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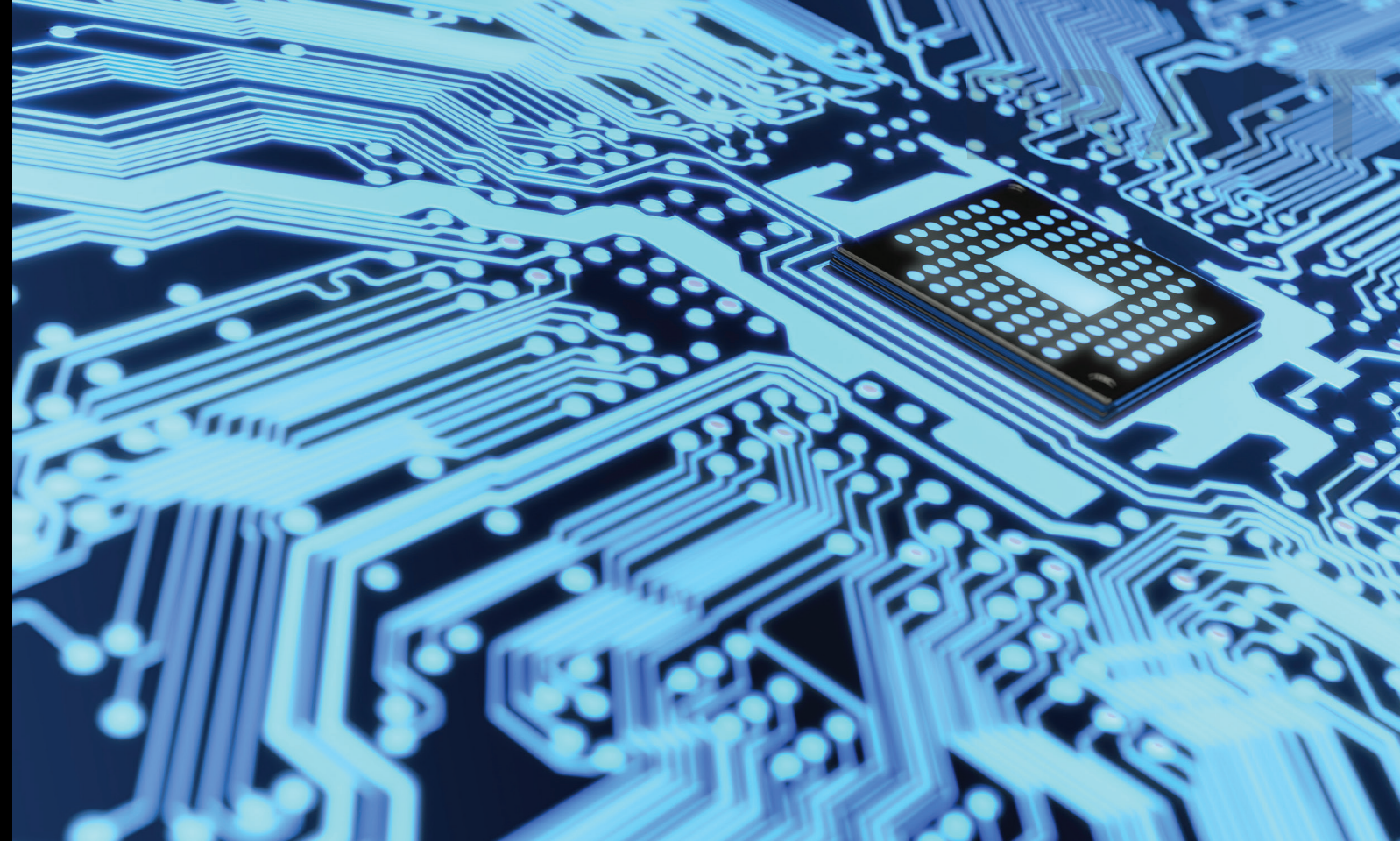
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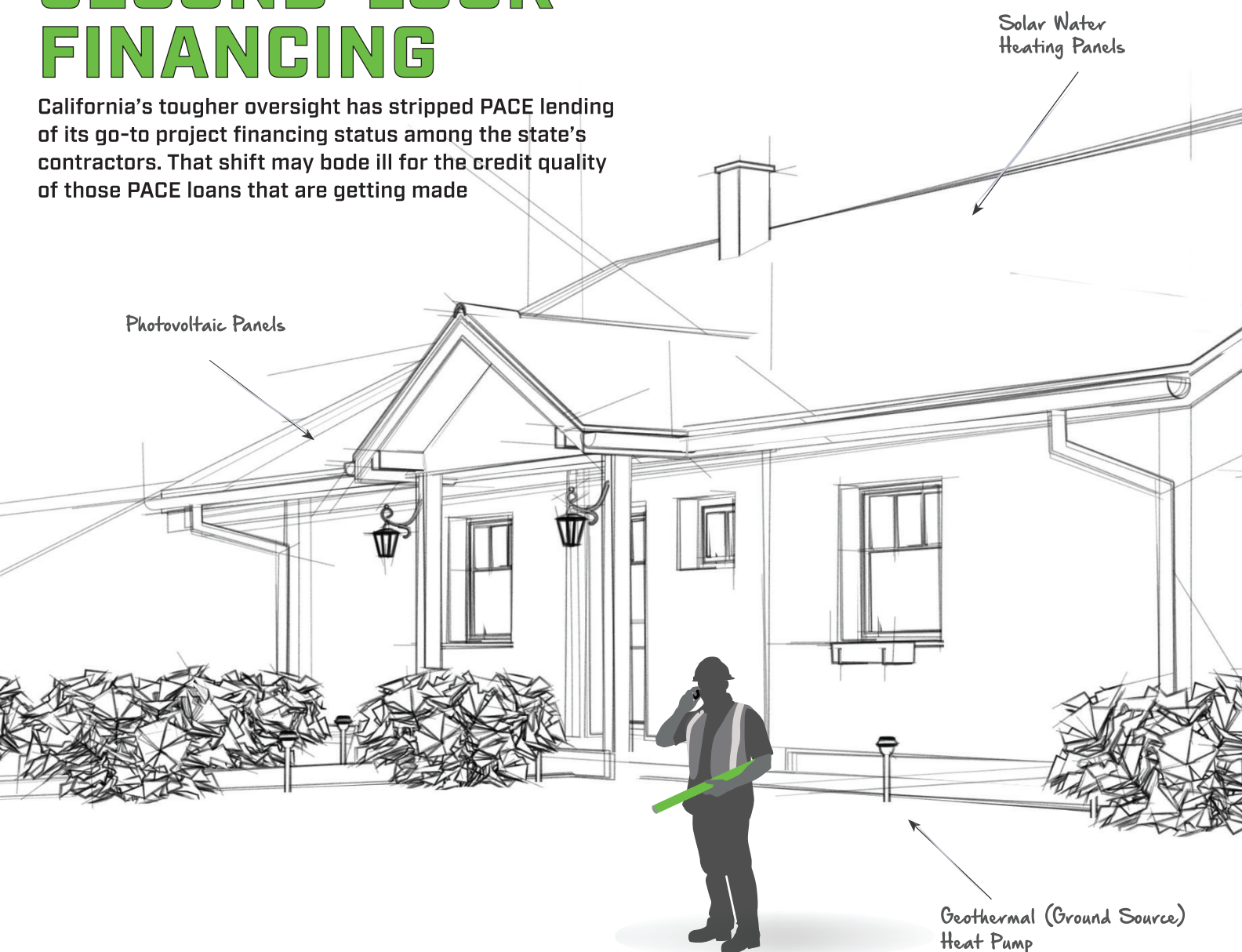
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## SECOND-LOOK FINANCING

California's tougher oversight has stripped PACE lending of its go-to project financing status among the state's contractors. That shift may bode ill for the credit quality of those PACE loans that are getting made





**RICK D'EMILIA**  
rdemilia@wilmingtontrust.com  
212.941.4414



**STEVE O'NEAL**  
skoneal@wilmingtontrust.com  
972.383.3155



**PATRICIA SCHULZE**  
pschulze@wilmingtontrust.com  
302.636.6104

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## **California is the Future**



In September 2017, when the California legislature passed bills that provide strong consumer protections and a regulatory framework for the state's residential PACE programs, most of the clean energy financing industry cheered. Lenders believed it was necessary to embrace income verification and ability-to-repay standards if they wanted to keep growing.

Since the regulation took effect in April 2018, however, origination has fallen sharply. PACE providers who thought they were signing on for oversight similar to that of mortgage lenders now feel they are at a disadvantage, in some respects.

The drop in origination volume isn't the only concern, however. It seems that the new regulation is leading to some adverse selection, as contractors are unlikely to recommend PACE to borrowers who can qualify for any other form of financing. PACE no longer offers the ease of approval and minimal documentation that made it so appealing. And contractors are now required to do a better job explaining this unique form of financing, which is secured by a lien senior to that of a mortgage and repaid via an assessment on a homeowner's property tax bill.

California's experience indicates what's at stake as the Consumer Finance Protection Bureau starts to consider rules requiring consumers nationwide to undergo ability-to-pay analysis before in order to be approved for PACE financing.

The market for PACE financing in California may never recover to the levels seen in 2016 or 2017, when originations topped \$1 billion. But at least it will be a safer product. James Vergara, managing director of capital markets at PACEFunding, points out that even if PACE is marketed primarily to homeowners who can't access unsecured loans, it will be funding energy efficiency improvements that wouldn't get installed otherwise. "From an impact standpoint, that accomplishes what it was set out to accomplish," he says.

— Allison Bisbey



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# ASR SCORECARDS

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# Remedy for 'True Lender' Lawsuits Already Exists

Regulators should consider guidance nearly two decades old to end uncertainty about the legality of certain bank partnerships

By Mark Dabertin

Online lenders continue to be plagued by "true lender" lawsuits that challenge whether the named lender in loans made through a partnership between a nonbank lender and a regulated bank is actually an artifice in a "rent-a-bank" scheme.

In such lawsuits, the plaintiff indirectly alleges that the bank is not the lender by arguing that the nonbank, which typically markets, services and invests in loans made under the program, is in fact the true lender. Because the nonbank lacks the legal ability to charge the rate of interest being assessed by the bank, the result of a successful true lender lawsuit is that the loans are deemed unlawful and unenforceable. The objective in such cases is to unmask the nonbank party to a loan program relationship as, in other words, a "wolf in sheep's clothing."

The resulting legal uncertainty dissuades the vast majority of banks from engaging in such programs, which have the potential to expand the availability of credit to underserved borrowers. The uncertainty concentrates such programs into a handful of banks, driving the high costs of such loans still higher.

The good news is that a potential means for ending this problem already exists. Federal bank agency opinions issued two decades ago in connection with then-newly authorized interstate branch banking could be used to clarify the issue. If the plaintiffs in a true lender lawsuit were to directly challenge whether the named bank lender actually made the loans, the bank would likely prevail based on the interpretations of the National Bank Act set forth in the Office of the Comptroller of

the Currency's Interpretative Letter 822 or the Federal Deposit Insurance Act in the Federal Deposit Insurance Corp.'s General Counsel Opinion No. 11.

