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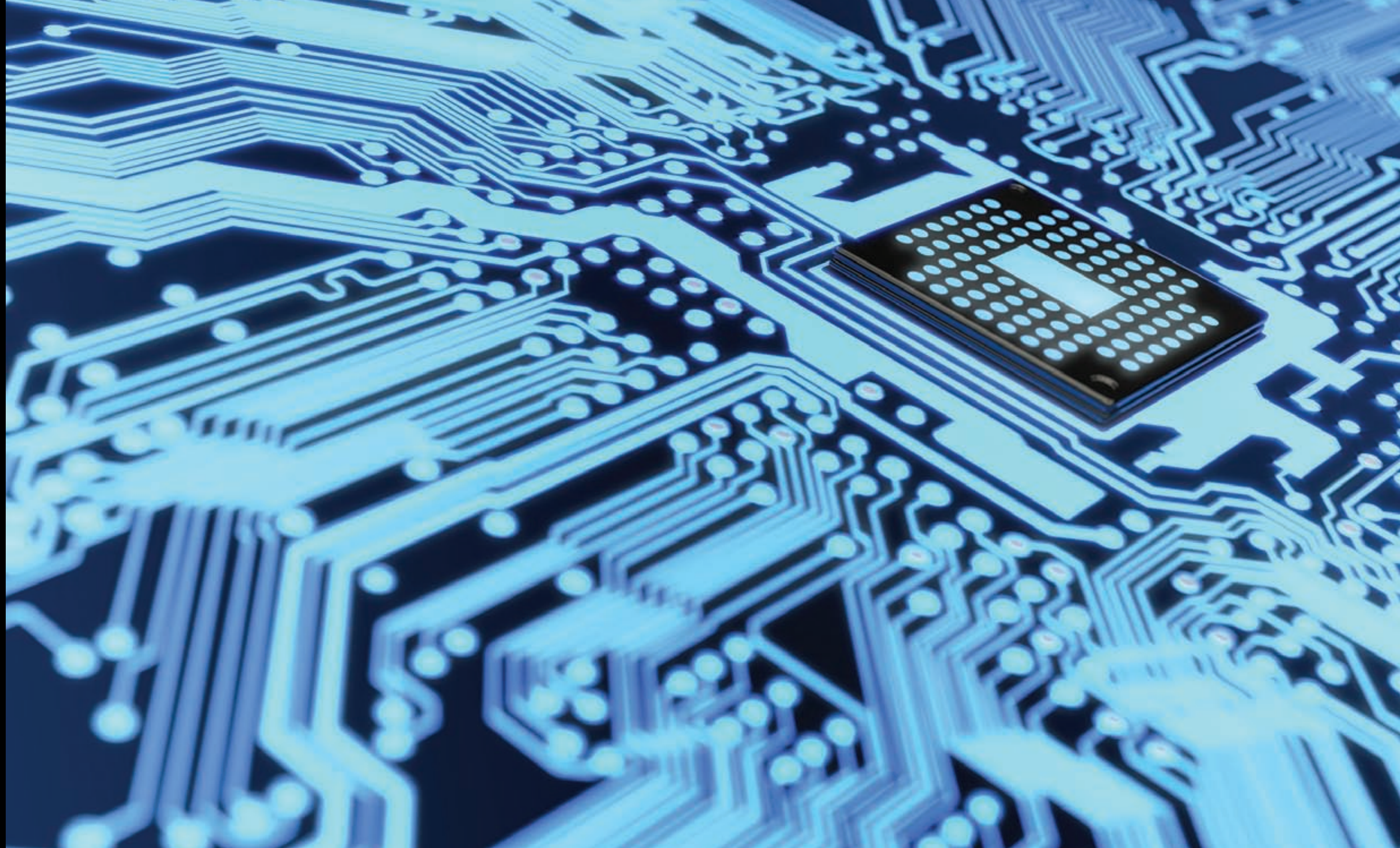

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Asset Securitization Report

A growing number of asset managers are waking up to the opportunity created as bigger banks cut back on lending to small and medium-sized businesses. Much of this direct lending is finding its way into the securitization market, as big names like GLO/Blackstone and Bain Capital join what had been a clubby market of firms issuing middle market CLOs There are already concerns about the impact on credit quality.

October 2018 | Volume 18, Number 7

Small Loans, Big Business

Middle market lending is typically done on balance sheet, whether by banks or nonbanks. Issuance of CLOs backed by loans to small and medium-sized companies reached just $12 billion last year, a fraction of the total for CLOs backed by broadly syndicated loans to larger companies.

But, like other kinds of floating-rate debt, this corner of the credit markets is attracting attention from some very large players. The heavyweights of the private equity world, including Ares, Bain, Blackstone and Carlyle, are raising large sums to put to work in direct lending. While not all of these loans will be securitized, the competition for borrowers will inevitably lead to deterioration in underwriting across the board, the subject of Glen Fest's cover story.

And business development companies, some of the biggest issuers of middle market CLOs, now have an easier time doing so. In September, the Securities and Exchange Commission gave Golub Capital the green light to use another means to comply with risk retention. The LSTA thinks it's likely to boost issuance.

We also have a wrap on the ABS East conference in Miami, Fla., hosted by Information Management Network and its new partner, the newly founded Fixed Income Investment Network. Highlights include the securitization industry's alarming lack of preparedness for a transition from Libor, and the surprising lack of growth in the asset-backed market for community bank subordinated debt.

Other hot topics included prospects for securitization of property assessed clean energy bonds for commercial properties, and the potential impact that import tariffs for the auto industry would have on the tail end of a busy year for prime and subprime vehicle finance securitizations.

— Allison Bisbey

Asset Securitization Report

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No Room for REITs, Captive Insurers at FHLBs

A former Federal Home Loan bank president argues that the system should limit its exposure to risky nonbanks

By Alfred DelliBovi

An August rating agency report should be a wake-up call to every shareholder in the 11 Federal Home Loan banks

While the S&P Global Ratings' report is overall positive on the Federal Home Loan Bank System — with an AA+/Stable rating — it highlights a budding danger to the system's 7,000 members: shadow nonbanks slowly infiltrating this vital source of liquidity for the nation's local lenders.

Specifically, S&P calls out the "small, but growing, exposure to non-depository financial institutions" as a weakness facing the Home Loan Bank System. These "captive" insurance companies and real estate investment trusts, or REITs — highly levered investment vehicles with very troubling "borrow short, lend long" balance sheets — seek Home Loan bank membership to access low-cost financing for their risky real-estate lending.

These organizations pose a threat to the Federal Home Loan banks because, unlike traditional members, they lack direct, prudential supervision, they are not insured by the Federal Deposit Insurance Corp. and they have no real capital. That means that, if they were to access the system through even just one Federal Home Loan bank and their loans were to turn sour, all 11 banks and their members, which hold FHLB stock, would be the ones that take the hit.

As the former president of the Federal Home Loan Bank of New York, I view this risk as reminiscent of the savings and loan crisis of the 1980s. At that time, savings and loan associations were permitted to use federally-insured deposits to make risky loans — including investing in speculative real estate, fast food franchises and windmills. When these loans blew up, the result was a $132 billion taxpayer-funded bailout.

Just as the S&Ls used political muscle and lobbying to expand risky lending, today the captive insurers and the REITs are working behind closed doors in Washington to roll back safeguards imposed in 2016 by the Federal Housing Finance Agency.

