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What does the first downgrade of a subprime auto securitization since the credit crisis say about the state of lending?

Dubious Honor

Honor Finance raised some eyebrows late in 2016 when it sold double B rated securities as a first-time issuer. This summer it earned a different kind of notoriety when both S&P and Kroll downgraded these notes, warning that investors were at risk of not being repaid.

But this has hardly soured investors on speculative grade bonds backed by subprime auto loans. To the contrary, demand for higher yield is fueling issuance of securities rated as low as single B. Until this year, no subprime auto lender had ever issued an asset-backed with such a low credit rating; as of June, three issuers had printed a total of $141 million. Westlake, the most prolific issuer, subsequently issued a third deal with a single B tranche in August.

We've been down this road before. A new crop of subprime auto lenders raised private equity money, ramps up lending, and taps the securitization market. Credit continues to expand until too many loans go bad and the lending industry contracts. Before the financial crisis, expansion of credit into double B securities was accomplished with the help of bond insurance. This time, however, investors are relying more heavily on overcollateralization to cushion against loan losses. While rating agencies have given their blessing, using addition collateral does not cure all ills, as I explain in my cover story. In fact, it may be encouraging credit drift.

S&P itself has warned that there's no telling how single B securities will perform in a credit or business downturn. Investors, who may have been lulled by the wave of subprime auto ABS upgrades in recent years, should prepare for more "ratings volatility" among single B securities.

— Allison Bisbey

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Keep Fintech Changes at the State Level

State regulations are the best laboratory for financial services innovation, not federally derived oversight

By John Ryan

The national fintech charter announced by the Office of the Comptroller of the Currency has been positioned by its supporters as a means of encouraging innovation and growth, but instead it brings new risks and market distortions to the U.S. economy.

If facilitating fintech innovation and protecting consumers is the goal, preempting state licensing and consumer laws with a federal charter is not the answer. The OCC's charter creates a new class of institutions that benefits large, established fintech firms and harms the very innovation and choice that U.S. Treasury Secretary Steven Mnuchin and the Comptroller of the Currency Joseph Otting say it would provide.

As CSBS made clear in our lawsuit against the OCC last year, we believe a federal fintech charter will have harmful consequences for our nation's financial system. The American history of building successful economies has not been driven by top-down industrial policy that picks winners and losers.

Instead, it has been one that encourages innovation and competition from the bottom up.

Based on our experience, a federal charter has been most successful at enabling a handful of large, dominant players, as seen in the national banking system. To believe that a federal fintech charter will encourage innovation, as has been argued, is misguided. That overlooks where financial innovation and competition originate in this country. These come from a system fostered by the states.

State regulators have been the primary regulator of fintech companies. The state system is accessible to all types and sizes of fintech firms. It plays a significant role in the economy and serves as a source of diversity and innovation that leads to the world's most competitive financial system. States have been and should be the laboratory of innovation for financial services.

Here's why. In addition to overseeing 79% of the nation's banks, state regulators are the primary regulatory authority of the tens of thousands of nonbank entities that range from mortgage companies to fintech firms. It is a system that works well and is improving as states work together to harmonize the licensing and oversight system.

Our system allows for a diverse pool of firms, encouraging small startups and innovation. A state system is a de facto sandbox where successful innovations can gain broader scale. From the state system emerged interest-bearing checking accounts, ATMs, mobile wallets, prepaid cards, mobile points of sale and phone-based international remittances.

At the same time, state regulators are in close proximity to consumers and the communities they are charged with protecting, making them uniquely situated to recognize and act upon consumer financial protection issues.

Federal preemption in financial services regulation should be the exception, not the rule. If misapplied, preemption can undermine financial market competition, innovation and consumer protections.

Case in point: We need to only look back to the early 2000s, when states enacted laws to protect consumers when they became aware of predatory mortgage lending. The OCC acted to preempt those laws, which contributed to the mortgage crisis and the largest number of home foreclosures since the Great Depression.