The OCC issued Interpretative Letter 822 on Feb. 17, 1998, in response to the Neal-Riegle Interstate Banking Act of 1994, which brought about interstate branch banking and created the possibility that a national bank could be subject to the usury laws of more than its home state. The OCC said it would be "nonsensical" for a national bank to be expected to engage in a nationwide lending business "without a reference point for determining appropriate state interest rate law."

As a result, it created a three-part test in the letter for conclusively determining where a national bank is "located" when it makes a loan. This same test was adopted by the FDIC several months later in its opinion.

Under the three-part test, the activity of making a loan is boiled down to the decision to approve the loan, the communication of the approval decision and the physical disbursement of the proceeds. If any one of these activities takes place in the bank's home state, it may choose to charge its home state's interest rates to all borrowers. As a general rule, the fact that a bank subcontracts marketing, loan servicing or other "ministerial," or nonessential, lending activities to third-party service providers has no effect on the bank's ability to export its home state's interest rate.

To this end, the Bank Service Company Act expressly authorizes banks to utilize the services of third-parties. There is no "tipping

point" beyond which a servicer becomes the lender.

Yet federal bank agency guidance is silent regarding true lender risk, despite the growing number of states in which such lawsuits have arisen. The FDIC published draft third-party lending guidance in July 2016 that had the potential to provide some clarity, but it is still pending. Moreover, the guidance merely observes in a footnote that "courts are divided on whether third-parties may avail themselves of such preemption."

As to whether a bank's status as the lender could be undermined by its use of agents, the guidance says nothing. This silence is problematic because, as things stand, one could evaluate the facts of the same loan program and reach opposite conclusions with respect to the program's status under usury laws depending on whether federal interest rate preemption rules or judge-made, state true lender rules are applied.

In drafting the 1998 guidance, the OCC's goal was to avoid having confusion over the interest rate exportation rule of the National Bank Act, mirrored in the Federal Deposit Insurance Act. Such confusion results whenever state authorities create or adopt legal tests that contradict federal banking agency interpretations of federal law.

The OCC or FDIC have the tools they need to end this legal uncertainty, if they so choose. **ASR**

*Mark Dabertin is special counsel in the financial services practice group of the law firm Pepper Hamilton in Berwyn, Pa.*

# GSE Reform Should Include Capital Rule Changes

Policymakers must address the problem of capital arbitrage to avoid overleveraging the mortgage system

By Alex J. Pollock

Acting Federal Housing Finance Agency Director Joseph Otting has certainly gotten the mortgage market's attention.

To the great interest of all concerned, but especially to the joy of the speculators in Fannie Mae and Freddie Mac's shares, he recently told agency staff that the FHFA and the Treasury would be working on a plan to soon take Fannie and Freddie out of their 10 years of government conservatorship. Their share prices jumped.

The joy — and the share prices — have since moderated, after more careful comments from the White House. Still, it appears that any near-term change would have to be done by administrative action, since there is zero chance that the divided Congress is going to do so by legislation.

The FHFA and Treasury can do it on their own. They put Fannie and Freddie into conservatorship and constructed the conservatorship's financial regime. They can take them out and implement a new regime.

But should they? Only if, as part of the project, they remove the Fannie and Freddie capital arbitrage which leads to the hyper-leverage of the mortgage system.

Running up that leverage is the snake in the financial Garden of Eden. As everybody who has been in the banking business for at least two cycles knows, succumbing to this temptation increases profits in the short term but leads to the recurring financial fall.

Leverage is run up by arbitraging regulatory capital requirements in order to cut the capital backing mortgages. Before their failure, when they had at least had some capital,

Fannie and Freddie still served to double the leverage of mortgage risk by creating mortgage-backed securities.

Here's the basic math. The standard risk-based capital requirement for banks to own residential mortgage loans is 4% — in other words, leverage of 25 to 1. Yet if banks sold the loans to Fannie or Freddie, then bought them back in the form of mortgage-backed securities, Fannie and Freddie would have capital of only 0.45% and the banks only 1.6%, for a total of 2.05%, due to lower capital requirements for the government-sponsored enterprises.

Voila! The systemic leverage of the same risk jumped to 49 from 25. This reflected the politicians' chronic urge to pursue expansionary housing finance. Now that Fannie and Freddie have virtually no capital, even the 0.45% isn't there. The risks of the assets are the same no matter who holds them, and the same capital should protect the system no matter how the risks are moved around among institutions — from a bank to Fannie or Freddie, for example. If the risk is divided into parts, say the credit risk for Fannie or Freddie and the funding risk for the bank, the sum of the capital for the parts should be the same as for the asset as a whole.

But the existing system abysmally fails this test. If 4% is the right risk-based capital for mortgages, then the system as a whole should always have to have at least 4%. If the banks need 1.6% capital to hold Fannie and Freddie mortgage-backed securities, then Fannie and Freddie must have 2.4% capital to support their guarantee, or about five times as much

as their previous requirement. If Fannie and Freddie hold the mortgages in portfolio and thus all the risks, they should have a 4% capital requirement, 60% more than formerly.

The FHFA is working on capital requirements and has the power to make the required fix.

Bank regulation also needs to correct a related mistake. Banks were encouraged by regulation to invest in the equity of Fannie and Freddie on a super-leveraged basis, using insured deposits to fund the equity securities. Hundreds of banks owned \$8 billion of Fannie and Freddie's preferred stock. For this disastrous investment, national banks had a risk-based capital requirement of a risible 1.6%, since changed to a still risible 8%. In other words, they owned Fannie and Freddie preferred stock on margin, with 98.4%, later 92%, debt.

In short, the banking system was used to double leverage Fannie and Freddie. To fix that, when banks own GSE equities, they should have a dollar-for-dollar capital requirement, so it really would be equity from a consolidated system point of view. Fannie and Freddie will continue to be too big to fail, even without the capital arbitrage, and will continue to be dependent on and benefit enormously from the Treasury's effective guarantee. They need to pay an explicit fee for the value of this taxpayer support. **ASR**

*Alex J. Pollock is a distinguished senior fellow at the R Street Institute in Washington. He was president and CEO of the Federal Home Loan Bank of Chicago from 1991-2004.*

# Second-Look Financing

California's tougher oversight has stripped PACE lending of its go-to project financing status among the state's contractors. That shift may bode ill for the credit quality of those PACE loans that are getting made

By Allison Bisbey

It used to be very easy to qualify for Property Assessed Clean Energy financing in California, and that made it a popular option with many contractors pitching energy and water efficiency upgrades. PACE creates a lien that is repaid via a homeowner's property taxes, and until recently, it was not subject to the same kinds of consumer protections as a mortgage; the primary requirement was having enough equity in your property. A homeowner looking to replace windows or an HVAC system or install solar panels could be approved for financing within a few minutes.

Between January 2014 and June 2018, over \$3 billion of efficiency upgrades were financed with PACE, according to data from the California State Treasurer.

Not everyone with equity in their homes can afford to pay thousands of dollars a year in additional property taxes, however. After several years of criticism from consumer advocates that contractors misrepresented how the financing works, legislation was passed late in 2017 establishing new underwriting guidelines for PACE that include income verification



and ability-to-pay standards.

Since the rules took effect in April 2018, origination has fallen sharply. In the first half of last year (the latest data available from the California State Treasurer), new financing was \$430.4 million, less than two-thirds of the \$677.9 million financed in the second half of 2017.

PACE administrators say contractors are now much less likely to suggest this form of financing unless a homeowner is unable to qualify for any other kind of financing, such as a home equity loan or unsecured loan.

"It's become more of a second-look product," said James Vergara, managing director of capital markets at PACEFunding.

Vergara attributes this to the additional time now required to underwrite PACE. "In general, before we could just approve a borrower in five to 15 minutes; now we have to collect income documentation, we have to have an underwriter verify that the documentation matches the borrower's stated income, run a [payment] waterfall and come up with an [assessment of] ability to pay and have it work," he said.

PACEFunding is a relative newcomer in California, so it hasn't had to make as many changes to its underwriting process as some bigger competitors; the lender's origination volume has actually been rising, albeit from a low level. "The way we've grown our volume over the past year is by investing in headcount and staffing up," Vergara said. "We have more people involved in the underwriting process and confirmation process. We've also invested in technology to help streamline the income-verification process."

Not only is overall PACE origination volume down sharply, however; there also appears to be some adverse selection. Since borrowers with better credit are less likely to get pitched on PACE, the credit

quality of the pool of applicants has declined.

In a statement provided to ASR, Renovate America, the biggest PACE administrator in California, said that the state's underwriting criteria are in many cases less flexible than those of the Federal Housing Administration and, to some extent, Fannie Mae. For example, borrowers who made a single late payment on a mortgage in the past 12 months are now ineligible. Borrowers are also excluded for two years after exiting bankruptcy; and if they make a single late payment in those initial two years, they can be excluded from taking out PACE financing for up to seven years.

"These underwriting criteria are arbitrarily removing homeowners who might otherwise pass the income verification screen," Greg Frost, a spokesman for Renovate America, said in an email.

"At a time when Californians have seen electricity prices rise three times faster than in the rest of the country, when the bankruptcy of PG&E threatens to raise electricity prices further, and as the need to reduce climate-changing emissions becomes greater by the day, the disabling of PACE carries negative economic and environmental consequences for this state," Frost said.

In the first few months after the income verification component of the law took effect, Renovate America saw a decline in the share of applications from consumers with FICO scores of 661 and higher, and an increase in the share of applications from homeowners with FICO scores of 660 or less.

Frost said this negative credit migration in the profile of applications suggests that home improvement contractors are not leading with PACE in higher credit profile homes because they know the customer does not want to go through the required "hassle factor" when other options are available.

## **Still too soon to see any impact on performance of PACE ABS**

Both the decline in origination volume and the potential for adverse selection are a concern on Wall Street, where PACE liens are bundled into collateral for bonds that can be marketed as "green." Residential PACE securitization volume fell from \$1.5 billion via seven deals in 2017 to \$693 million via three deals in 2018, according to Finsight. Issuance is expected to be around the same level this year, with some of the volume potentially coming from first-time issuers.

While the overall credit quality of applicants may be declining, rating agencies say this is not showing up in pools of PACE liens that have been securitized, at least not yet.

"If businesses are indeed under pressure because of reduced volume due to cumbersome consumer protection laws, the fear of adverse selection is understandable. However we have yet to observe any trends to be able to comment on them," said Rohit Bharill, head of ABS at Morningstar Credit Ratings.

"We are keenly focused on it, but we have not seen any change in origination characteristics" in PACE financing originated in California, said Irene Eddy, the lead PACE analyst at DBRS.

Eddy said it would be too soon to see any change in performance, since homeowners who obtained PACE financing in California after the consumer protection laws took effect have yet to make their first payment.

