," Navient wrote.

Navient is clear in what should happen next. "In considering its revised methodology, Moody's should adopt a balanced, long-term and sustainable approach to rating FFELP ABS that mitigates the risk of unnecessary ratings volatility."

Setting aside the contention that the "true, long-term average of FFELP loan performance" remains unchanged from its pre-2008 level, Navient misses a big point - a rating agency does not forecast loan performance as an end in itself but as one of many inputs in evaluating rated liabilities with sufficient conservativeness. A rating agency model is an interconnected and necessarily simplified tool with a primary purpose of assigning ratings that are robust and sustainable. No input (e.g., evaluation of an asset, interest rates, etc.) is off-limits for stressing in an inconvenient way.

In resolving the rating of an ABS tranche on review for downgrade, a rating agency examines the idiosyncratic features of the tranche and ABS in light of the applicable methodology. In changing a methodology, a rating agency examines a sector both on a standalone basis and in relation to other ABS sectors. For instance, the performance of a highly-rated tranche of a FFELP ABS must be comparable with similarly rated tranches of the same FFELP ABS, other FFELP ABS, non-FFELP student loan ABS, and non-student loan ABS (e.g., credit card ABS, auto ABS, CLOs, CMBS, etc.)

Maintaining an Aaa or Aa rating for a tranche of a FFELP ABS that is projected to extend past its final maturity would represent a serious rating failure. Moreover, a rating agency that is regulated by the US SEC is obligated to publish transition matrices of its ratings on at least an annual basis. A rating that is artificially kept at Aaa or Aa long after its risks have been publicly discussed by a rating agency, then suddenly downgraded by a large amount as an event of default accumulates, would be evidence of serious failure of governance.

by Bill Harrington

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