Because the OCC did not listen to the states on predatory lending, Congress had to step in to reaffirm the need for state and federal collaboration. In 2008, Congress codified a regulatory technology platform created by the states to coordinate licensing and supervision of mortgage market participants nationwide. Congress further responded to the crisis by reaffirming the state regulatory role for nonbank entities and narrowing the scope of national bank preemption in the Dodd-Frank Act.

[State regulation] is a system that works well and is improving as states work together to harmonize licensing and oversight.

State financial regulators will continue to fight to stop preemption efforts and preserve the state financial regulatory system.

And all options are on the table.

We want states to continue to be the laboratory of innovation and encourage competition. We want a system that remains responsive to, and protective of, our citizens.

It's time again to listen to the states.

John W. Ryan is president & CEO of the Conference of State Bank Supervisors, the nationwide organization of state banking and financial regulators from all 50 states, the District of Columbia and the U.S. territories

What's Missing from OCC's Fintech Charter

Online lenders aren't subject to the capital and operational norms of regulated banks. Will regulators take this into account?

By Karen Shaw Petrou

The Office of the Comptroller of the Currency recently finalized its controversial decision to authorize a special-purpose fintech charter.

Although the OCC emphasizes that it's holding these special-purpose charters to standards equivalent to those demanded of national banks, this is only sort of true with regard to the named prudential requirements, and it looks to be completely incorrect on critical restrictions on competitive and financial risk. These omissions have significant consumer protection, safety and soundness and structural impacts. Absent egregious violations, a charter granted cannot be revoked. The OCC should be sure it isn't a shadow-bank enabler before it hands out these high-powered charters.

If other U.S. regulators follow the OCC's example and grant charters or authorize ground-breaking activities before these policy questions are fully considered, a lot of embedded risk could quickly confront both consumers and the overall financial system.

The first structural problem we've spotted is that bank capital and liquidity standards (let alone most other structurally significant prudential ones) cannot be applied in like-kind fashion to fintech, because most fintech charters will not be anything like most national banks. For all the work around fintech's edges, national banks are first and foremost financial intermediaries. This means that most risk comes from extensions of credit or, for larger ones, trading exposures, and most funding comes from the deposit or debt market.

Yet fintech risk is different. Very few fintechs are capital intensive. Instead, they handle transactions or interfaces, making money through cross-selling, advertising, add-on fees or other strategies. As a result, the most important risk for many fintechs is operational. Would the big-bank operational risk-based capital framework work here? It doesn't even work for the banks for which it was designed. The Basel brush-up — which is retrospective — is even worse-designed for fintech ventures. Is capital even the right way to ensure fintech operational resilience? It would be good to know before there are a lot of special-purpose banks. .

Secondly, what exactly will these fintechs do in relation to parent companies and/or partner institutions? Banks are under a lot of restrictions here, starting with all the disclosures customers have to get to be sure that they know a nontraditional product isn't backed by the Federal Deposit Insurance Corp. I know fintechs aren't allowed to take insured deposits, but any company with "bank" in its name could be easily understood to do so. Bank holding companies are also barred from tying products so that customers are forced to get something they don't want Bank holding companies also cannot offer a deeply subsidized price on one product to encourage customers to get others.

Since fintech parents are unlikely to be bank holding companies, no such anti-tying prohibitions apply. Given the tied offerings already evident by fintechs seeking nonbank bank charters, this market power is clearly desired. Should it be allowed?

Finally, will fintech parents stand by their special-purpose banks or throw them to the wolves under stress? Bank holding companies can't do so and the Dodd-Frank Act extended this source-of-strength requirement to nontraditional charters. The general theory here is that there is a need to ensure parent-company shareholders take the pain as well as gain from ownership of an insured depository, a theory that doesn't apply to fintech special charters.

The OCC should be sure it isn't a shadow-bank enabler before it hands out these high-powered charters.