In February of 2018, DBRS published a report evaluating the performance of PACE financing for the 2013-14 through the 2016-17 tax years in the 10 California counties that have the highest number of liens. It found that the delinquency rate peaked at a range of 2% to 4% one month after the first installment payment was considered past due, and then fell to under 1% within 12 months. In month 22, PACE delinquencies were at "an excep-

tionally low" level ranging from 23 basis points to 27 basis points, DBRS said,

Eddy noted that, over the past year, there has been a shift in the mix of collateral from issuers Renovate American, Renew Financial and Ygrene Energy Fund to include more financing from Florida and Missouri, the two other states with active residential PACE programs.

However, PACE origination has yet to reach a level in either Florida or Missouri that could offset the decline in California. And lawmakers in Missouri have introduced two bills that would centralize oversight with the state's Division of Finance, among other changes, potentially impacting activity in the state.

Consumer advocates question how much the decline in origination volume in California is attributable to the state's consumer protection laws, since the drop began before the new rules took effect.

Origination peaked at \$824.4 million in the second half of 2016, according to the state treasurer's office. So the decline started in 2017.

They note that some fintech lenders, such as GreenSky, have arrangements with contractors for point-of-sale financing similar to those of PACE administrators

### Consumer advocates say current regulations may not be adequate

Consumer advocates are also unhappy with the new regulation, though for different reasons. "Our experience is that the new laws have not as yet translated to a decline in complaints about the PACE program," said Jennifer Sperling, an attorney at law firm Bet Tzedek. "Because of the delay between funding and recording of a PACE lien onto the property, clients

whose transactions funded after July 1, 2018 will not see their first property tax increase until they receive their 2019-2010 property tax bill in October 2019. For that reason, it is too soon to tell whether the new laws intended to protect consumers are adequate to fully do so."

Sperling added, "For the clients we have encountered who entered into transactions after April 2018, we are still investigating, but it is not clear if all of the new requirements are being followed."

In January 2018 comment letter, Bet Tzedek and eight other legal services organizations said that the laws do not go far enough to protect consumers. Among other shortcomings, contractors are only obliged to make a "reasonable estimation" of a consumer's ability to meet "basic household living expenses," and that estimation can be based on number of people living in the house. The signatories believe that contractors should be required to inquire about caretaking, medical expenses and debt.

"The 'finance first, evaluate later' business model implied [in the new law] is

unlikely to prevent extension of credit to homeowners with inadequate ability to repay," the letter states.

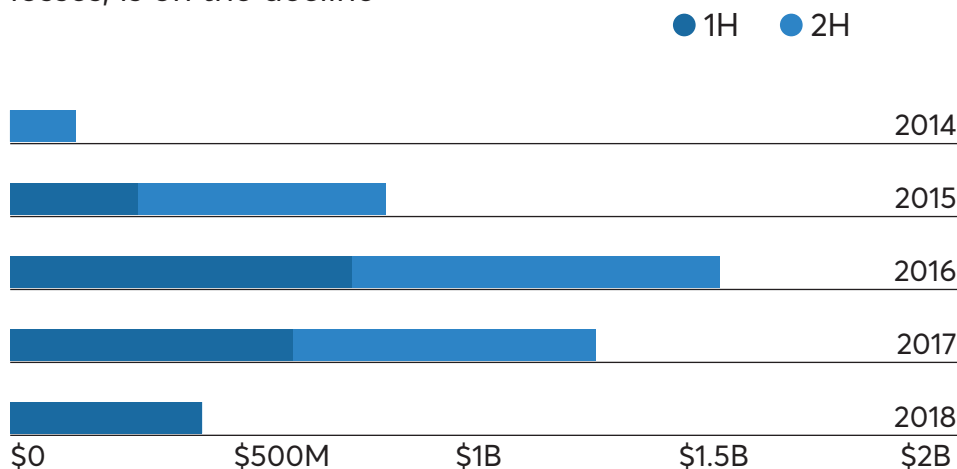
Among other areas ripe for rulemaking, the signatories said, are tracking of price data for PACE-eligible products and services.

With both PACE officials and consumer advocates pushing for changes, it remains to be seen whether this form of financing will regain its former appeal with either contractors or homeowners. If nothing else, lenders are hopeful that the expansion of eligible upgrades to include weather resiliency will help. The same legislation gave communities in high fire zones the ability to use PACE to finance wildfire safety improvements

"I hope that the market recovers to the heights we saw in 2016 or 2017," Vergara said. "It should be safer product for folks who really need it, who can't access unsecured loans. So it's funding improvements that wouldn't get installed otherwise. From an impact standpoint, that accomplishes what it was set out to accomplish."

## Slower PACE

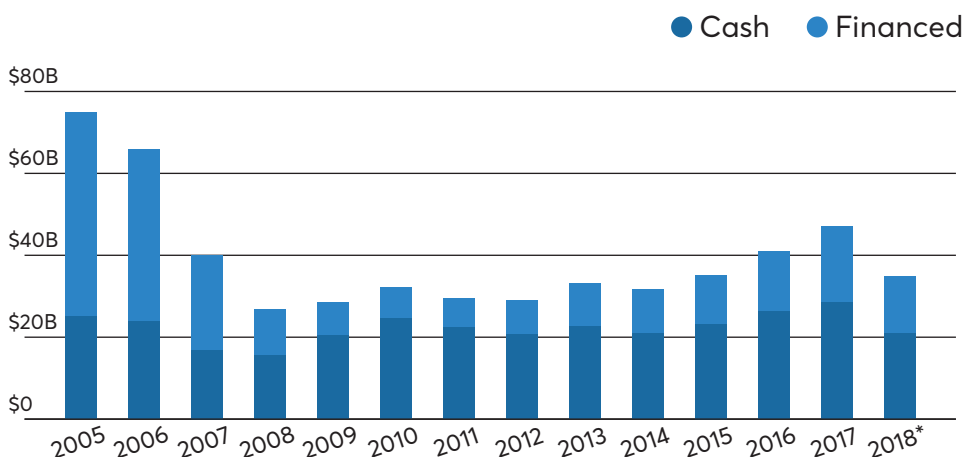
Origination in California, as measured by enrollment in a program designed to compensate mortgage lenders for losses, is on the decline



Source: California State Treasurer

## On the flip side

The dollar volume of fix-and-flip purchases using financing increased every year between 2011 and 2017



Source: Attom \*Through 3Q18

## Rated Deals May Whet Appetites for Fix-and-Flip

Investors are increasingly relying on financing to flip houses; so far, only Morningstar is developing rating criteria for the asset class

By Brad Finkelstein

Plans to begin rating securitizations backed by fix-and-flip mortgages may help lenders create new capacity and satisfy growing demand for short-term financing of house flipping projects.

While the majority of house flippers still use cash, the share of projects that are financed has hovered around 40% since the second quarter of 2017. That's up from a low of 21.4% in the first quarter of 2011, but well below the peak of 67.7% in the third quarter of 2005, according to Attom Data Solutions.

The securitization market for fix-and-flip

loans is still relatively small. But rated securitizations could change that by injecting fresh capital from institutional investors that won't buy bonds without a third-party assessment of their risk. Morningstar Credit Ratings, for one, is currently developing criteria to rate fix-and-flip securitizations in anticipation of the opportunity.

"These deals might become more commonplace, as investors and issuers become more aware of these securitizations," the ratings agency said in a recent report.

There are a number of factors behind this

trend. As the price to acquire properties continues to rise, house flippers are increasingly turning to financing to fund their projects. Lenders are more willing to offer fix-and-flip financing as a way to offset mortgage volume lost to rising interest rates. And that drop in originations also has investors in search of new ways to deploy capital.

But ultimately, Wall Street's willingness to invest in securitizations backed by fix-and-flip loans will drive the niche product's growth prospects in 2019.

Fix-and-flip loans are secured by a lien on the property, similar to a traditional mortgage, but with lower loan-to-value ratios than owner-occupied financing. In most cases, fix-and-flip financing have a draw feature like construction loans and consist of interest-only balloon loans, with terms typically no longer than three years.

"I think it's pretty interesting because you can lend on something with reasonable interest rates with a 50% LTV," said Michael Nierenberg, CEO of New Residential Investment Corp. "We really haven't done a lot of volume there. We're starting to offer the product through our mortgage company, but there really hasn't been a lot of volume."

New Residential does cleanup calls on the nonagency residential mortgage-backed securities it services. As a result, it acquires nonperforming loans and foreclosed properties.

"It would be great to offer consumers and fix-and-flip buyers mortgages that would go along in parallel with the properties that we're offering,"

Nierenberg said.

Its recently acquired mortgage origination subsidiary NewRez, formerly New Penn, is "now beginning to offer some products, out in conjunction with some of the folks that are purchasing REO," he said. "But in general, there's been very little done by us."

Having a securitization outlet for the product only enhances New Residential's interest. Nierenberg compared its potential to the growth of lending outside qualified mortgage requirements and other private-label securitizations in the post-crisis era.

"I think down the road you'll see some rated deals, similar in nature to how the non-QM market started," he said. "Initially, very quiet and now we're starting to see a little bit more activity."

Marketplace lender and single-family bridge loan specialist LendingHome did six securitizations of fix-and-flip loans from 2016 to 2017, totaling nearly \$183 million, but none were rated. While it did not do any securitizations in 2018, there was an unrated transaction from Angel Oak issued in March and another from Civic Financial Services in May.

"This asset class has come out of the 'mom and pops' and out of the country clubs, so to speak, and into the mainstream," said Josh Stech, a senior vice president at LendingHome. "When something comes from Main Street to Wall Street, it comes with a tremendous amount of oversight and sophistication," Stech said.

In California alone, the percentage of flips purchased with financing was 48% in 2017, up from 36.5% in 2014, according to a LendingHome report based on data from the lender and Attom. During 2017, 48,020 homes were purchased in the state to be flipped, up from 28,646 in 2014. The current growth in financing is a result of diminished returns for investors. Because of leverage, they can make more when they sell a property where they financed the purchase versus one that they

used their own money, according to an Attom report for second quarter 2018.

Lenders price fix-and-flip loans better than construction loans because of the shorter duration, which reduces risk, said Builders Capital CEO Curt Altig. There is much less risk in rehabbing an existing property compared to a brand-new construction project.

Builders Capital's primary business is construction lending. But in its primary market in the Puget Sound area in Washington state, there is a limited amount of available land to build new homes.

"What we began to notice was our builders were having to source different types of properties," like redeveloping existing homes to keep their pipeline going, Altig said, adding the fix-and-flip loans are very similar to construction loans, but with just one or two draws.

While 75% of its business is in the Puget Sound market, it also lends in the Portland, Ore.-Vancouver Wash., area along with the Colorado Springs and Denver markets.

"We have ambition to grow outside of [those areas]," as it looks to take advantage of this burgeoning market, Altig said.