Legitimate mortgage companies that want to join a Federal Home Loan bank to fund their business have a tried and proven path to follow: buy a bank or form one. But captives and REITS don't want to do that. Why? They don't want to pay the price for coming out of the shadows. They don't want to comply with consumer protection regulations, the Community Reinvestment Act, bank secrecy laws, risk-based capital requirements and all the other regulations banks are required to follow. And, of course, these shadow operations don't want to be the subject of intrusive, but necessary, safety and soundness exams.

Several years ago, Ronald Rosenfeld, a former top regulator of the FHLB system, warned in American Banker that "the Home Loan Banks were established to provide liquidity to tightly regulated community lenders, and to traditional life and property casualty insurance companies, not to riskier, unregulated shadow lenders draped in the artificial mantle of insurance company membership."

Mr. Rosenfeld understood that captive and REIT members could very likely have a negative impact on the value of Home Loan bank stock held by regulated members. Ironically, reckless mortgage lending by captives and REITs could lead to a capital call from the traditional regulated FHLB members.

Members are not the only stakeholders put at risk by shadow nonbanks' desire for membership. The FHLB system is one of the largest providers of affordable housing grants each year.

Last November, 136 nonprofit housing organizations serving communities in more than 20 states sent a letter to the FHFA highlighting the problem when REITs are admitted to membership in an FHLB.

The captive insurers and the REITS are working behind closed doors in Washington to roll back safeguards.

They reported that one REIT was "using relatively cheap funding" to buy non-qualified mortgage loans. The housing advocates also expressed concern that REITs "have a perverse incentive to engage in poor mortgage servicing of these loans in order to foreclose and add more homes to its REO rental empire."

In its report, S&P stated the FHLB system plays a "critical public-policy role as one of the primary liquidity providers to U.S. mortgage market participants, especially in times of stress."

But captive insurers and REITs are creating their own stress points within this critical system.

Alfred DelliBovi is chairman of the board of Flushing Bank. He served as president and CEO of the Federal Home Loan Bank of New York from 1992 to 2014.

It's a Mistake to Block the OCC's Fintech Charter

The special-purpose charter would be an important step forward for the regulatory system

By Thomas Curry and Jason Cabral

The Conference of State Bank Supervisors recently announced it intends to refile a lawsuit against the Office of the Comptroller of the Currency, and the New York State Department of Financial Services has refiled a suit against the OCC, each in an effort to block the agency from offering special-purpose national bank charters to fintechs.

The news again raises the potential for a major missed opportunity for the creation of a "dual fintech system" — a system which, if fostered and allowed to grow, stands to benefit all stakeholders and the public.

Charter choice is, and has been since 1864, a key component of the traditional dual banking system and it is now a key component of the emerging dual fintech system.

As a result of the OCC's announcement that it will accept applications from fintechs for special-purpose charters, fintechs, just like banks, may now weigh the possible advantages of the special-purpose charter against the existing state regulatory systems. There are several key considerations: having a single regulator versus 50-plus regulators, a single licensing process versus multiple licensing and approval processes, a single "rule book" versus a patchwork of activity-based laws and regulations and uniform federal supervision versus supervision by multiple independent state regulators.

We appreciate why there are and will be continued challenges from the states, prompted in large part by divergent views over, among other things, the meaning of the "business of banking" and consumer protection considerations. However, both sides must recognize that, from a legal and public policy standpoint, a dynamic rather than static definition of "banking" under a dual fintech system is consistent with the National Bank Act. This view creates healthy regulatory competition that promotes excellence in regulation and benefits all stakeholders and the public.

In fact, we are already seeing the benefits of a dual system from a regulatory standpoint. Since the OCC's launch of its responsible innovation white paper in March 2016 [released while Curry headed the agency], the states have responded by trying to better harmonize their disparate licensing and supervision regimes. The OCC also seems to recognize that fintechs may represent a different banking model that require a different supervisory mindset. The agency's adoption of receivership regulations and the chartering manual's emphasis on recovery plans clearly indicates that the agency has a more nuanced risk appetite towards fintechs.

Moreover, there are a variety of types of fintechs that could benefit from the special-purpose charter and dual fintech system, ranging from online marketplace lenders and payment service providers to providers of blockchain technology-based products or services. While fintechs with a national or global market may prefer a federal supervisor, fintechs with niche products or a narrower geographic reach may prefer more local supervision despite its redundancy and cost. The new OCC charter is capable of providing additional flexibility and optionality that fintechs, which are at various stages of maturity and offering a wide variety of products and services, so desperately need.

Nevertheless, the OCC's accepting applications from fintechs and the creation of a dual fintech system is not the end point. Although proponents of the charter believe the OCC has finally established a clear path forward for fintechs to seek a special-purpose charter, several potential obstacles still need to be assessed. From a basic business model standpoint, for example, a simple question arises: Who's going to use it? There remains a question as to whether startup or early-stage fintechs will be able to or will want to comply with, among other things, the charter's capital, liquidity and risk-management requirements.

The OCC recognizes that fintechs may represent a different banking model that requires a different supervisory mindset.

As in any system that creates and promotes healthy competition, the dual fintech system must stand on its own The states must recognize the potential of a dual fintech system and with the OCC leverage that potential to develop a system that promotes regulatory and business competition, innovation, financial inclusion and, most important, protects consumers.

Thomas Curry is a partner in Nutter's corporate and transactions department and a co-leader of the firm's Banking and Financial Services group; Jason Cabral is a partner in Nutter's corporate and transactions department and a member of the firm's banking and financial services group.

A growing number of asset managers are waking up to the opportunity created as bigger banks cut back on lending to small and medium-sized businesses. Much of this direct lending is finding its way into the securitization market, as big names like GLO/Blackstone and Bain Capital join what had been a clubby market of firms issuing middle market CLOs There are already concerns about the impact on credit quality.

Middle market CLOs once played a limited role in the financing of below investment grade companies.

But a growing number of asset managers is waking up to the opportunity created as bigger banks cut back on lending to small and medium-sized businesses. Middle market loans are increasingly popular with investors because they pay floating rates of interest and are higher yielding, and often better underwritten, than loans that are originated by banks and broadly syndicated.

More of this direct lending is making its way into the securitization market.

In the last two months, private equity firms GSO/Blackstone and Bain Capital have both issued their first middle market collateralized loan obligation, and each is roughly $500 million in size and backed in part by loans originated by a direct-lending fund they manage.

GSO/Blackstone and Bain join what had been a clubby market comprised of asset management firms including The Carlyle Group, Golub Capital and Churchill Asset Management that securitize loans

By Glen Fest

made in-house, via middle market CLOs.

(Golub and Carlyle also acquire loans to large corporate loans in the "open market" and securitize them via broadly syndicated loan CLOs.)

"For businesses that have robust CLO franchises, and have a robust direct lending franchise, it's kind of natural to pursue something in middle market CLOs," said Michael Herzig, a managing director with THL Credit, another firm that provides direct lending to lower middle market firms (under $50 million annual EBITDA) via first- and second-lien loans as well as unitranche investments.

THL, a regular issuer of BSL CLOs, has yet to issue a middle market CLO.

Large asset managers aren't the only sponsors of middle market CLOs. Business development companies, a kind of closed-end investment fund that specializes in middle market lending, are also regular issuers. Securitizing loans on their balance sheets frees up capital to put back to work, allowing them to skirt regulatory restrictions on investing with borrowed money.

And while middle market CLOs are still subject to risk retention, a recent ruling from the SEC gives them another option for complying with skin-in-the-game rules. The Loan Syndications and Trading Assocation thinks that this could encourage more business development companies to securitize loans on their books. [See article on page 12]

Through mid-September, $11.6 billion of middle market CLOs had been issued, putting the market on track to beat the $14.5 billion issued for all of last year and the $8.4 billion issued in 2016, according to Thomson Reuters LPC.