What about the competitive power of fintech parents not forced to bear any capital or liquidity costs for the activities that otherwise consolidate into their earnings? When can fintechs upstream earnings given that they are not to be covered by stress tests even though the OCC says its standards are banklike? Who loses and what financial-stability risk might result from fintech operations of different sizes, business models or interconnectedness?

These questions are critical not only to fintech special-purpose charters but to the OCC's broader principle that it can establish a category of special-purpose national banks when it thinks a policy or market benefit would ensue. If the OCC doesn't build out its special-purpose charter policy, we'll get a lot more innovation at the cost of a lot less responsibility.

Karen Shaw Petrou is a managing partner at Federal Financial Analytics

Risks of Credit-Scoring Bill Are Overstated

Including rental and utility payment history, in a proposed amendment to the Fair Credit Report Act, can benefit thin credit files

By Dara Duguay

Current legislation designed to enhance consumer credit scores is a win-win for all concerned.

On June 25, the House unanimously passed The Credit Access and Inclusion Act, sponsored by Reps. Keith Ellison, D-Minn., and Robert Pittenger, R-N.C., which would amend the Fair Credit Reporting Act to clarify Federal law with respect to the reporting of certain positive consumer credit information to consumer reporting agencies (i.e. rent, utilities and telecommunications).

A Senate companion bill by Sens. Tim Scott, R-S.C., and Joe Manchin, D-W.V., has also been introduced.

Whether we like it or not, a good credit history is crucial in today's economy. Far more than just a number, a good credit score is a prerequisite for accessing everyday financial products like a credit card, a personal loan or auto financing. It has also become a hugely influential factor in the tenant and employment screening process. However, those with no credit score or a poor credit score have limited prospects. These consumers often turn to high-cost payday lenders to obtain credit and are unable to access rental housing or jobs.

According to Experian, 64 million Americans have no credit or a thin file. For these Americans, the need to build a positive credit history is paramount. However, building credit is often a vicious circle. If you don't have credit, it is hard to get credit. But, if you can't get access to credit, how are you ever able to build credit?

This is where the current legislation fills a gap. If regular bills can be reported to the credit bureaus, then positive behaviors such as paying on-time can be rewarded. Since most consumers have utility, telecom and rental payments, they would immediately benefit.

Experian has found that including on-time utility payments has reduced the number of consumers marred with a subprime credit history by 50%. Similarly, LexisNexis has analyzed using a more expansive alternative data set, including such things as asset ownership and occupational licenses. Their results reveal 33% more minorities scorable and 31% more renters approved for credit products when alternative data is factored in.

Credit Builders Alliance is aware of the main objection to the pending legislation: the concern that this bill would damage the credit scores of millions of Americans. The worry is that late payments would result in a negative credit history. The contention is that "having a bad credit history is worse than having no credit history whatsoever."

But CBA has not found this to be true.

Our experience with our more than 500 non-profit members located throughout the U.S. has been that the absence of a credit history remains a significant barrier to accessing credit products, rental housing and jobs among the 50% of employers who conduct a credit history check during their job application process.

Adding to CBA's anecdotal evidence is research conducted by the Federal Reserve. In a study on alternative financial service providers, including payday lenders and pawn shops, the Fed found that there is no clear evidence that "no score" is better than a "low score." In fact, if anything, this data (table 2) suggests the opposite — AFSPs are congregating in higher numbers in "no score" neighborhoods than in "low score" neighborhoods. The proliferation of these types of alternative lenders in majority "bad" and no-credit neighborhoods suggests that they simply locate where the demand for their services is greatest, because a significant portion of the population does not qualify for more mainstream forms of credit.

Having bad credit history is worse than having no credit history whatsover? The CBA has not found this to be true.

A very important point to remember is that negative data is currently being reported on utility and telecom payments, if the past-due account is reported to the collection agencies. The fact remains that consumers are already experiencing negative information on their credit reports. This bill attempts to level the playing field by having positive payment history reported.

As a case in point, CBA led a successful rent reporting pilot with affordable housing providers. The act of reporting ontime payments for more than 1,200 residents resulted in 100% of the residents, who were previously credit invisible, now having a credit score. Additionally, the average VantageScore was 670, which brought them out of the subprime category.