Securitization will lead to enhanced liquidity and investor interest in these loans, something which has been happening over the past few years. But fix-and-flip financing also comes with unique credit risks that make it more difficult to rate securitizations back by the loans.

"The credit risks as we view them include abandonment of the properties because of lower-than-expected profits owing to a miscalculation of the rehab costs, property valuation, or a decline in the demand, which would require the properties to be sold for a longer period of time or at a lower price," said Youriy Koudinov, a Morningstar senior vice president and analyst who wrote its recent report.

At the Structured Finance Industry Group's February 2017 conference in Las Vegas, 35% to 40% of Morningstar's

meetings were about fix-and-flip loans and the possibility of doing securitizations, said managing director Kevin Dwyer. "Now that the unrated deals have been done in the market, we think there is a higher chance of rated deals coming," he added.

So far, none of the other rating agencies are developing their own criteria. "We do not have a methodology to rate fix-and-flip loans," said Jack Kahan, managing director, RMBS for Kroll Bond Rating Agency. "However, we're always evaluating new opportunities and we have been active in discussions with a number of market participants in the space."

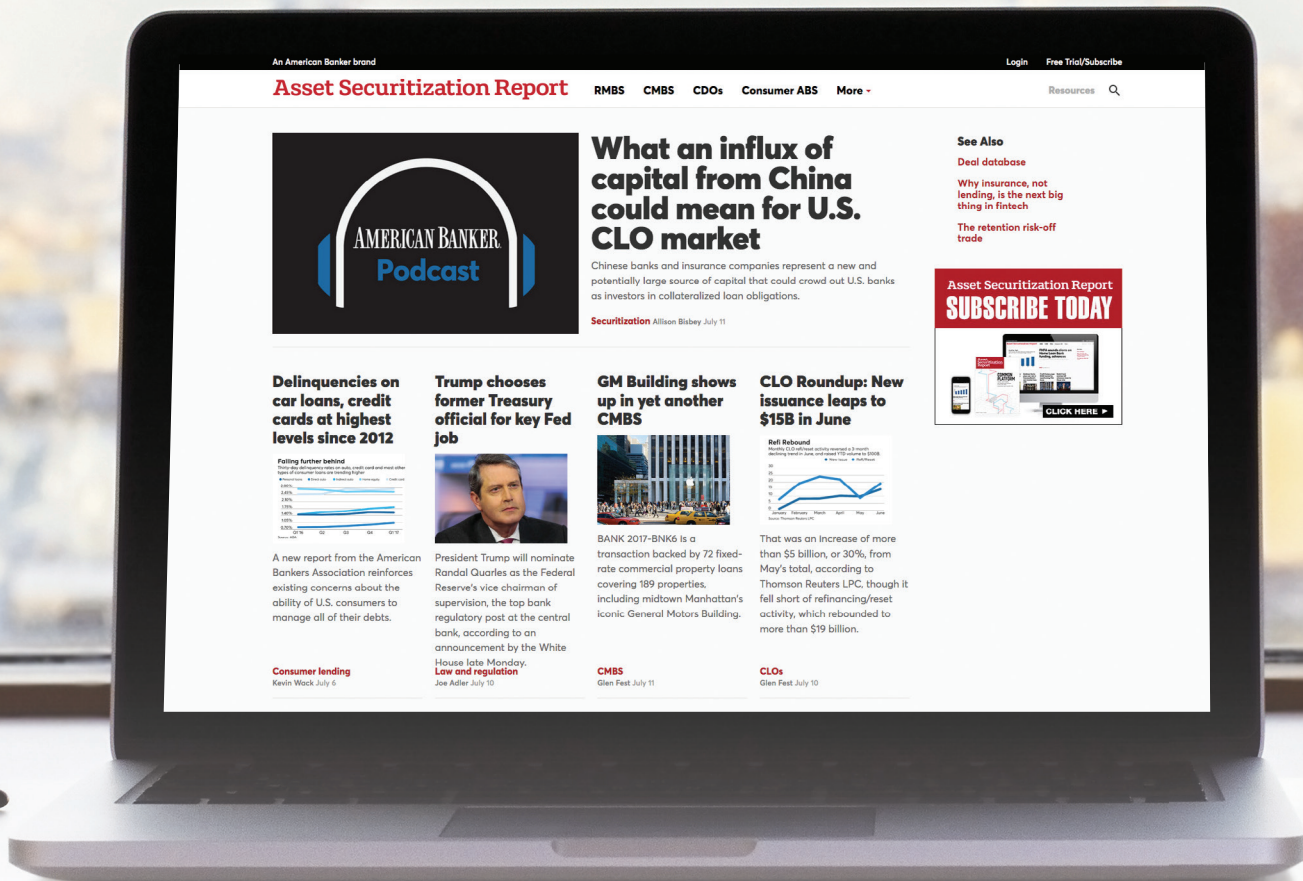
Likewise, Moody's Investors Service and Fitch Ratings have not created specific methodology or rated any fix-and-flip securitizations.

"The biggest obstacle for us is the lack of historical performance data of the product through an economic stress," said Grant Bailey, who heads the U.S. RMBS team at Fitch. "The low LTVs are a big mitigating factor. However, there's some uncertainty about how the take-out of the fix-and-flip loan would hold up in a stress environment where both buyers and lenders are pulling back."

Despite the optimism, it's possible the demand for fix-and-flip lending has already peaked. Taking the opposite view for fix-and-flip lending's prospects is Hunton Andrews Kurth, a law firm whose practice includes structured finance. The firm was the issuer's counsel for a fix-and-flip securitization in 2018, as well as the asset manager's counsel for a different transaction.

Fix-and-flip lending and securitizations will slow, given the downturn in the housing market along with higher borrowing costs and low property inventory in many regions, the firm wrote in a recent market outlook report. "Secondary market whole loan sales will most likely continue to be the preferred takeout option for originators and lenders," Hunton said in the report. **ASR**

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# Bridging the Pond: Resolving conflicts between US and EU risk retention rules



**MODERATOR:**  
**Reed D. Auerbach**, Partner,  
Morgan, Lewis & Bockius LLP

With the evolution of risk retention rules, challenges abound for dealmakers who transact globally. It's a daily struggle to determine where U.S. rules and EU rules overlap, where the requirements vary and what transaction structures will be economically advantageous as well as compliant. To discuss these issues and what lies ahead for the industry, Asset Securitization Report hosted a roundtable that included participation from brokers, attorneys and lenders. Sponsored by Morgan Lewis, what follows is an excerpted version of the conversation.

**Auerbach:** Charlie, can you give us an overview of the U.S. risk retention requirements?

**Sweet:** In broad strokes, the Dodd-Frank Act rules require 5% risk retention, either as a vertical slice of 5% of all ABS interests issued in the deal, or as a 5% GAAP fair value horizontal piece, which is basically the most subordinated piece in the capital stack. Or a combination of the two. There are special risk retention methods for some types of deals, such as CMBS, ABCP and master trusts.

## PARTICIPANTS



**Bill Heskett**  
Managing Director,  
Head of ABS  
Banking,  
Cantor Fitzgerald



**Paul Matthews**  
Partner,  
Morgan, Lewis &  
Bockius LLP



**Karan Mehta**  
Head of Capital  
Markets,  
Marlette Funding




**Francisco Paez**  
Head of Structured  
Finance Credit,  
MetLife Investment  
Management



**Charles A. Sweet**  
Partner, Morgan,  
Lewis & Bockius  
LLP



  
**Paul Vanderslice**  
CEO,  
Cantor Commercial  
Real Estate  
Not pictured

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**Auerbach:** Paul, how does that compare to the European Union's (EU) regulations?

**Matthews:** The EU risk retention rules also require 5% credit risk retention, but they approach it differently from the U.S. in several respects. For example, the EU rules permit risk to be held as 5% of the nominal value of each investor tranche, which is like the U.S. vertical option, or as a first loss tranche of 5% of the nominal value of the securitized exposures, which is similar to the U.S. horizontal option but with a different valuation method, although you can't combine these methods. No value is given to excess spread under the EU rules. And there are a variety of other differences.

**Sweet:** And those differences can make structuring dual-complaint deals very tricky.

**Auerbach:** So what's new as of January 1, 2019 in the EU scheme?

**Matthews:** Even before then, EU-regulated investors in securitizations were required to ensure that transactions in which they invested complied with risk retention requirements as well as a number of other regulations, including due diligence and transparency requirements. Two sets of changes came into effect on the first of January 2019 – one relates to the changes to the capital treatment for banks and investment firms for securitization positions, and the other relates to due diligence requirements, risk retention and disclosure requirements for securitizations.

The regulators introduced an STS regime, which stands for "simple, transparent, and standardized" securitizations. This is a regime where the EU is trying to encourage securitizations to be as standard and straightforward as possible, by providing that transactions that comply with the STS regime can receive favorable capital treatment. However, there are numerous criteria that need to be met for a transaction to qualify for an STS designation, the first of which is that the originator, issuer and the



sponsor need to be EU entities. As a result, investing in U.S.-sponsored transactions could require EU investors to hold higher capital relative to their EU counterparts that comply with the STS regime.

The EU risk retention regime historically was imposed indirectly, by placing the onus on investors to ensure that they invested in compliant deals, versus directly on the sponsor as in the U.S. system. The EU regulations now also impose direct obligations on sponsors, originators, original lenders and issuers, with an apparently unintentional extension in some circumstances to U.S. affiliates of EU institutions. They also indirectly affect securitization market through obligations imposed on a broad group of institutional investors, which now include undertakings for the collective investment in transferable securities, or UCITS, and certain non-EU alternative investment funds. The investors are required to verify credit granting procedures, meaning the criteria and processes for extending credit to borrowers, including the assessment of the creditworthiness of individual borrowers. They're also required to verify that the required retention has been undertaken and disclosed to them. Investors are required to assess the risks of the security position, the underlying assets and the transaction structure, to develop written procedures to monitor their position going forward, to perform stress tests, to make internal reporting to management so that their risk position can be managed, and to be able to confirm to their regulator that they have a thorough and comprehensive understanding of their securitization positions. That's quite a daunting set of provisions for investors.

**Sweet:** So in the EU, the risk retention requirements are embedded in a broader regulatory scheme that includes other investor diligence and transparency



**"The regulators introduced an STS regime, which stands for "simple, transparent, and standardized" securitizations."**

—Paul Matthews

securitizations clumped together, each investor's pool is being valued individually, and therefore their slice of securities and proceeds that they're taking back is not necessarily proportional to the assets that they put in. Risk retention in that context has become a little complicated.

Our approach has been to take a vertical slice, as opposed to horizontal. We have three different majority-owned affiliates and in the securitizations we have done, the required risk retention sits in one of those three affiliates. And so those affiliates are now collateralized by multiple different assets, and each affiliate has a loan, which enables us to finance a significant portion of its risk retention holdings.

requirements, whereas in the U.S., they're more or less a standalone regime.