Banks started pulling back from middle market lending as early as the 1990s, when they were freed from Glass-Steagall restrictions on investment banking. Restrictions on lending to the riskiest companies introduced by banking regulators in 2014 made it even more attractive for banks to arrange wholesale financing, leaving nonbanks to make the loans, service them, and manage the risk (in some cases, via securitization).

"Wells Fargo does not do a tremendous amount of lower middle market sponsored direct lending today, but Wells is a very active provider of financing to leading middle market managers like Churchill who do," said Ken Kencel, Churchill's president and CEO.

In a white paper published in April, Ares Management estimates that banks now hold just 9% of loans to below investment grade companies of all sizes, down from 71% in the 1990s.

Scramble for market share after GE Capital bows out

Initially, GE Capital picked up much of the slack, making loans and funneling them through its GE Antares unit. But in 2015 GE sold the direct lending business (now Antares Capital) to the Canadian Pension Plan Investment Board for $12 billion, a move designed to help shed its designation as a systemically important financial institution. GE's exit opened the door for competitors like Golub, Monroe Capital and Newstar Financial as well as newcomer Churchill , which was acquired from Carlyle Group and established as a standalone asset-management platform through TRIAA-CREF affiliate Nuveen.

Last year more than $54 billion was raised for direct, or nonbank, lending, to small and medium-sized companies, according to Preqin.

Through the first half of 2018, fund closings this year lagged last year's pace at $12.9 billion – but Preqin estimated that at the start of the second quarter, 47% of the $160 billion in capital being sought by 350 global funds is focused on direct-lending needs.

In addition to Blackstone's GSO Capital Partners and Bain, the list includes Ares Management, KKR, which has teamed up with FS Investments; Carlyle Group and Apollo Global Management.

To be sure, not all of the middle market loans made by nonbanks are used as collateral for CLOs. Still, the asset management firms that have long worked in the space – and remain the primary issuers of middle market CLOs in today's market – also plan to expand their direct lending platforms. Guggenheim Securities closed on a $2 billion direct lending fund in the first quarter, according to Preqin.

In its April report, Ares estimated the size of outstanding middle market direct loans held by private funds and asset managers in the U.S. to be $910 billion – nearly three times the $300 million they held in 2012. The report acknowledged that reported data is limited, and likely understates the size of the market opportunity.

"We've essentially replaced the traditional commercial banks as the primary providers of senior debt financing to these companies," Kencel said. "Middle market direct lending has grown dramatically in popularity as investors look for yield."

It remains to be seen how all of the capital being raised for direct lending will impact yields. In August, the average middle market loan spread (including mezzanine, second-lien and blended rates of unitranche loans) was 480 basis points over Libor, compared to 371 basis points for broadly syndicated loans pooled in CLOs, according to Thomson Reuters LPC.

Wells Fargo expects that the increased use of leverage by business development companies alone is likely to depress yields. The U.S. government budget bill that President Trump signed in March included a provision lifting a cap on leverage ratios for these funds to 2:1x. Previously, they could only borrow $1 for every $1 of equity.

In an August report, Wells Fargo said it expects business development companies will only increase leverage ratios to 1.25x, but even that will result in "increased leverage will likely also pressure middle market loan spreads tighter" as middle market CLO managers compete for loan collateral, the report said.

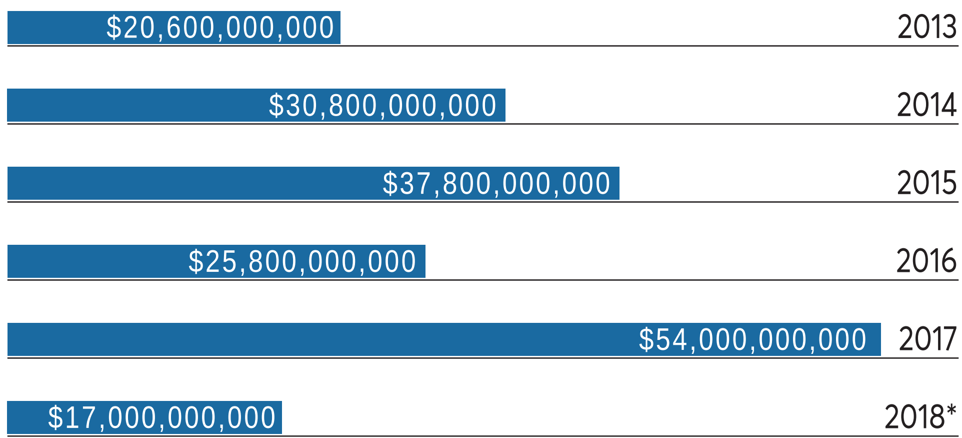
This increased leverage could well come from issuing more CLOs, as opposed to using lines of credit or issuing other kinds of debt, according to Kencel. He noted that the corporate credit ratings of several publicly traded business development companies were put under review for a possible downgrade after the cap on leverage was lifted.

"What they [business development companies] failed to take notice of is that the borrowing costs …. were quite low because the rating agencies were willing to assign them a corporate investment grade rating based on the 1-to-1 leverage limitations," said Kencel.

Issuing CLOs would allow BDCs to raise money without boosting their leverage ratios, he said.

Direct fundraising

Asset managers are accumulative large sums to put to work lending to small and medium-sized companies



Source: Preqin *1H

Credit quality can only go south

As middle market lending expands, some also worry that the credit quality of the loans will inevitably deteriorate.

Unlike broadly syndicated corporate loans, the majority of which have few restrictive covenants, middle market loans are closely monitored through maintenance covenants by lenders. And for good reason: middle market lenders either have these loans on their books, or with a CLO in which they hold substantial equity – usually around 50%, according to Kencel.

And if a middle market borrower defaults on a loan, the recovery prospects are much dimmer than on a larger senior loan, said Kevin McLeod, a managing director for Cerberus Capital Management, another direct lender.

If a middle market loan reached a payment-default stage "is far, far too late" to salvage the loan, McLeod said at IMN's ABS East conference on Sept. 25. "Companies have lost their supplier relationships, their customer relationships, probably their employees. It's over. After a payment default, recovery is probably going to be abysmal."

But strong investor interest in middle market loans also makes it easier to issue CLOs with fewer investor protections. Wells Fargo, citing research from S&P LCD, said that there has been a "rise of loan terms historically reserved for BSL loans," with an increase in EBITDA addbacks and adjustments, delay-draw terms, "stretched-senior" and unitranche deals.

One newcomer in the middle market space, Vista Credit Opportunities, issued its debt CLO with single-industry (software and IT) concentration exceeding 75%, well above the industry exposure in a typical broadly syndicated loan CLO, which is under 10%.

In early September Fitch Ratings called out two of its competitors for assigning triple-A ratings to the Vista CLO. Although the report did not name the CLO, a description of the deal's top-heavy exposure to the software industry, and the reference to the lack of caps on industry exposure clearly fit the $305 million VCO CLO 2018-1, which priced in August via Wells Fargo and GreensLedge Capital Markets.

Fitch said the heavy concentration in high-tech could elevate default risk to senior noteholders in the event of a downturn in the sector, similar to the recent experience of many 2013- and 2014-vintage collateralized loan obligations with heavy exposure to oil and gas.

S&P Global Markets and DBRS rated the deal. S&P declined to comment on Fitch's report.