Dara Duguay is the executive director of Credit Builders Alliance

HAZARD SIGN

What does the first downgrade of a subprime auto securitization since the financial crisis say about the state of lending?

By Allison Bisbey

Over the past couple of years, subprime auto lenders have been able to offload more and more of the risk in their loans to investors desperate for higher yields.

Despite the high rate of default among borrowers with poor credit, investors are snapping up billions of dollars of auto loan-backed securities with below investment grade ratings – in some cases as low as single-B. They are willing to do so in large part because lenders are putting up additional loans as collateral for the bonds, and because credit rating agencies believe that this overcollateralization will insulate investors from expected losses.

Problems at Honor Finance, an Evanston, Ill. lender backed by CIVC Partners, show that this form of credit enhancement can't cure all ills. In July, both S&P Global Ratings and Kroll Bond Rating Agency downgraded the most subordinate securities issued in a 2016 transaction after Honor lost much of its senior management, stopped originating loans, and resigned as servicer. Losses on collateral for the deal are so high that both rating agencies believe investors are at substantial risk of not being

CREDIT LINE HERE

repaid.

Honor wasn't the first subprime auto lender to run into problems since the financial crisis. At least two others, Summit Financial Corp. and Spring Tree Lending, have folded this year after allegations of fraud or misreported losses caused their banks to withdraw funding. But none of these other lenders had tapped the securitization market for funding, so investors didn't feel it.

"Pre-crisis, many subprime bonds came with a financial guarantee; they were wrapped with insurance, in addition to overcollateralization," said Joseph Cioffi, chair of the insolvency, creditors' rights & financial products practice group at Davis & Gilbert. "Today, there is more reliance on excess collateral."

He said this is often accompanied by a drift in credit standards.

Certainly, Honor played at the deep end of the subprime auto market, lending to borrowers with FICO scores ranging from 475-650, according to S&P. And nearly a quarter had no FICO score. But many of its lending practices, such as high loan to value ratios (the initial weighted average LTV of the loans Honor securitized was 135.12%) are common in the industry. And it appeared to avoid one of the industry's riskiest practices, extending the terms of loans in order to lower monthly payments. None of the loans in the 2016 securitization had terms beyond five years, according to rating agency research.

Nevertheless, the transaction raised some eyebrows because, at that time, only more seasoned issuers had been able to issue bonds with such low ratings.

"It was a very bold move," Cioffi said.

Honor was able to pull this off in part because its management team had individual experience in the subprime auto lending industry and so were not unknown. Co-founders James Collins and Robert DiMeo had worked together for over 20 years, including their stints at another lender, Mercury Finance, where Collins was brought in as COO to lead a restructuring and DiMeo was the vice president of credit.

Moreover, the company had been profitable since 2012.

And investors were desperate for yield and were becoming more comfortable taking on additional risk, thanks to the increased credit enhancements.

"Beginning in late 2016, across all structured products, spreads compressed significantly and issuers began increasing leverage within securitizations by issuing further and further down the capital stack. I don't think subprime auto was any different," said Neil Aggarwal, a senior portfolio manager at Semper Capital.

While there was some market turmoil early in 2016, by the time the Honor securitization was issued in December, the markets had recovered and "a full-on grab for yield was taking place," Aggarwal said. "Much of the ABS sector had rallied back in spread terms, and interest rates were still very low. So a lot of deals that could get done were getting done."

Both S&P Global Ratings and Kroll Bond Ratings believed that investors in Honor's auto asset-backeds would continue to receive interest and principal so long as losses stayed within their expectations for 20.5% to 21.5% of the original balance of the collateral over the life of the transaction.

The rating agencies based their views on the fact that the initial overcollateralization of Honor's transaction was 11%: it was issuing $100 million of bonds backed by $111 million of loans. This meant there would be more interest payment rolling in each month than were needed to pay interest and principal payments on the bonds. These extra funds could be used to pay down additional bond principal, quickly building the overcollateralization to 20.5% of the outstanding bonds. In other words, there would be fewer bonds left outstanding, leaving the remaining bonds better insulated from losses.