**Auerbach: Karan, your company, Marlette, is a regular issuer in the ABS markets and you've been complying with the U.S. risk retention regime. How have you done that, what obstacles have you overcome and how have you managed to finance the cost of risk retention in the U.S.?**

**Mehta:** This has certainly been on our mind since the end of 2016. Our situation is somewhat atypical of the marketplace lending sector, not to mention the ABS market as a whole, because we sell whole loans to investors who need access to securitization. And while we stand behind our transactions and we are the issuer, we are securitizing on their behalf, on our own behalf as well as for Cross River Bank, which is the originating bank for the loans. In a sense, this represents multiple

**Auerbach:** When you're allocating the required risk retention internally via your majority-owned affiliate structure, you're not looking at the face value of the loans in the pool, you're looking at what's believed to be the market value of those loans. Is that correct?

**Mehta:** Exactly. Otherwise, you've potentially got some sort of value transfer that was unintentional. For us, there's an efficiency and there's some degree of uniqueness in having majority-owned affiliates set up solely to hold and finance the risk retention interests.

**Auerbach:** Has the market generally adapted to the risk retention rules and how has it impacted the marketing of securities and the cost of securitization?

**Vanderslice:** I can speak with respect to commercial mortgage-backed security (CMBS) markets in the U.S. There is a special method of risk retention for CMBS, which allows a sponsor to transfer its risk retention requirement to a qualified third party purchaser. What it means, as a sponsor, is you can keep a vertical slice, a horizontal slice, or an L-shaped combination. Or you can transfer a horizontal, or a horizontal piece of an L, to a third party B-piece purchaser.

It's interesting, in 2017 there were a total of 73 different U.S. CMBS deals. About 38% of those were done as horizontal, where the interests were sold off to a third-party purchaser, 36% were done as verticals, and 26% were done as Ls. In 2018, about 53% were done as horizontal, which is about 15% higher than 2017. Only 22% were done as verticals, and that's down almost 50% from 2017. And about 26% were done as Ls, which is pretty much flat to last year.

The trend in the market is to sell the horizontal piece to third party B-piece purchasers. I bring it up because that third-party purchase option is not available under



**"Our approach has been to take a vertical slice, as opposed to horizontal."**

—Karan Mehta

the EU rules. If you do a CMBS deal, your only option of moving forward is actually a vertical deal, which will change the market. We keep hearing that at least the direct applicability of the new EU rules to U.S. affiliates of EU entities was a mistake. If this gets fixed, which we hear could take up to six months, it will help, at least for U.S. deals that are not marketed to EU investors. They will still have to be Dodd-Frank compliant, but exempt from the EU rules. We expect in the short run for European banks to lean more toward vertical deals.

**Sweet:** So we've got these very complicated U.S. rules that provide a special method of risk retention, for CMBS, which basically operates as a built-in financing method for any horizontal risk retention, consistent with historical CMBS B-piece practices. And the market seems to have adapted well overall.

**Heskett:** For all issuer categories, there was about a 12-month period where there was a lot of handwringing and industry group analysis on risk retention. Then the market settled in on certain approaches, and unfortunately, the approaches have added extra disclosure and extra diligence costs for most issuers. As an economic matter, maybe the vast majority of larger "flow" ABS issuers were already holding at least 5% skin in the game, so it hasn't been economically off-putting to them to have to document it and stand behind it.

For small or specialty finance companies and marketplace lenders, they've been focused on acquiring the capital they need to comply with the risk retention rules – they have used a myriad of approaches and financing techniques. Additionally, I don't believe that many investors will have significant focus on the type of risk retention that's selected; they mostly will want to make sure that they're going to be investing in deals that are compliant and stay compliant.

**Matthews:** Regardless of whether the direct applicability of the EU rules to U.S. sponsors is narrowed or eliminated, EU investors in U.S. deals still need to make sure that the deals that they invest in are compliant with the EU rules. Which as we discussed makes things complex. L-shaped holdings, for example, aren't permitted under the EU rules. Holding risk retention in a majority-owned affiliate, the third-party B-piece investor option for CMBS, those things don't exist under the EU rules. So to the extent that you have EU investors in U.S. deals, it will be a struggle to use many existing U.S. risk retention structures.

**Vanderslice:** What you're saying is exactly correct. In fact, in the U.S. CMBS market, there are deals that are not EU compliant. The other complication with U.S. CMBS is there is a five-year hold requirement. Assume a transaction has an expected life of 10 years. On the third party purchase option, if you sell a horizontal B-piece to a qualified third-party purchaser, the buyer is only required to hold it for five years. At the end of five years, they can sell it to another qualified third-party purchaser that then has to hold it for another five years. If you do the deal to be EU compliant, there is none of this flexibility.

**Sweet:** That's another general difference between the EU and U.S. rules, the EU rules apply for the life of the deal, but the U.S. rules for most risk retention options have sunset periods. It's hard to make a deal comply with two various sets of rules that are meant to get at the same thing, but that have a lot of very technical differences.

**Vanderslice:** The problem is you will get many fewer European investors in U.S. CMBS deals. You sacrifice the depth of the market in exchange for not being compliant. Certainly, U.S. issuers would love to be able to sell more to European accounts.



**"It's hard to make a deal comply with two various sets of rules that are meant to get at the same thing, but that have a lot of very technical differences."**

—Charles A. Sweet

**Auerbach:** Francisco, on the buy side, when you look at a deal and it's risk-retention compliant, do you have a different view whether the risk retention is vertical, horizontal or L-shaped, or are you okay with it as long as it's compliant?

**Paez:** The whole idea behind risk retention was to help align incentives between issuers and investors. From an investor's standpoint, one of the things that we were hoping that risk-retention may help prevent was the severe decline in collateral quality that we saw leading into the financial crisis. From that perspective, what we try to focus on is really to what extent we are accomplishing that alignment of incentives. That said, one of the things that I shy away from and get a little bit concerned about is when a sponsor takes advantage of mechanisms that mean that it may not ultimately be holding much skin in the game – for example, selling significant equity interests in a majority-owned affiliate to third parties. That's something that's going to turn us off as investors.

**Auerbach:** Do you see a big difference in a vertical holding and a horizontal holding, in terms of incentive for the retention holder?

**Paez:** One of the concerns with horizontal holdings is that there may be diverging types of incentives between issuers and investors. If you are a vertical holder, you basically have the exact same incentives as all the investors. If you're a horizontal holder, then you may have interests that are in conflict with your investors.

**"The problem is you will get many fewer European investors in U.S. CMBS deals."**

—Paul Vanderslice

**Auerbach:** One of the EU changes that went into effect in January was an expansion of the types of investors that need to comply with the rules. Among these are the UCITS that we've been hearing a lot about. How might this change affect the marketplace?

**Heskett:** U.S.-based asset managers are just beginning to consider the impact of increased UCITS regulation on their offshore managed funds.

**Paez:** The fact that you're asking UCITS to comply with these requirements certainly adds a burden. The main question for an investor is the extent that a deal is reasonably attractive from a relative value standpoint, after considering any potential burdens. As a regulated entity ourselves, we deal with this balancing act all the time, and to the extent that those deals are attractive from a relative value perspective – including any capital or other burdens – those are deals that any investor would look at.

On that note, one important challenge we see is the risk capital treatment of securitizations under the EU rules. That has made many securitization investments less attractive for EU-based insurance companies, pension funds, and banks. I think UCITS don't really have that issue, but some of their clients may.

Relatedly, I think that the big question is really, what is that universe of EU-compliant deals today? This will shape the demand of EU-based UCITS clients. For

**"Most of the U.S. ABS, on a volume basis, are sold to large asset managers."**

–Bill Heskett



**"The whole idea behind risk retention was to help align incentives between issuers and investors."**

–Francisco Paez

example, our interpretation is that non-European deals are not going to be STS eligible. From that perspective, I think that is something that's going to take away some of the potential demand that you could have from regulated investors in the EU, including UCITS clients, because the capital treatment that you're going to get for non-European deals is not going to be that attractive.

**Matthews:** I don't want you to hold your breath, but the European Commission has been instructed to report by 2022 on whether or not STS treatment should be expanded to cover equivalent regimes in other jurisdictions.

**Auerbach:** Has there been feedback as to how the application of the new EU rules to UCITS would affect the marketability of U.S. deals?

**Heskett:** We've started asking the question. Most of the U.S. ABS, on a volume basis, are sold to large asset managers. And they are gathering funds across the globe and then making the investment decisions out of the U.S. If they have investors that place funds with them, or parts of their asset management operation, that are UCITS, it's going to cause them at the very least a complication. More likely, a shrinkage in demand.

**Auerbach:** Is there an element of the new EU rules that impacts asset-level data disclosures?

**Matthews:** Yes, the rules require asset-level data disclosures but even for EU issuers the templates aren't finalized.

**Sweet:** Which in any event are different from U.S. asset-level data requirements, and even then those apply only to some public asset classes. So a U.S. sponsor might not have the systems to provide asset-level data for an

EU deal, and even if they do it may not capture all the same fields.

**Auerbach:** Is it too soon to tell whether the applicability of the EU rules to a broader investor base will make it more compelling for a U.S. issuer to try to be dual-compliant?

**Mehta:** For us, ensuring dual-compliance on a deal where just a small fraction of demand is coming from Europe on its own sounds like a pretty heavy lift financially. I've reconciled myself to the idea of potentially doing Euro-only deals. What if we take \$100 million or \$200 million of assets, find a way to transfer them into a Euro region, get STS compliant, line up the investors in Europe with a few large money managers, and just to do a pure Euro-focused deal that we don't market in the U.S.? We could do our U.S. deals separately.

**Sweet:** The question really is, what are the costs of splitting your existing deal into two deals, one for the U.S. and one for the EU? Is it more or less expensive than trying to structure a single deal to comply with all of these various sets of rules?

**Paez:** Right.

You have really reduced the universe of European investors for whom U.S. securitizations will be attractive due to the capital rules associated with STS until there's some sort of alignment of the compliance regime. From that perspective, you really are going to be talking about the non-bank, non-insurance, non-pension funds as the only segment of the investor world that won't be adversely affected by the capital treatment associated with non-STS securitizations. In that sense, I frankly don't know whether or not the critical mass exists to justify for the issuer the burden of going through this process. I think the jury's still out.



**"One of the EU changes that went into effect in January was an expansion of the types of investors that need to comply with the rules."**

—Reed D. Auerbach

**Auerbach:** While the scope of the EU rules and their implementation are being developed, what are we supposed to advise clients?

**Matthews:** There's the element of watching and waiting and complying as far as we can. Some issuers are comparing what disclosure is typically being given with what's applicable under these interim provisions, and trying to comply as far as they can with those rules pending clarity on the more extensive rules anticipated in the next 18 months or possibly longer. There are potentially significant penalties under the EU rules and so there is some degree of discomfort among market participants that are paying close attention to these requirements.