Green light

As of March 2018, Golub had issued or refinanced six middle market CLOs relying on a capitalized manager-owned affiliate to hold the risk; a no action letter gives it another option for compliance

- GCP CLO 34(M): $411
- GCP CLO 16(M)-R: $754M
- GCP CLO 17(M)-R: $907M
- GCP CLO 18(M)-R: $899M
- GCP CLO 21(M)-R: $796M
- GCP CLO 24(M)-R: $750M

Source: Fitch Ratings

Regulatory Relief for Middle Market CLOs

A conflict between risk retention rules and prohibitions against self-dealing was limiting compliance options for some lenders

By Allison Bisbey

The Securities and Exchange Commission has made it easier for middle market lenders to tap the securitization market for funding by giving them an additional option for complying with risk retention.

While some people question whether the regulatory relief was really necessary, the fact that it was pursued at all illustrates just how eager many nonbanks are to lend to small and medium-sized companies.

Of course, securitizations of broadly syndicated corporate loans are no longer subject to skin-in-the-game rules enacted under Dodd-Frank late in 2016. A court ruling in February of this year excludes them. But the exemption only applies to managers of collateralized loan obligations that acquire collateral for deals in the "open market."

Lenders who securitize loans that they originated themselves and hold on the balance sheet still have to comply.

In theory, this should not be onerous. Essentially, it means that middle market lenders cannot borrow against 100% of the value of loans on their balance sheet, just 95%. And in practice, most were already holding on to more than 5% of the risk in deals before risk retention was enacted.

However, many nonbank lenders to small and medium-sized companies elect to be treated as business development companies, a type of closed-end investment fund, because it's an efficient way to raise equity. And this election limited their options for complying with risk retention. Or at least some people believed that it did.

One way to comply with risk retention is for the "sponsor" of a deal to hold on to the risk. But the staff of the SEC's corporate finance division has told lenders that business development companies cannot be "sponsors" for the purposes of risk retention; only the affiliated company that acts as investment adviser to the business development company can be the sponsor.

"It is possible that middle market CLO issuance might increase, with other BDCs following the roadmap set out by Golub."

Another way to comply with risk retention is for the "originator" of the loans, which a business development company clearly is, to hold on to the risk. However, until last month, business development companies were unable to employ this method, either. This was the result of a conflict between the risk retention rule and rules enacted under the Investment Company Act of 1940 designed to prohibit self-dealing.

The risk retention rule requires the originator to acquire the risk retention interest from the "sponsor" of a deal. The originator can't simply sell loans to a securitization trust and receive a portion of securities issued by the trust as part of its compensation. Instead, the originator has to sell the loans to the sponsor, which then sells the loans to a securitization trust. The trust then sells the risk retention securities to the sponsor, which in turn sells them to the originator.

However, the series of round-trip transactions described above would have put business development companies in violation of 40 Act restrictions on buying securities from an affiliated party. So it was a no-go.

Instead, many business development companies complied with risk retention via an arrangement that is just as complicated, using what is known as a capitalized manager-owned affiliate. This involves creating a new corporate entity that is controlled by the adviser to a CLO but partly owned by a third-party investor; the capital contributed by this investor helps to fund the capitalized manager-owned affiliate's purchases of risk retention interests.

This option is far from ideal, however. For one thing, it's relatively expensive to set up a capitalized manager-owned affiliate. And lenders that use them have to share the fees earned by the entity with the third-party investor.

This is no longer necessary. On Sept. 7, Golub Capital, an asset manager that lends to middle market companies through two business development companies, got the green light from the SEC's Division of Investment Management to use the originator option to comply with risk retention rules.

In a letter to the SEC submitted on behalf of Golub, law firm Dechert described the series of "round trip" transactions that either of the Golub business development companies would have to enter into in order to use the originator option to retain risk in a CLO: GC Advisers, the investment adviser to the two business development companies, would purchase a loan from one of them,, sell it to a securitization trust, and take the equity securities sold by the securitization trust and put them in the business development company.

"We believe that the proposed transactions … do not raise the concerns of overreaching and conflicts of interest by an affiliate underlying the 1940 Act's prohibitions on affiliated transactions, which were enacted to address 'unscrupulous' self-dealing by investment advisers and their officers and directors to the detriment of the investment companies they manage," the letter states.

The Commission concurred, issuing a no-action letter stating that it would not recommend any enforcement against the BDCS or their adviser if they engaged in such transactions.

The upshot?

"If you have a BDC or other 40 Act originator that has the capacity sell 100% of the assets required to do a CLO to a CLO issuer, you now have a green light to allocate 100% of the risk retention to such BDC," said Sean Solis, a partner at law firm Milbank, Tweed, Hadley & McCloy.

Solis added that the no-action letter is "purely limited to the resolution of this regulatory conflict under the 'allocation to originator' option under the U.S. risk retention rules."

The Loan Syndications and Trading Association was less equivocal. "With the issuance of the no-action letter, it is possible that middle market CLO issuance might increase, with other BDCs following the roadmap set out by Golub," the trade group stated in a brief posted on its website Sept. 20.

While Dechert declined to comment, citing client sensitivity, other securities lawyers think that the no-action letter raises some interesting questions about compliance.

In a Sept. 13 client update, two partners at Mayer Brown, Paul Forrester and Carol Hitselberger, took issue with the SEC's view that a business development company cannot be a sponsor, for the purpose of risk retention. While the adopting release for risk retention "was reasonably clear that 'sponsors' must be active participants in the related origination and initiation activities ... why is it the case that this must be the adviser for a BDC that is externally managed, rather than the BDC itself?" they ask.

Forrester and Hitselberger also question whether any party in a middle market CLO issued by an externally managed business development company is required to retain risk, since it can be argued that there is no sponsor. Their reasoning: The adviser to a business development company does not meet the criteria for a sponsor established in the DC Circuit Court's February ruling if it never holds title to a loan.

"While the granted relief in the Golub letter is a clear path to compliance with the CRR [credit risk retention] Rule, it is not an exclusive one," the client update states. "There are other alternative structures and differing views of whether there is a 'sponsor' for the CRR Rule and, if so, which entity would be considered the 'sponsor' in the eyes of affected parties and their counsel given the significant consequences of being a sponsor."

Certainly the inability to retain risk on balance sheet did not stop Golub's business development companies from issuing CLOs. In fact two recent deals suggest that Golub wasn't even waiting around for a no-action letter.

In June, Golub Capital Investment Management refinanced a $750 million transaction, Golub Capital Partners CLO 25 (M), originally issued in 2015, triggering compliance with risk retention. A majority-owned affiliate of GCIM acquired subordinate notes in order to comply with risk retention, according to Fitch Ratings.

And in August, the same company issued the $814.5 million Golub Capital Partners CLO 38 (M), which also relies on a majority-owned affiliate to comply with risk retention, according to Fitch.

Golub Capital did not respond to requests for comment. **ASR**

Students Leaving Federal Loans on the Table

An advocacy group focused on affordability says schools should do a better job of educating students about their eligibility

By Kevin Wack

More than half of all students who took out private education loan were eligible to borrow more from the federal government than they ultimately did, and 30% of them did not use government-backed loans at all.

That's according to a new report from The Institute for College Access & Success (TICAS), a nonprofit organization that says many student borrowers are leaving money on the table when they turn to private-sector lenders.

The report's authors recently found interest rates as high as 14.24% on private undergraduate loans, compared with 5.05% on federal loans. They are calling on colleges and universities to do a better job of educating students about their eligibility for government loans.