That's not how things turned out.

According to both S&P and Kroll, Honor had a policy of offering borrowers additional time to make payments that was unusually lenient. After this policy was revised, delinquencies and losses started to pile up faster. That meant there wasn't as much additional cash available to pay down the principal of the bonds. By July, losses had already reached 20%, and overcollateralization had fallen to 13.36%, prompting both S&P and Kroll to downgrade the $8.9 million of BB-rated bonds,

It was the first time S&P had downgraded a subprime auto loan asset-backed since 2002, and the first downgrade of any kind of auto loan ABS since 2011.

Things could get even worse. Honor's two co-founders and chief financial officer have left the company and Wells Fargo has withdrawn a line of credit Honor relied on to warehouse loans until they could be securitized. This brought new originations to a halt. On July 13, Honor notified the indenture trustee (which is also Wells Fargo) that it intended to resign as servicer. In August, senior noteholders approved the appointment of a successor servicer, a unit of Westlake Financial Services, a subprime lender based in Los Angeles.

A servicing transfer comes with its own risk: A potential disruption in payment collections. Kroll said in July it was concerned that this could result in a majority of borrowers who were currently behind on payments or had obtained an extension to eventually default. When the servicing transfer was approved, the rating agency issued a report saying it was closely monitoring the situation.

S&P has said it expects that losses on the collateral for Honor's deal could eventually reach 30%.

Problems at Honor have had little impact on demand for subordinated asset-backeds issued by other lenders. They have continued to tap the securitization market for bonds rated both double B and single B. In fact, issuance of single B notes, which were unheard of until this year, had reached some $141 million through June, according to S&P.

Most recently, Westlake completed a $1.1 billion securitization in August that included $62.2 million of single B notes. It was the lender's third deal of the year, and was upsized from $800 million initially.

In a report published in June, S&P noted that this follows a similar pattern in which demand for higher yield spurs increased issuance of riskier securities, just as the credit cycle is turning.

"This is reminiscent of the mid-1990s when BB rated classes first become popular," the report states. Issuance of BB rated auto asset-backeds grew from $5.2 million in 1995 to $26.2 million in 1996, and approximately $60 million in 1997, just as the subprime auto loan industry was beginning to unravel.

The rating agency warned that there is no rating history of single B auto bonds, so its unclear how they might perform in an economic or business downturn.

Lenders aren't just offloading more of the risk in their deals, they are also loosening underwriting – so there is more risk to unload. Prime and subprime lenders alike are increasingly using features such as longer terms, which lower monthly payments, and high LTVs, which allow borrowers to roll the balance of existing loans into new loans.

Jeremy Acevedo, manager of industry analysis at Edmunds.com, said the extension of loan terms, combined with a propensity to roll over the unpaid balance of old loans "is a recipe for trouble ahead," and not just for subprime loans, but for loans to prime borrowers as well.

Another factor that is tough on borrowers, but good for asset-backed investors is that used car prices have held firm, and in some cases are still rising.

"This is largely coming from the leasing phenomena," Acevedo said. "It's causing a tidal wave of near-new vehicles to hit the market, bringing prices up significantly We've never seen this many near-new used cars. Older cars are in shorter supply, and demand is really heavy."

High used car prices encourage borrowers to stretch their budgets, though it also reduces losses for investors when a borrower defaults and the vehicle is repossessed.

Aggarwal acknowledged that problems at Honor "highlight some of the embedded risks" in the subprime auto sector, even if he it did not impact demand for the broader market..

"With subprime auto ABS, there's very little information available about the payment history and creditworthiness of borrowers when compared to other sectors within structured products," he Aggarwal said. "So investors have to base their assessment of risk more heavily on the lender and servicer. And there's a significant amount of inherent risk in originating and servicing subprime auto loans." That's why there is often tiering of these operators that determines how easy it is to sell the securities when something goes wrong.