**Sweet:** Many U.S. issuers are deciding not to make their deals compliant with the EU risk retention rules and saying that in their offering documents. Some other issuers have stated that they intend to comply with the EU risk retention rules but not the transparency rules. It remains to be seen if EU investors will be willing to buy U.S. deals on those terms and whether there will be any effect on pricing. ■

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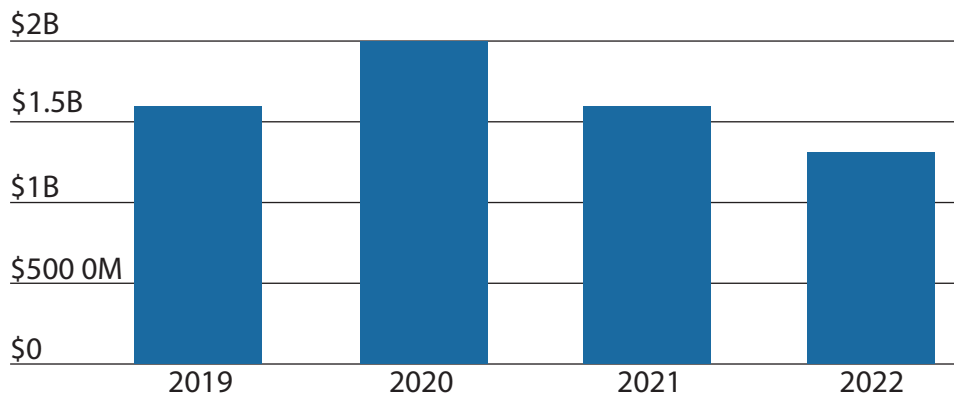


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## Attractive business

Navient's current private education loan portfolio is projected to generate \$7.6 billion in cash flow over the next five years



Source: Navient

# Navient, Sallie Mae Going Head-to-Head

Now that a noncompete agreement has expired, Navient plans to market private student loans to borrowers still in school

By Allison Bisbey

Four years after it was spun off from Sallie Mae, Navient Corp. has been freed from restrictions on competing with its former parent.

On Jan. 23, the student loan servicer made it official, announcing plans to go head-to-head against Sallie Mae by originating private student loans to borrowers who are still in school. The initial target is modest: just \$300 million for the first academic year. Still, the move has the potential to change the competitive dynamics in a market that, since the financial crisis, has been dominated by

four players. Together, Sallie Mae, Discover Financial Services, Wells Fargo and Citizens Financial Group account for about 85% of private loans to current students.

"In-school lending is an attractive opportunity and we have credit expertise and unique marketing insights that should generate access and deliver return on equity in the mid- to high teens," Navient CEO Jack Remondi said on a conference call Wednesday following the release of fourth-quarter financial results.

Remondi offered few details about the product, except to say that it will be "a highly

competitive offering that promotes responsible borrowing."

Navient will focus on first-time borrowers, since the company expects many students and families who are already borrowing in the private market will return to their existing lenders, the CEO said. The company expects to disperse \$150 million in the third quarter of 2019, which represents half of target originations; the second half would be disbursed in early 2020.

Michael Tarkan, an analyst at Compass Point Research & Trading, said it makes sense for Navient to start off with a conservative origination target, given how mature the market is. Industry wide, originations run at \$10 billion to \$12 billion annually.

The expiration of Navient's noncompete agreement also provides the company with the opportunity to market refinance loans to borrowers with loans held by Sallie Mae. Remondi said the company was already seeing the benefit of this. "January is shaping up to be the best month ever" at Earnest, the online refinance lender it acquired in 2017, he said. Navient expects to make \$3 billion of refinance loans this year.

A spokesman for Sallie Mae declined to comment. However, CEO Raymond Quinlan fielded questions during the lender's own earnings conference call the next day. "We'll watch the competition," he said. "We have a great deal of respect for them."

However, "we think we have several significant advantages and... we expect to burnish them over time and we think that heads down, do a good job for

the schools, do a good job for the college students, do a good job for the family, concentrate on outcomes that are successful as they realize their ambitions is the best thing we can do," he said.

Sallie Mae executives acknowledged on the conference call that the company had seen an uptick during the fourth quarter in loans on its balance sheet that were refinanced by other lenders consolidating debt for borrowers.

Unlike the four biggest private student lenders Navient cannot rely on cheap deposits for funding. However, it does have access to competitive financing in the securitization market, where it is a regular issuer of bonds backed by Federal Family Education Plan Loans and private refinance loans. With current industrywide private student loan yields in the 8%-9% range, Tarkan expects Navient may be able to pick up share through lower borrower rates.

(The three biggest lenders after Sallie Mae – Wells Fargo, Discover Financial Services and Citizens Financial Group – are all banks.)

Navient isn't alone; other firms with deep knowledge of the student loan market, including Nelnet and the Pennsylvania Higher Education Assistance Authority, plan to offer private loans to students still in school.

On Dec. 17, Nelnet officially relaunched an in-school private student loan offering under the U-Fi brand, in conjunction with Union Bank & Trust. According to the website, the product will offer undergraduate, graduate, MBA, law and health professions loans, with variable and fixed rates starting at 4.37% and 5.74%, respectively. Nelnet had previously announced plans to enter the in-school private student loan market through an industrial loan company charter, but the company withdrew its application in September.

The Pennsylvania Higher Education Assistance Agency is also preparing to launch an in-school offering, according to information posted on its website. **ASR**

## Navient Seeks to Narrow CFPB's Student Loan Servicing Lawsuit

Navient Corp. is seeking a speedy resolution to the Consumer Financial Protection Bureau's two-year-old lawsuit against the student loan servicer.

On Jan. 17, it filed a request with a federal judge in Pennsylvania for a summary judgment in two counts against it, accusing the CFPB of failing to provide evidence.

The CFPB filed suit against Navient in January 2017, when Richard Cordray was its director, alleging the servicer had unfairly and abusively "steered" borrowers into forbearance, which allows them to temporarily stop making payments, "rather than an income-driven repayment plan," which reduces the amount of monthly payments.

"Two years after filing suit—and more than five years after launching its investigation—the CFPB has not only failed to show that 'hundreds of thousands' of borrowers were harmed, it has not identified a single borrower who supports its allegations of 'steering,'" Navient said in the motion.

A summary judgment is a request to rule on the facts, without going to trial. In its motion, Navient said narrowing the case is warranted because the CFPB's steering allegations are not supported. The CFPB identified 32 borrowers who were harmed, according to the filing. After Navient deposed three, who admitted to receiving income-driven repayment information, the CFPB promptly withdrew 15; the bureau has since removed three others and added one. Fifteen borrowers remain, and Navient has deposed all but one. "All 14 borrowers whom Navient deposed were informed about IDR, including prior to and immediately after obtaining forbearance," Navient said in the motion.

In the filing, Navient notes that servicers are not permitted to enroll borrowers in income-driven repayment over the phone, and that it followed phone calls with further information about the program. It also noted that borrowers often request forbearance to allow time to complete paperwork for income-driven repayment, which generally requires tax returns or pay stubs.

"The CFPB cannot meet its burden to show a genuine dispute of material fact with respect to whether Navient informed borrowers about IDR," the motion states. "At a minimum, a ruling as to Navient's conduct toward the identified borrowers would serve to define the relevant issues for trial."

The CFPB did not respond to a request for comment.

Factual discovery was initially set to close in May 2018, but the bureau has obtained three extensions, moving the deadline to June 2019.

The bureau's January 2017 suit also alleged that Navient failed to properly apply borrowers' payments and deceived private loan borrowers about releasing their cosigners from their loans. The Jan. 17 motion does not speak to these allegations.

In addition to the CFPB's lawsuit, Navient faces consumer abuse allegations leveled by Pennsylvania, Illinois, California and Washington state.

And members of the Teachers Federation of America are suing Navient alleging that it misled borrowers in public service professions from accessing a loan forgiveness program to boost its own profits. The complaint, which was filed in federal court in New York, seeks classwide injunctive relief.

# Auto lenders upbeat amid fears credit cycle will sputter

Executives from Ally Financial and Santander Consumer USA all have rosy outlooks for 2019 consumer trends

By Kevin Wack and Laura Alix

Lenders that specialize in auto lending are expressing confidence that the boom they have been riding for much of the last decade still has some life remaining.

During earnings calls in January, executives at Ally Financial and Santander Consumer USA struck a mostly optimistic tone regarding 2019. They betrayed little concern about the chance of a recession that could make it harder for many Americans to meet their obligations.

"Everything we see across our portfolios reinforces that the consumer remains healthy," said Ally CEO Jeffrey Brown. "Employment conditions are strong across the country. Wage growth is accelerating. Tax reform and falling gas prices have been incrementally beneficial. All of this leads to a strong consumer balance sheet. We'll continue to monitor trends, but our data remains favorable."

U.S. auto loan originations hit an all-time high of \$157.6 billion in the third quarter of last year, according to the Federal Reserve Bank of New York and Equifax. Strong loan growth over the last half-decade has been fueled by low interest rates and a belief — which emerged from relatively strong performance of auto loans following the financial crisis — that consumers need a car to get to work even in tough times.

The perception that auto loans are a solid bet has enabled lenders to take bigger risks — notably by offering consumer loans of 72 months or more — which can result in outside losses when borrowers stop paying. Another worry for lenders is that used-car prices will decline, which will result in smaller recoveries

when borrowers default.

Santander Consumer is forecasting a modest 1% decline in used-car prices in 2019, as more vehicles enter the market. But CEO Scott Powell did not sound overly concerned about the possibility of a price decline.

"Just keep in mind that that outlook last year was for used-car prices to be down 4%, 5%, 6%, something like that, and we actually ended up 3%," he said. "So I always take those things with a little bit — with a lot of salt, actually. And based on our view of the strength of the consumer and the demand for the used cars, we're pretty optimistic."

Still, Santander Consumer increased its provision for credit losses to \$691 million at the end of the fourth quarter, up 15% on the year.

Executives at the Dallas company voiced concern about the possibility of another government shutdown, which could hurt many Americans' ability to purchase cars and to make payments on their existing auto loans. The Congressional Budget Office said that the five-week shutdown in December and January cost the U.S. economy \$11 billion.

The Internal Revenue Service is currently funded through Feb. 15. Another government shutdown could delay tax refunds, which would damage household balance sheets in the short run.

"That has a big impact on our delinquency rate and our loss rate," Powell said. "We're hopeful there that we get the issues settled."

The pain would likely be more acute at subprime lenders like Santander Consumer, since many of their customers have small financial cushions. In the fourth quarter, 64% of the

firm's retail installment contract originations went to borrowers with credit scores of 640 or below.

At Ally, which has a smaller subprime footprint than Santander Consumer, executives did not identify any warning signs about the financial outlook for U.S. consumers. The Detroit company reduced its provision for credit losses by 11% to \$266 million in the fourth quarter.

**"Just keep in mind that the outlook last year was for used-car prices to be down 4%, 5% 6%, something like that, and we ended up 3%."**

"Credit performance in our portfolio remained solid throughout 2018," Brown said.

Though Ally has been taking steps to diversify its business, 84% of its pretax income from continuing operations last year came from its automotive finance unit.