"Private education loans are one of the riskiest ways to pay for college," the report argues. "Unlike federal loans, they typically have variable interest rates and lack the important borrower protections and repayment options that come with federal loans."

The report from TICAS, an advocacy group that focuses on college affordability and availability, offers a preview of how the policy debate with respect to student loans is likely to change if Democrats take control of Congress in November.

The education finance industry has argued in recent years that the federal government, which does not consider borrowers' ability to repay their loans, bears far more responsibility than banks do for the massive run-up in U.S. student debt. bears far more responsibility than banks do for the massive run-up in U.S. student debt.

Student debt outstanding rose from less than $800 billion in

2010 to $1.4 trillion this year. Federal loans represent more than 90% of that debt, according to industry data.

Following President Trump's election in 2016, industry officials hoped that congressional Republicans would scale back the federal program in ways that would benefit the private sector — such as by restricting government-backed loans to parents and graduate students. Shares in SLM Corp., the student loan giant known as Sallie Mae, climbed 59% between Nov. 8 and Dec. 7, 2016. But over the last 20 months, the GOP-led Congress has failed to enact major changes to the nation's student loan programs.

If Democrats gain control of the House in November, they may well point to the report released Sept. 17 as evidence for the need to steer more borrowers into government-backed loans.

The report's authors support legislation — introduced over the summer by Democratic Sens. Richard Durbin of Illinois, Tina Smith of Minnesota and Jack Reed of Rhode Island — that would require schools to counsel students about any unused federal student aid eligibility before they shoulder private debt.

That bill has drawn opposition from the Consumer Bankers Association, which represents the nation's largest private student lenders, including Sallie Mae, Wells Fargo and Discover Financial Services.

"Provisions in this legislation are needed, but not for private student loans," the trade group's president, Richard Hunt, said in a July 16 press release. "Private loans have comprehensive, plain-language disclosures so students and their families know the full cost of their private student loan upfront. The same disclosures simply do not exist for federal loans and should."

Banks also argue that the structure of the federal loan program — borrowers are not underwritten based on their ability to repay — contributes to fast-rising tuition bills at colleges and universities. They say that students can get federal loans even if their job prospects are likely to be poor, driving up the demand for higher education. They also maintain that student default rates have been rising as a result of the federal government's dominant role in the market.

But in its new report, TICAS flips that criticism on its head. The nonprofit organization argues that as a result of the underwriting done by private student lenders, students from poorer families pay more than those from wealthier households. **ASR**

Alarming Lack of Prep for Libor

In early September, the Bank of England and the Financial Conduct Authority issued letters urging U.K. bank executives to get the ball rolling on plans to transition to Libor replacement.

Participants at IMN's ABS East conference in Miami got more or less the same message firsthand. "I still see a concerning lack of preparation and people being proactive at very large institutions," said Eli Stern, a principal at consulting advisory firm EY.

"Even walking around here and talking to people … they're saying, 'I'm just going to wait to see what happens,' " he said. "That's not going to cut it."

Stern added, "I'm curious to see how regulators will start to respond if they start to see blatant lack of preparedness."

He was among five panelists who expressed a mix of dismay and alarm that firms seem to be dragging their feet on planning for a transition to a new benchmark rate for loans and derivatives contracts once the London Interbank Offered Rate is no longer available.

After 2021, the FCA will no longer require 16 global panel banks to submit daily quotes on interbank lending rates varied by term and currency.

Several audience polls during the panel discussion underscored either the apathy or bewilderment in how firms expect to move forward with a replacement rate that will cover an estimated market of $200 trillion in loans and swaps/derivatives contracts.

Nearly 72% of attendees polled electronically said their institutions were either only going to get involved "at the appropriate time" or "let the market figure it out"; only 12.5% stated their firms were actively engaged with a companywide program planning on transitioning to a future alternative benchmark, while 15.7% stated these initiatives were siloed within a business-line level.

While waiting on the market may be seem like the path of least resistance, there's a price for kicking the can down the road, the panelists warned. More than $500 billion of outstanding student loans and consumer and corporate debt are pegged to Libor, and in many cases, the language in loan documents does not ensure a smooth transition to a new rate. Typically, for example, there are clauses requiring both issuers and investors to subsequently agree on a new rate.

"People are beginning to focus on legacy transactions that will mature after 2021 or before 2021 if the market moves away from Libor prior to that. And a majority of these transactions do not have robust fallback language, or fallback language at all," said EY's Stern.

The contracts should include details on trigger events for a new rate, the definition of the new rate, any necessary spread adjustments and timings to compensate any loss of potential value transfers between counterparties, he said. And it won't be simple to update deal documents, which "may not be easily searchable" for rate-transition clauses. **ASR**

GSE Rental Pilot Short but Effective

Fannie Mae and Freddie Mac's involvement in the single-family rental market may have been short-lived, but it still had a positive effective, according to Beth O'Brien, CEO of CoreVest.

The pilot financing programs lasted just two years before the Federal Housing Finance Agency announced last month that it was pulling the plug. FHFA Director Mel Watt said the agency had concluded that market for financing larger rental programs is sufficiently liquid without any help from the government-sponsored enterprises.

The FHFA acknowledged that smaller landlords may have limited options for long-term financing, but was unwilling to allow GSE involvement in this segment of the market – at least not yet.

Though CoreVest participated in Freddie's pilot, O'Brien isn't complaining about its demise.

GSE involvement "did actually help the market in that it generated a lot of buzz," she said..

O'Brien agrees with the FHFA's assessment that the single-family market is functioning pretty efficiently without the involvement of the two GSEs. Case in point: Pricing on $200 million of bonds Corevest issued through Freddie's pilot in December 2017 (with the GSE guaranteeing 80% of the certificates issued) was not that different from a private-label securitization it had just completed in November.

They were executed "almost on top of each other," she said. "If you look at the bonds the classes are all different and priced differently, but if you add in the G-fees and everything else, from the issuer perspective we were literally within three basis points of each other."

"I think markets were incredibly efficient, more efficient than I was even expecting them to be."

CoreVest , which is controlled by Fortress Investment Group, lends to landlords acquiring or fixing up portfolios of between one and 500 single-family homes. To date, it has securitized $3.5 billion, 84% of which has gone to single-family rental properties.

Likewise, pricing on a $1 billion pilot transaction that Invitation Homes did with Fannie Mae early in 2017 was not much better than a private-label rental securitization completed shortly afterwards by Progress Residential, O'Brien said.

Invitaton Homes, which is controlled by the Blackstone Group, and Progress Residential, which is controlled by Pretium Partners, are two of the largest owners of single family rentals in the United States. They finance their portfolios by obtaining a single mortgage backed by several thousands of homes; these mortgages are then securitized.

Drumming up investor interest wasn't the only benefit to Fannie and Freddie's involvement, either. "Having the GSEs look at the market this closely, doing the research that they did … they did come out with a lot of standardized documentation," O'Brien said.

"The market now has a good feel for what this looks like."

This benefits everyone who lends to landlords. "The more standardization we can see, the better liquidity we're going to have in the bonds and loans," O'Brien said. "It is its own asset class and deserves to be financed, not just be this kind of hybrid between sometimes at this bank it's commercial and sometimes at this bank it's residential." **ASR**

Lax Lending Guidance May Not Last

Don't get too comfortable.

That's the message that Robert Villani, partner at law firm Clifford Chance, has for lenders that are taking advantage of the relaxing of bank regulatory guidelines to underwrite corporate debt packages well above the 6.0 times leverage limit adopted in 2013, under the previous presidential administration.