"Something like the events at Honor definitely creates more caution" for other third and fourth tier operators. However, it's not impacting prices of the top tier of subprime issuers," he said.

"The structure of subprime auto securities is fantastic; there's a lot of excess spread to turbo [pay down] bonds, it's short-dated, and there are a lot of structural protections." However, liquidity is not always there. "As an investor, you have to evaluate how much spread you require to take at that level of risk."

'B' is the new 'BB'

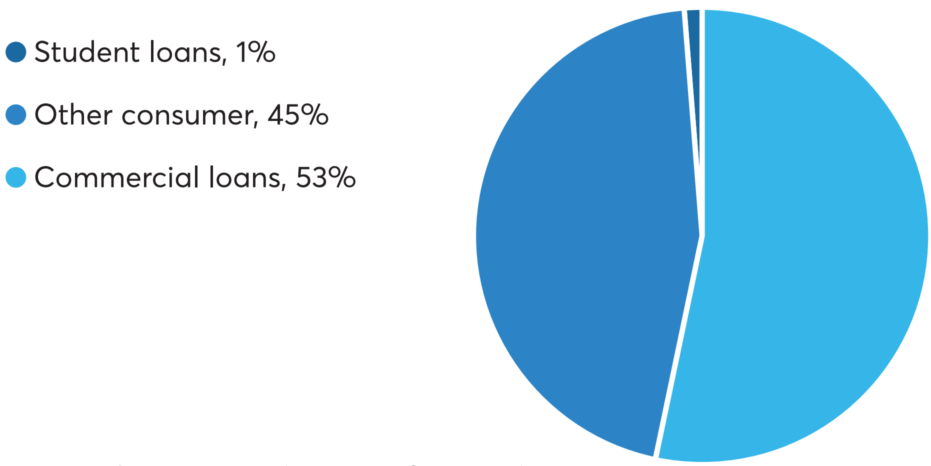
Subprime auto lenders issued $141 million of single B rated securities through June, compared with none in 2017

- **WLAKE 2018-1 Class F: $56.7M**
- **WLAKE 2018-2 Class F: $56.7M**
- **UACST 2018-1 Class F: $6.1M**
- **ACAR 2018-1 Class F: $14M**
- **FIAOT 2018-1 Class F: $7.5M**

Source: S&P Global Ratings

It's academic

Private student loans are only a tiny portion of the $944B loan portfolio at Wells Fargo. It has the heft to conquer the student refi market, but would it be worth it?



Source: The company (Data as of June 30)

Wells Fargo Can Upend Student Loan Refis; Will It?

Cheap funding and marketing muscle could give it an advantage, but the market may not move the needle for the bank

By Allison Bisbey

With cheap funding and plenty of marketing muscle, Wells Fargo has the potential to shake up the student loan refinance business.

But does it really want to?

Wells is the second biggest underwriter of private student loans, which are used to finance the cost of higher education over and above what federal student loans cover. It is now looking at offering loans that will not just consolidate private student debt, but also repay federal loans.

Refinance loans take advantage of the lack of underwriting done by the federal government, offering better rates to borrowers who have obtained advanced degrees and high-paying jobs. These borrowers are highly coveted, but they represent a small corner of the $1.4 trillion student loan market, and the competition is growing.

In addition to fintech lenders such as Social Finance and CommonBond, a number of smaller banks, including Citizens Financial, Laurel Road and SouthEast Bank, as well as many state student loan agencies, also offer refinance loans.

Since 2013, SoFi and others have bundled some $18 billion of refinance loans into collateral for bonds, according to DBRS. This figure excludes whole loans that were financed by being sold to investors or held on balance sheet.

"It feels like a lot of the low-hanging fruit has already been taken out of the refi market," said Robert Kelchen, assistant professor of higher education at Seton Hall University.