At banks that rely less heavily on auto lending, executives offered less effusive outlooks on the sector.

Mark Tryniski, the CEO of Community Bank System in DeWitt, N.Y., said the company's posture toward auto lending is closely tied to the state of the U.S. economy and the employment picture. "So that one is really difficult to project," he said.

At Capital One Financial in McLean, Va., the auto loan charge-off rate fell by 7% year over year in the fourth quarter. But CEO Richard Fairbank cautioned, "Over the longer term, we continue to expect that the auto charge-off rate will increase gradually." **ASR**



## U.S. CLOs Risk Losing Japanese Investor Base

The FSA is considering increasing capital requirements for holdings of securitizations if the sponsors don't retain some risk

By Glen Fest

U.S. CLOs just can't seem to dodge rules requiring managers to have "skin in the game."

Less than a year after a U.S. appeals court overturned federal risk-retention rules for collateralized loan obligations, "skin in the game" is once again front and center for loan portfolio managers – this time through a proposed Japanese regulation impacting the CLO sector's largest investor base.

The Japanese Financial Services Agency (JFSA) published a proposed rule on Dec. 28 that would discourage investments by Japanese institutional investors in securitizations

that lack risk-retention structures. The Japanese retention requirement would apply punitive regulatory capital risk charges on Japan's regulated banks for their ABS holdings that aren't compliant with Japanese risk-retention standards that resemble current European Union regulations.

The proposed rules would only impact future asset purchases; existing CLOs holdings are grandfathered. Still, they raised alarms in the U.S., where Japanese banks purchase between 50% and 75% of all newly issued AAA rated CLO securities, according to global

law firm Milbank, Tweed, Hadley & McCloy.

The Loan Syndications & Trading Association in late January filed a response with the JFSA opposing the measure, stating CLOs should be exempt from the risk retention requirements since CLO structures don't fit within the proposal's very definition of a securitization conduit to be regulated.

Regardless, LSTA executives believe that CLOs will be carved out from the final rule because Japanese authorities will deem that U.S. CLOs are "appropriately" underwritten.

The LSTA has "been engaged" with Japanese FSA officials for "several months" about carving out an exemption for CLOs, the trade group's vice president Meredith Coffey said in a January email.

Nevertheless, CLO market participants are concerned. In a client alert published in mid-January out of its London office, Milbank warned that the new proposal, if it goes into effect, could apply de facto risk-retention standards on managers who would have no choice but to comply if they want to preserve access the cornerstone investor base for senior CLO securities.

The proposal means the U.S. CLO industry could "see a return to retention-compliant U.S. CLO structures, to the extent that such transactions are to be marketed in Japan, together with its consequent costs and complexities," the report states.

In a Jan. 16 report, Wells Fargo said the rule could both damp new CLO issuance in the near term but lead to more favorable

pricing for existing deals that comply with risk retention.

Wells expects “tightening for deals that would comply” – including European CLOs and U.S. middle market (which should have an easier path to compliance), and “widening for non-compliant deals,” the report stated.

The Milbank alert, written in conjunction with Tokyo law firm Anderson, Mori & Tomotsune, stated that the risk-retention proposal “may result in some Japanese investors being disincentivized from purchasing [securitization] positions where an appropriate entity has not committed to hold a 5% retention piece in the transaction.”

U.S. and European risk retention rules also both compel sponsors to hold on to 5% of the economic risk of deals.

The Milbank newsletter stated that U.S. CLO managers who construct deals to meet the European standard will likely pass muster with Japan’s regulations since EU rules ‘are generally structured to include risk retention and disclosure obligations that are, in fact, more far-reaching than those posed’ in Japan’s proposed rule.

According to Wells Fargo, however, only 18% of U.S. CLOs issued in 2018 were in compliance with European risk-retention requirements.

The Wells Fargo report cautioned that if the new regulations are implemented to cover CLO investments, “we would expect much less U.S. CLO issuance in the near term” until managers could comply.

At the same time, secondary market pricing of existing deals that comply with risk retention would become more favorable, despite that fact that these deals are grandfathered under the proposed rules, per Wells Fargo.

Milbank noted the rules would put the onus on Japanese institutional investors through an “indirect” compliance requirement showing their securitization holdings meeting the minimum retention standards. Failing that, an imposed

extra capital charge for a noncompliant securitization asset would be applied, and would be triple what it otherwise would cost in the risk-weighting of the Japanese bank’s ABS holdings.

“As with the existing U.S. and European risk retention regimes,” the Milbank newsletter stated, “the Japanese Retention Requirement is driven by the Basel III international regulatory framework for banks,” which in 2016 incorporated an alternative capital treatment for simple, transparent and standardized (STS) securitizations.

### **Exemption for “open market” CLOs may already be baked into rules**

A record \$128.1 billion of open-market, broadly syndicated U.S. CLOs were issued in 2018, the vast majority of them subsequent to a D.C. Court of Appeals ruling in February (later finalized that spring) that set aside regulations that had required managers retain a minimum 5% value of newly issued deal – either on their own books or assigned to a majority-owned capitalized vehicle.

“[F]ollowing the D.C. Circuit Court ruling that the U.S. risk retention legislation does not apply to ‘open market CLOs, compliance with the US risk retention rules now applies only to a small subset of US CLOs,” according to the client alert.

In its Jan. 28 letter to the Japanese regulators, the LSTA questioned whether the new rules could apply to CLOs as they were proposed.

The LSTA’s viewpoint is that since CLO managers who acquire loans used as collateral in the “open market,” rather than originating the loans themselves, these vehicles don’t meet the criteria for a securitization as it is currently defined by Japanese regulators.

That includes describing a transaction as a “stratification” of credit risk related to the “original assets” transferred to a “securitization conduit.”

Under those terms, CLOs aren’t covered because there are no “original

assets” in their portfolio that meet the JFSA’s definition, because independent CLO managers do not underwrite the loans, the LSTA claims.

Without “original assets,” there’s no securitization – and therefore no “securitization exposure” for investors in CLO notes, the letter added.

“While the LSTA is not an expert in Japanese law or regulations, it appears that the FSA’s regulations, much like the U.S. statutory requirement, could be construed as not applying to Open Market CLOs and their managers.”

### **Without ‘original assets’ there’s no securitization - and therefore no ‘securitization exposure’ for investors in CLO notes, according to the LSTA.**

LSTA general counsel Elliot Ganz said the LSTA is ultimately banking on getting the exemption through the provision “that suggests that an investor would not have to hold excess capital, even if there is no risk retention, so long as the assets underlying the securitization were not ‘originated inappropriately.’ ”

The LSTA’s 15-page letter included a description of the U.S. CLO industry’s soundness and deep investor protections, including the existing alignment of manager interests with CLO investors through numerous investor-protection deal covenants that, if breached, divert cash flow away from the equity holders (including managers) to pay senior noteholder principal.

The LSTA also emphasized the importance of CLOs to the leveraged loan market. CLOs are a primary source of funding for corporate speculative-grade loans, holding \$560 billion of \$1.1 trillion in outstanding loans at year’s end.

The reading of the proposal would not provide the same exemption from middle-market CLOs, since those are typically securitizations of loans held on balance sheet. **ASR**

## How Ellington Finds Value in Triple-C Rated Loans

The firm founded by mortgage veteran Michael Vranos looks for leveraged loans it considers to be “misrated”

By Glen Fest

Michael Vranos has always been comfortable with fallen angels.

Vranos is the founder and chief executive of specialty investment and advisory firm Ellington Management Group, a longtime player in the mortgage securities and derivatives space, including non-agency and sub-prime investments.

So it's no surprise that when Old Greenwich, Conn.-based Ellington took an interest in corporate loans six years ago, Vranos and his team gravitated to the speculative-grade side. It wasn't just the higher returns offered by leveraged loans; EMG's experience (through publicly traded affiliate Ellington Financial) foraging through the bargains in the volatile mortgage bond market of the late 2000s give the firm a different perspective on the values in the “misrated” debt of some of these borrowers.

The loans' ratings are not wrong in the sense that ratings agencies erred, but are out of line with current coupons and performance, in Ellington's view. “When we took a look at the leveraged loan market, we decided to figure out where there was value and to create portfolios around that value,” said Vranos.

Based on that opportunistic strategy, the \$7.7-billion asset firm established Ellington CLO Management and issued the first of three CLOs beginning in 2017 via Citigroup, under the direction of Vranos and Robert Kinderman, a managing director, partner and head of credit strategies.

The CLOs are notable for their heavy

exposure to triple-C rated loans, up to 50% of the collateral pool (a model followed since by two other firms, Z Capital and HPS Investment Partners). Vranos and Kinderman recently

discussed with their strategy and their outlook on the CLO market with Asset Securitization Report. What follows is an edited transcript.

**ASR: What attracted you to the leveraged loan market, particularly with the strategy of focusing on “misrated” loans?**

Vranos: Besides perhaps for their

rating, the loans that we source look superior to the loans that other managers have been putting into “regular-way CLOs” – our loans are at discount, they're almost all first-lien, about 90% first-lien, and they are low leverage at high 3s to low 4s on average.

Kinderman: And 80% of our loans have real covenants as opposed to the cov-lite trend in loans.

Vranos: Yes, and that's one of the most important characteristics. These loans on their own, pre-CLO if you will, looked to us like a great investment opportunity. We find it important to find a great portfolio first, and use the CLO as a source of permanent financing for the loans

Kinderman: Our strategy is to find loans that we deem attractive outright, figure out what permanent financing structure works for that loan portfolio, and then own a term-financed position in the portfolio. Our loan PMs don't think about managing a CLO, they think

about managing our loan portfolio as a total return investment portfolio. It's a very different mentality.

**Was there a challenge in sourcing loans last year because of tighter spreads?**

Vranos: The loans we source have very little overlap with the loans that are getting packaged into regular-way CLO deals. If you look at the deals we do, there are only a couple of other managers who have a similar strategy.

Kinderman: The competing bids for the loans that we're sourcing are not other CLOs. Instead, they're some form of an opportunistic loan fund, or a distressed fund that doesn't have enough opportunities in distressed, that's going for mid-nineties dollar-price, high single-digit coupon loans as a placeholder. We're looking for a set of loans that are entirely different than other managers who issue broadly syndicated CLOs. Simply put, the dynamics are just different.

**Where other opportunities and challenges were there in the fourth quarter?**

Kinderman: The price action in the fourth quarter was great for us because it gave us the opportunity to prove out our investment thesis. The loans we hold outperformed a mix of single-B and triple-C loans. If you were to look at a portfolio that was 70% single-B and 30% triple-C, those loans were down around 3% in December, and, during the same period, regularly broadly syndicated loans were down 2-3%. Our loan portfolio,



Michael Vranos

on the other hand, was down much less, because it's not the typical portfolio and didn't face the same sell pressure as [with] regularly broadly syndicated loans. The loans that came under pressure were larger loans that might have been part of a regular CLO warehouse or held by loan mutual fund

With this in mind, we were opportunistic in December. There were lots of loans that the market seemed

comfortable with – with more leverage, at par, no covenants – loans that were even riskier than what we typically buy. But in December regular-way CLOs and loan mutual funds weren't buying. Issuers had to sweeten the pot, and as such, the market ended up on our terms – offering covenants and discount dollar prices. When the CLO issuance market shuts down, sometimes we find an opportunity, and this was the case in December.