Villani noted that regulators could easily change their tune after the next presidential election, or even after the coming midterm congressional elections, should Democrats gain control of the Houses and/or Senate.

While regulators have advised large institutions not to worry about lending guidelines, "We're finishing up two years of four years of an administration that is regulatory lite," he said. Regulators don't want to put banks at a disadvantage to nonbank lenders. As a result, there are loans that are being made that exceed the guidelines and banks will continue to make them.

Just be prepared: Should the Democrats return to power, "you know those guidelines, and you can start following them again," he said.

Unfortunately for both banks and nonbanks, the current light-touch regulatory climate is unlikely to bring much relief for collateralized loan obligations, Villani said. He noted that the Federal Reserve's proposals to revise the Volcker Rule are not focused on the areas of most concern to CLOs: defining ownership and restrictions on using bonds as collateral. These accounted for just two of the over 1,000 questions on which the central bank is soliciting comment.

(However, seven Republicans on the Senate Banking Committee are asking regulators to include more revisions to the definition of "covered fund," which currently includes securitizations.)

While some may be concerned that lax lending so late in the credit cycle could contribute to rising defaults, Tom Majewski, CEO of Eagle Point Credit Co., sees little to worry about. Overall, he said, revenues and profits at below-investment-grade companies are growing, and the pace of revenue growth is coming "at an accelerating rate – that's good news."

For investors in the riskiest securities issued by CLOs, known as the equity, the best defense against a turn in the credit cycle is to maximize the weighted average life of deals, he said, reiterating comments made during Eagle Point's second-quarter conference call. **ASR**

Disaster Resiliency to Drive C-PACE

Colossal damage

The five costliest U.S. hurricanes; Morningstar thinks that projects to increase resiliency to natural disasters will help drive PACE financing

- **Katrina (2015): $161B**
- **Harvey (2017): $125B**
- **Maria (2017): $90B**
- **Sandy (2012): $71B**
- **Irma (2017) $50B**

Source: National Oceanic and Atmospheric Administration

While underwriting of commercial property assessed clean energy continues to lag that of residential PACE, the pipeline of deals financing energy efficiency projects is growing. "There are couple of different players that have put together equity facilities and are gearing themselves up to tap the debt markets, in particularly ABS," said Benjamin Cohen, the chief executive of T-Rex, a software platform and managed data services vendor for the esoteric ABS market.

"Thirty-four states have passed PACE legislation," and commercial PACE programs are active in 19 states, said fellow panelist Beth Starr, a managing director who leads structured finance activity for Credit Agricole Corporate and Investment Banking. "It is going to grow but it still has a lot of impediments from the origination side."

This year, Pennsylvania, Illinois, and Utah have each passed legislation either enabling or expanding the use of commercial PACE. To date, however, the only publicly rated commercial PACE deals have come from CleanFund, which completed a $109.3 million deal this year that financed projects in six states, and a $75 million deal sponsored by Greenworks Lending in the fourth quarter of last year.

Commercial PACE projects face impediments that residential PACE does not. The mortgage lender must consent to a commercial PACE lien. And while residential PACE loans are "homogeneous" and have borrower credit histories and property records easily tracked by investors and ratings agencies, end-users, or "off takers," of commercial PACE loans, on the other hand, "are harder to analyze" and usually consist of non-rated corporate borrowers with varying project needs, cash-flow projections and debt-service coverage, Starr said.

T-Rex is building a platform to provide a "transparent" data views into the performance of commercial property assessments, as well as the municipal bonds and the ABS portfolio they are rolled into. Cohen thinks this could stir more commercial PACE originators to ramp up ABS issuance — perhaps building the market to as many as four or five issuers by the end of the year.

One driver of commercial PACE origination could be an increased demand for project financing in states like California and Florida where businesses look to retrofit building to better defend structures against natural disasters, as opposed to increasing energy efficiency or reducing water use. In Sept 21 report, Morningstar Credit Ratings noted that many property assessed clean energy financings in both California and Florida have been dedicated to increasing resiliency to hurricanes, floods, and earthquakes. "Given the increase in natural disasters — including 2017 hurricanes Harvey, Irma, and Maria — it is not surprising that property owners have migrated their building enhancement efforts toward wind, flood, and seismic resiliency," the report states.

Morningstar thinks that legislation in California and other states could be a catalyst for future PACE-funded retrofits In October 2015, The Los Angeles City Council passed an ordinance requiring select buildings identified by the city's Department of Building and Safety to improve their structures to increase seismic resiliency. **ASR**

Less Spread Tiering in Auto ABS

Despite a slight cool-down in sales of new vehicles, banks and captive finance companies are tapping the securitization market at a faster pace than last year. Panelist Amy Sze, executive director at JP Morgan Securities, expects issuance to reach $100 billion for 2018 as a whole, up from $93 billion in 2017.

Investors' appetite for auto asset-backeds remains strong because the economy is strong and unemployment low, and used-car values remain strong, she said. Another important factor in investors sentiment is the ongoing credit upgrades of outstanding asset-backeds as low default levels allow credit enhancement in deals to build up.

As a result, yield spreads on auto asset-backeds are narrowing, even for "lower-tier" issuers, Sze said The tiering normally seen between larger issuers with longer track records and smaller players with shorter track records has "collapsed," she said. As a result, even lower-tiered issuers are enjoying cheaper funding.

One area of relative weakness has been resale values of used sedans, which have fallen out of favor with U.S. consumers. However, Steve Hetrick, Treasurer at Nissan Credit Acceptance Corp. and another panelist, said that values of sedans coming off-lease have started to recover after weakening earlier this year. (So-called "residual values" are important in lease securtization, since the proceeds from the resale of a vehicle form part of the collateral.)

Other panelists sounded a cautious note about the threat of higher tariffs on non-U.S. vehicles. Jamie Feehely, managing director of securitization at Canada's National Bank Financial, said the tariffs being discussed don't recognize the global nature of the auto market. He cited as an example the Toyota RAV4, which is manufactured in Ontario, using parts from Mexico (40%) and the U.S. (40%) as well as Canada (20%).

The result could be a "dearth" of new-car sales, Feehely said, adding, "I don't know if there's a [prime] securitization that's been done with used cars."

Stefan Glebke, president of BMW US Capital, acknowledged that the German auto manufacturer may have to produce sedans in the U.S. "We are trying to optimize as much as we can. Automotive industry is really a global industry, and we have suppliers everywhere in the world," he said. **ASR**

Sub Debt Still Tough Sell for Banks

Ten years after the financial crisis, subordinated debt remains a tough sell for regional and community banks, and that's stalling a revival of a corner of the securitization market that has a ready following with investors

"If you look at the regulatory requirements in terms of Tier 1 capital requirements and total capital requirements ... essentially you would expect banks to issue roughly a quarter of their market cap in subordinated debt," said Navid Abghari, a senior portfolio manager at the private equity firm Angel Oak Capital, which has sponsored several securitizations via its Buckhead Financial affiliate. Instead, capital structures at these institutions average about 95% equity"

Banks currently issue just $40 billion to $60 billion of subordinated debt annually, mostly via private placements.

"It's been a little bit underwhelming how much issue has come through on the sub-debt side," said Scott Levy, a senior managing director at Guggenheim Securities, which has underwritten several deals. "I can remember sitting with some of my colleagues in 2012 and 2013 talking about $60 billion or $70 billion pre-crisis is going to turn into $100 billion in the new era." And here we are, five or six years later, and there isn't a lot happening there."