### **What are your investors seeking that's unique to this strategy?**

Vranos: On the equity side, we are much higher yielding and significantly more resilient – we essentially have our LPs lining up for the opportunity to participate. On the debt side, the spread differential of the higher rated debt tranches in our deals can be pretty significant compared to a regular-way, broadly syndicated deal.

Kinderman: Generally, I'd say that that our investors also invest in regular broadly syndicated deals. They are investors who are large enough that they have their own credit analysts doing full diligence on our portfolio. They're combing through data and recognize that the loans in our portfolio are not as risky as the ratings suggest.

### **What is the reason for the triple-C cap to be at 50% on your CLOs?**

Kinderman: The triple-C bucket is

typically dictated by senior and mezz investors. In a number of ways, we could have made our lives much easier by making the triple-C limit tighter. Our initial portfolios are only 25% triple-C, and a lot of those loans are not rated.

Our primary concern is that all of these tests and triggers are so far away from affecting us that we don't want our loan PMs to even be thinking about what the

rating of a loan is or how it's going to affect some test. Our loan team thinks about what's the best value and total return, and manages the loan portfolio from that perspective because that's ultimately going to be best for our equity investment.

Vranos: To that end, let's talk about returns and yields of the assets. The assets themselves, are on average, in our first three deals, in the Libor plus mid 600s [coupon] range.

Kinderman: If the coupon is in the low 600s and your 96 dollar price performance for your maturity, you're going to be into the 700s discount margin.

Vranos: The spreads on the assets are very wide, so the fact that we might need more subordination from the equity, up to the triple-B, is not a big deal. It makes for a rather safer-looking equity piece, because zero yield occurs at much, much higher [constant default rates] as compared to a regular-way CLO; we're not fighting over every last penny or having to tranche the deal very thinly.

### **Are there sectors where Ellington finds much of its collateral, or are these mostly company-specific loan purchases?**

Kinderman: Some investors assume that in order for us to find the spreads we do on our portfolio, we must be concentrated in sectors like retail and energy. But in fact, our sector concentrations are low. Rather, our portfolio is diverse across

industries. It's a company-specific analysis, but we are also conscious to limit our exposures to challenged sectors like retail. Our largest industry concentration is approximately 1/3 of the limit allowed.

### **Will the reduced number of expected Fed rate hikes impact your loan acquisition plans for 2019?**

Kinderman: We may see a number of deals start to get done now that had warehouses already outstanding from last year; however, given the thinness of the arbitrage in regular deals, it is likely we will see less issuance in the first and second quarter. So we expect that CLO issuance is going to be well below the pace we saw in 2018. We believe that dynamic is more significant for our CLO platform than is the prospect for fewer rate hikes.

Vranos: For us, sourcing loans has not been difficult, regardless of the rate environment. The big story last year, which has less to do with Ellington, was when refinancings occurred, because you saw a lot of [net interest margin] compression on regular-way equity deals; you saw those who refinance can and those who can't stay in the pool.

### **So the bout of loan refinancing did not reduce your existing loan opportunities in the secondary market?**

Kinderman: Actually, what was hurting regular-way CLO managers last year was a great tailwind for us. If we're taken out of a loan we own at 95-96 through a refi, ratings agencies likely haven't looked at that credit in several years. So, when the loan goes to refi, it's given a rating that fits a regular-way CLO. That activity takes us out of the loan that we bought at a discount at par, meaning we can then go find another investment at a discount.

If you assume this aggressive refi behavior continues, that's a big problem for a typical [BSL] deal because of the NIM compression Mike mentioned, but it's a great benefit for us. **ASR**



Robert Kinderman

## No rush

More than half of BDCs tracked by DBRS plan to increase leverage limits, but most are subject to a one-year cooling off period

- **BDCs followed by DBRS: 40**
- **BDCs adopting 150% asset coverage: 25**
- **BDCs that sought shareholder approval: 14**
- **BDCs that lowered management fees: 6**

Source: DBRS

## Most BDCs Will Need Time to Boost Leverage

At least 25 have approval to increase borrowing in line with a new regulatory limit, but most are subject to a cooling-off period

By Allison Bisbey

When limits were lifted on the amount of borrowed money that business development companies could put to work, there were concerns that they would rush to take advantage of the new rules, adding to the competition to lend to small and medium-sized companies.

New research from DBRS suggests that's not the case.

The Small Business Credit Availability Act (SBCAA), which became law in late March 2018, increases the amount of debt BDCs can employ, relative to their equity, to 1.5 from 1.0

previously. There are two ways BDCs can get approval to access the higher leverage levels. The simpler and less expensive option involves getting approval from the BDC's board of directors. However, this method requires a one-year cooling-off period before the lenders can borrow in excess of 1.0 their equity. A faster, but more labor-intensive option is to get shareholder approval; this allows BDCs to increase leverage on the following day.

Since the law took effect, 25 of the 40 BDCs that DBRS tracks have received approval from their boards to operate under a higher regula-

tory leverage limit, putting them in a position to increase leverage toward the middle of this year. DBRS only cited a single example, the \$729 million Goldman Sachs BDC, in its report. Others include industry heavyweights Ares Capital Corp. (\$12.3 billion of assets), Apollo Investment Corp. (\$20 billion) and Pennant-Park Floating Rate Capital (\$2.7 billion), according to company press releases.

Of the 25 BDCs tracked by DBRS that sought board approval, 14 also sought shareholder approval, allowing them to increase leverage right away.

Still, DBRS characterizes the industry's overall approach to increasing leverage as "measured." The report, which was published Jan. 30, notes that the BDCs that have adopted the higher leverage limit have committed publicly to target ranges that provide a "solid cushion" below the new regulatory limit. Typically, these new target leverage ranges are between 0.9x and 1.25x.

Setting the range at a conservative level ensures that the BDCs have a sufficient cushion below the regulatory limit to cope with adverse events" that might cause them to mark down the value of a holding or sell it at a loss, the rating agency notes in its report.

Importantly, DBRS says, BDCs still face restrictions if they breach the regulatory leverage limit. These include a prohibition from issuing additional debt or preferred stock or declaring dividends on its common stock, the report states.

Shareholder consent and rating agency concerns are not

the only things keeping BDC from stepping on the gas, however. In many cases, covenants with their existing lenders and creditors also restrict the amount of debt they can take on. These agreements need to be amended to put restrictions in line with the new higher regulatory limit.

In November 2018, eight months after the regulatory limit on leveraged was increased, Apollo announced that it has amended its senior secured revolving credit facility to decrease the minimum asset coverage financial covenant from 200% to 150%, according to a company press release. The BDC's lenders also increased borrowing capacity under the facility by \$400 million from \$1.19 billion to \$1.59 billion. The maturity was also extended by approximately two years to November 2023.

In the press release, Gregory W. Hunt, Apollo's CFO, said the company intends to "prudently increase leverage over the next 18 to 24 months with a target debt-equity ratio of 1.25x to 1.40x." And CEO Howard Widra said Apollo would use the incremental investment capacity to "shift the portfolio mix to more senior, first-lien floating rate loans."

The same month, PennantPark announced it had completed all necessary amendments to its secured credit facility to enable it to use the incremental leverage provided by the SBCEA; the facility was also upsized to \$520 million from \$405 million.

In some cases, credit facilities cannot be amended; the only option is to wait until they can be replaced. Gladstone Capital, a BDC with \$327 million in assets, has obtained board approval to increase its permitted leverage that takes effect in April 2019. However, the company has said it will not be in a position to act on this approval until it refunds its existing preferred stock, which has a covenant restricting leverage. This will not be possible until September 2019. Gladstone will also have to modify covenants with bank lenders, but the company does not expect

this to be difficult.

"Once completed, you should expect us to see us move to the 0.9 to 1.25 debt-to-equity range, which is intended to provide us the flexibility to be more competitive on senior secured assets that we originate in the marketplace while providing incremental cost efficiencies and enable us to improve the returns to our shareholders," Gladstone President Bob Marcotte during a November conference call.

BDCs are an important source of credit for small and medium-sized businesses as banks increasingly focus on lending to larger companies. But before the SBCEA was enacted, many BDCs were starved of capital. They were unable to raise equity capital because their stocks had been trading below net asset value, and without new equity, they were unable to take on more debt.

Research published last year by William Blair indicates that the number of IPOs and follow-on offerings by BDCs plummeted in recent years after surging to a high of 39 in 2012. From the beginning of 2015 to March 2018, there were only 45 BDC equity offerings. On the debt side, activity peaked in 2013, according to the investment bank.

Increasing leverage limits could create a positive feedback loop, as BDCs put more money to work, enhancing the value of their common stock, which in turn could allow them to issue new shares. (BDCs must seek shareholder approval for follow-on offerings when their stock is trading below net asset value.) That's assuming they can find enough attractive investment opportunities.

Not all BDCs are starved for capital, however. Golub Capital BDC's shares have traded at an average premium to net asset value of 15% over the past few years, giving it serious buying power. In November 2018, the company announced an agreement to acquire a sister BDC, Golub Capital Investment Corp., in a stock-for-stock transaction. Following the merger, GBDC is expected to be

the fourth-largest externally managed, publicly traded business development company, with \$3.5 billion of assets.

On a Feb. 7 conference call, David Golub, president and CEO of both BDCs, reiterated that the decision to merge was driven, in part, by a desire to give the combined companies better access to funding in the securitization market,

**Those that have adopted the higher leverage limit have committed publicly to target ranges that provide a "solid cushion" below the new limit.**

In September, the two Golub BDCs got the green light from the Securities and Exchange Commission for an alternative way to comply with risk retention requirements; two months later, in November, GBDC issued a new CLO with a weighted average spread over Libor of 1.64%.

On the Feb. 7 conference call, the CEO said this was about 50 basis points lower than the current spread over Libor of the company's bank facilities. "So (it's) a very meaningful savings."

He said the SEC's blessing of the firm's preferred method of complying with risk retention "informed our board's thinking about whether increasing our regulatory leverage limit would be good for shareholders."

Like other BDCs, GBDC is boosting its ability to employ leverage, but does not necessarily intend to use it. On Feb. 5 (a week after DBRS' report was published) GBDC's shareholders approved a measure to reduce the closed-end fund's asset coverage from 200% to 150%.

"What does this mean for GBDC in the near term? It means primarily that we will have additional flexibility to manage capital and a peer cushion to the regulatory leverage limit," the CEO said on the conference call.

"It's GBDC's current intention to continue to target a GAAP debt-to-equity ratio of about 1 times," he said. **ASR**

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