This disappointing levels of activity can likely be attributed to the tarnished reputation of trust-preferred securities, a debt-equity hybrid issued by banks precrisis and securitized in vehicles called Trups CDOs. Trust preferreds, which allowed issuerst to defer payments for several years, did not perform well during the financial crisis, and many investors - and potential issuers - still shun any talk of subordinated debt securitization, according to Regina Richardson, the president of EJF Capital.

"When we started doing our [sub-debt] deals ... in 2016, people would think of it as a CDO and they're like, I don't want to invest in it because it has the name 'CDO,' " Richardson said. "I think we've come a long way in the past two years in educating people, having new issues to get people to realize these are really solid structures."

Post-crisis securitization of subordinated bank debt totals just $2.8 billion, according to Guggenheim Securities. By comparison, $25 billion of trust preferreds issue precrisis is outstanding. **ASR**

CFPB Director Mick Mulvaney; Bloomberg News

Small Biz Loan Data Rules a Legal Minefield for CFPB

The agency wants more information, but conflicting statutes make writing a data collection rules difficult

By Kate Berry

A recent report by the Consumer Financial Protection Bureau underscores the puzzle facing regulators as they consider asking small-business lenders for data on their borrowers.

On the one hand, the CFPB wants more data as it conducts fair-lending exams of small-business lenders to assess redlining risks. Yet the Equal Credit Opportunity Act's prohibition on collecting race and gender information from small businesses has made it difficult for the bureau to write rules on what data to collect.

"The CFPB expects supervised entities to keep better information to determine if they are discriminating in small-business lending," said Jeff Naimon, a partner at Buckley Sandler. "Exactly what data a financial firm is supposed to have is unclear since there isn't a regulation allowing them to collect data."

The CFPB said in its Supervisory Highlights report earlier this month that the data limitations could impact the CFPB's ability to monitor and regulate supervised entities.

"Institutions collect and maintain (in usable form) only limited data on small business lending decisions," the CFPB said in the report. "Limited availability of data could impede an institution's ability to monitor and test for the risks of ECOA violations through statistical analyses."

Although the Dodd-Frank Act mandated that the CFPB write rules on data collection for small-business lenders — similar to the mortgage data collection framework under the Home Mortgage Disclosure Act — the potential conflict with ECOA has

"The reason why [the CFPB] waited so long to do this is because they don't really know how to test for fair lending" of small biz loans.

led to delays in implementing the provision. The agency has found navigating around the various statutory decrees difficult under both former CFPB Director Richard Cordray and under current acting Director Mick Mulvaney.

"The fact that the previous leadership wasn't able to do it in seven years, [means] that it's difficult to accomplish what the statute wants," Mulvaney said in a speech to the U.S. Chamber of Commerce in March. "Small-business lending is different than credit cards, it's different than large commercial banking — it's hard to do."

At the same time, industry representatives may prefer that the baton was passed to the Mulvaney-led agency — which has moderated the bureau's aggressive approach toward lenders under Cordray — on a small-business loan data rule, since that makes it more likely the data requirements will be tailored to the industry's liking.

"It's going to be a massive cumbersome process, but it's something we want done with people in there who understand how difficult it is," said Kate Larson Prochaska, vice president and regulatory counsel at the U.S. Chamber of Commerce.

Prochaska specifically praised Grady Hedgespeth, the CFPB's assistant director of small-business lending markets, who would likely be undertaking the effort. Previously an official at the U.S. Small Business Administration, Hedgespeth was hired by Cordray.

"We do want [the CFPB] to move forward ... because we think they have a good project leader who has decades of small-business experience," said Prochaska. "Hopefully, we can get this done in the next couple of years under this administration."

ECOA prohibits discrimination in consumer transactions, but it also applies to business-purpose credit transactions such as small-business loans. The CFPB's report did not find any violations of ECOA among small-business lenders. But the report and the CFPB's latest rulemaking agenda indicate the bureau may finally add language to Regulation B, which implements ECOA, that would require financial institutions to compile, maintain and submit to the bureau certain data on credit applications by women- and minority-owned small businesses.

Mulvaney has repeatedly said the CFPB under his leadership will stick to its statutory mandate, and he has cited the Reg B addition as a requirement. But his focus on strict legal adherence suggests criticism of Cordray, whom Mulvaney says went beyond the agency's legal authority.

"We have to do this. [Dodd-Frank] says: Thou shalt promulgate rules on small-business lending," Mulvaney said at the Chamber speech. "Figuring out a way to implement this statute has been extraordinarily difficult."

Mulvaney already has assured lenders that he would ease the expanded HMDA requirements imposed by Cordray that would have exposed lenders to far greater scrutiny of fair-lending violations. Reg B is often viewed as a HMDA-like rulemaking for small-business lenders.

Bank trade groups have long been concerned that any small-business data collection would impose rigidity on small businesses, limiting the ability of banks and financial firms to do high-touch, customized lending.

Underwriting of consumer loans is far more standardized while the decisions and factors that go into small-business lending — including the fact that there often is no formal application but rather a give-and-take between a loan officer and a small-business owner — can be more complicated, industry experts say.

"The reason why [the CFPB] waited so long to do this is because they don't really know how to test for fair lending of small-business loans," said Lyn Farrell, a senior advisory board member at the consulting firm Treliant.

In the short term, supervised entities are expected to create procedures to collect data internally that would identify fair-lending risks in small-business loans.

Fair-lending exams for small-business lenders became a priority for the CFPB in 2016 and 2017, after the bureau pulled back from targeting indirect auto lenders.

"Examination teams may evaluate an institution's fair lending risks and controls related to origination or pricing of small business lending products," the CFPB's report stated. "Some reviews may include a geographic distribution analysis of small business loan applications, originations, loan officers, or marketing and outreach, in order to assess potential redlining risk."

Richard Horn, founding attorney and managing member at the law firm Garris Horn and a former CFPB senior counsel and special adviser, said the CFPB's intent to scrap the expanded HMDA data while adding a statutorily required data collection requirement for small-business lenders could be viewed as "conservatively adhering to statutory mandates."

"It fits with the viewpoint that government should help businesses thrive," he said. **ASR**

U.S. Bank Takes on Fintechs with Online Loans for Small Businesses

U.S. Bank is launching two small-businesses offerings that seek to outdo fintech competitors like OnDeck Capital and Kabbage, which have been scarfing up market share from banks.

The Minneapolis bank has built an online small-business-loan platform that can render loan decisions within a day. And it has created a small-business credit card with flexible rewards.

The online loan was "completely crafted from scratch in order to look and feel fintech-ish," said Scott Beyer, who has the unusual title of agile experience owner for the Business Banking Experience Studio at U.S. Bank. This newly formed group develops digital-first solutions for business banking.

While filling out a loan application in a branch with a banker takes 30 to 45 minutes, the online application process lasts about five minutes and can be done on a smartphone, tablet or PC. Customers can sign the loan documents online and receive funds electronically — often on the same day.

"We've been interviewing business owners every other week, and we heard from them they wanted something fast, but they wanted simplicity," Beyer said. "They never need to set foot in a branch or talk to a human being if they don't want to."

The interest rates range from 4.99% to 11.99% for loans, and from 6.25% to 13% for lines of credit. The maximum loan is $250,000. Some of the loan decisions will be made completely by the software, which is based on the bank's existing underwriting process. Loans that appear riskier will require manual intervention. **ASR**

Why It Will Be Hard to Find New CEOs for GSEs

The leaders of Fannie and Freddie are stepping down after returning the GSEs to profitability. Finding replacements won't be easy.

By Bonnie Sinnock

The return to financial stability at Fannie Mae and Freddie Mac resolves a big problem from the past, but each government-sponsored enterprise must now turn to a task that will shape its future: picking a new CEO.

In contrast to a decade ago, when the Great Recession decimated their finances and government officials placed them into conservatorship, Fannie and Freddie are profitable. The leaders originally charged with restoring their profitability are stepping down because they consider their jobs done.

That leaves the GSEs to find CEOs who can lead them into a new phase, and attracting top-flight candidates may not be easy.

One hurdle to finding qualified candidates is that there is a $600,000 cap on compensation that would amount to a pay cut relative to the current salaries of Fannie Mae's or Freddie Mac's executives, or anyone with similar private market experience.

"The money is nothing to scoff at, but it seems like a paltry sum compared to what executives at investment or large, money-center banks command," said Tim Rood, chairman of the Collingwood Group.

Also, candidates for the two jobs must be willing to work in a very uncertain environment, under the oversight of a regulator — the Federal Housing Finance Agency — that like the GSEs themselves is being closely watched by lawmakers and is about to undergo a leadership change.

"I think the new CEO [at each company] is going to quickly be confronted with a new FHFA director who is going to be looking to shrink the GSE footprint, and likely going to find a way to recapitalize and release Fannie and Freddie from conservatorship," Rood said.

Egbert Perry, the chairman of Fannie's board, declined to discuss the specific parameters for Fannie's CEO search this fall except to say that its next leader must be able to handle the new demands Fannie will face — and that includes satisfying the FHFA's performance and risk management goals.

"The first stage was: How did we get to conservatorship? The next stage was: Now that we understand what has happened and what's going on, let's figure out what we need to do to stabilize the organization," Perry said. "The third stage is: OK, the world around us is changing. How do we embrace that and try to move the organization into a place where it is still able to deliver on its mission?"

Fannie's current CEO, Tim Mayopoulos, "laid the foundation for the early phase of stage three," Perry said. The next CEO will take it from there.

The Fannie CEO job is a hard one, Mayopoulos acknowledged. The company is still in conservatorship and the focus of intense regulatory scrutiny, he said.

"There are still plenty of challenges, but the role the institution plays presents a real opportunity," Mayopoulos said. "Housing is a good 15%-20% of the national economy and, so, to lead the biggest player in that market — setting standards and driving progress — is a great responsibility to have."

Whether either of the GSEs will choose an internal candidate to be the next CEO, like Fannie did when it moved Mayopoulos into the post, or whether either of the agencies will recruit an external one, like Freddie Mac did when it first hired current CEO Don Layton, remains to be seen.

Freddie says it is considering its new president, David Brickman, as one of its CEO candidates, but it is continuing to look at external candidates as well.

An internal candidate with a multifamily mortgage background like Brickman could be attractive to the GSEs. Some of the key financial instruments they have more recently used to shift single-family risk to the private sector resemble strategies used in the multifamily sector, said Willy Walker, chairman and CEO of the multifamily lender Walker & Dunlop.

The money is nothing to scoff at, but it seems like a paltry sum compared to what executives at money-center banks command

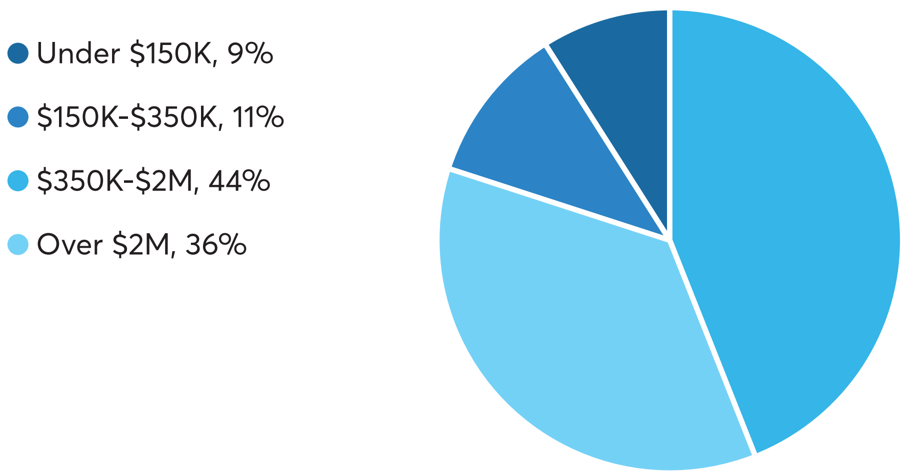
But with presidents who were promoted from within already in place to take care of internal operations, the GSEs might be more likely to bring in a CEO from outside the company. "They are really looking for a broader, visionary CEO," Walker said.

"Despite all these issues," said David Battany, executive vice president of capital markets at Guild Mortgage."I think they still will get lots of people who will demonstrate an interest who are qualified, but it's not going to be like your typical search."

"It could be, for example, somebody who is maybe approaching retirement, and wants to end their career on a note where they are doing something for the public good. "**ASR**

Small business lending

Over $24.5 billion of SBA 7(a) loans were originated year-to-date in fiscal year 2018



Source: Small Business Administration

For What It's Worth

The Appraisal Institute is lobbying against proposals to raise the waiver limit on evaluation requirements for SBA-backed loans

By Brad Finklestein

The U.S. House of Representatives passed two bills that would tie appraisal requirements for Small Business Administration loans to bank regulators' requirements for all commercial real estate loans. But the plan has been met with opposition from the Appraisal Institute, which claims the SBA will take on unnecessary risk if its members are cut out of transactions.

Following a rule change by federal regulators earlier this year, banks are not required to obtain appraisals on the collateral backing commercial real estate loans if the property is worth less than $500,000. Previously, the threshold was $250,000.

The bills, HR 6347, the 7(a) Real Estate Appraisal Harmonization Act, and HR 6348, the Small Business Access to Capital and Efficiency Act, would remove the current statutory $250,000 limit for SBA loan appraisal waivers and instead rely on the banking regulators' standards. Both bills passed on a voice vote taken on Sept. 25, and are in the Senate.

The higher thresholds would "virtually eliminate" the need to get appraisals for SBA 7(a) and 504 loans, the Appraisal Institute warned in a letter to House Speaker Paul Ryan. And while banking regulators require CRE lenders to obtain property evaluations on collateral eligible for appraisal waivers, a similar requirement is not included in the SBA bills. As a result, the bills "fail to fully align the SBA requirements" with the agencies' rules, the Appraisal Institute letter reads.

The Appraisal Institute "is making a mountain out of a molehill" when it comes to the pair of bills, said Chris Hurn, CEO of Fountainhead Commercial Capital, an SBA 504 lender based in Orlando, Fla.

Nonbank lenders like Fountainhead "are just as careful as any regulated entity. And we should be, or we will go out of business," Hurn said.

The bills "fail to fully align the SBA requirements" with the agencies' rules, the Appraisal Institute states in its letter to Paul Ryan.

Currently, the SBA does not require lenders to obtain property evaluations on loans exempt from appraisal requirements. But the SBA could require evaluations in the future, regardless of the bills' outcomes, an agency spokeswoman stated.

By not specifying how SBA lenders should assess the value of collateral, the bills are "too broad" and nonspecific, such as "whether it's an appraisal, whether it's a commercial evaluation or even a broker price opinion," said Randy Fuchs, the principal at Boxwood Means, a Stamford, Conn., company that provides evaluations on small-balance commercial loans.

The goal of the bills is to reduce both lender third-party borrower costs, Fuchs said. "We would hope further discussions about the legislation would refine it so that the minimal tool … would be evaluations." **ASR**