Breakdown of loan portfolio at Wells Fargo

Kelchen noted that SoFi, for

"My guess is they've had requests from existing [student loan] customers to refinance, and they want to have that capacity."

example, started out targeting students in certain programs at a small number of elite universities. SoFi has since expanded the number of schools and programs, but that means it is reaching students with somewhat more risk of not repaying their loans. And as this market broadens, the interest rate on refinance loans has begun to approach the rates for many existing private loans as well as federal loans for graduate students. This makes refinancing less attractive to many students in this broader pool.

Another reason the refinance market is so modest is that, even for the best borrowers, it generally only makes sense to use these loans to repay federally guaranteed loans to graduate students or parents, which pay rates of over 7%. Federally guaranteed undergraduate loans only pay around 5.5%.

"So the question is," Kelchen said, "can Wells Fargo potentially poach some of the low-hanging fruit, or is the goal to get people who have some private loans and some federal loans to refinance their federal loans with the company they already have private loans with?"

Michael Tarkan, an equity analyst at Compass Point, thinks the bank's goal is relatively modest. "My guess is they've had requests from existing [student loan] customers to refinance [federal student loans] and they want to have that capability," Tarkan said.

"Wells Fargo has a lot experience in student lending, so this is a logical step, but I don't get the sense it's intended to really drive a lot of volume or that it will significantly move the needle for Wells Fargo," he added.

A Wells spokesman would not comment on Wells' plans or analysts' speculation but wrote in an email that the bank "is continuously evaluating the marketplace to better serve customers."

Potential to drive consolidation among lenders

Unlike SoFi, CommonBond and some other refi lenders that rely on securitization and whole loan sales for funding, Wells Fargo holds the student loans it makes on balance sheet. Its student loan portfolio was $11.9 billion at the end of the second quarter. That was just a fraction of the bank's $441 billion consumer loan portfolio and an even smaller fraction of its total $944 billion portfolio of consumer and commercial loans.

Wells Fargo may be losing existing borrowers to refinance lenders "at the margin," Tarkan said, but not nearly as much as it likely lost during a big refinancing wave in 2017.

Jon Riber, senior vice president of U.S. asset-backed securities at DBRS, is skeptical that Wells Fargo would try to compete by going down the credit spectrum.

"I'd assume they'd go after the same types of borrowers" as refi lenders like SoFi and CommonBond "because they are a bank that will most likely hold their loans on balance sheet," he said. "They won't lend to non-super-prime borrowers, and potentially get into trouble down the road."

Even if the refinance market is too small to make a big impact on Wells Fargo's balance sheet, the bank could have a big impact on existing lenders. Certainly, Earnest has picked up the pace of origination since being acquired by the student loan servicing behemoth Navient in the fourth quarter of 2017; so far this year, it has completed three securitizations totaling over $1.2 billion, more than it did for all of 2016 and 2017. Navient's bigger balance sheet and strong servicing record also earned a higher credit rating on the deals, lowering its funding costs.

"It's a little too early to tell if Wells can be more competitive in the refi market, but presumably it could drive higher consolidation for lenders," Tarkan said.

"A new product with name recognition is certainly a concern" for existing refi lenders, "but at least some of the bigger refi lenders already out there have pretty good name recognition and relationships with colleges," Kelchen said. While relationships with colleges are not quite as important for refinance lenders as for undergraduate in-school lenders, "refi lenders want to get students fairly soon after graduation."

Another potential advantage for Wells, according to Kelchen, is the bank's existing relationships with borrowers through its in-school lending program, though he said this advantage seems to be fairly modest. "Wells Fargo is a large bank, and their cost of funds is probably lower than everyone else, and that could be an issue, as the other lenders won't be happy if Wells offers a lower rate," Riber said.

He said the bank's marketing muscle is also a potential advantage. "Acquisition costs in the refi space — meaning the marketing cost to acquire borrowers — have increased because of the competitive nature of the refi market. SoFi has spent a lot on expensive Super Bowl ads, which Wells could easily do. For the other lenders, this is not an option."

On the other hand, Riber said, "the refinance market could shrink if interest rates rise more than expected, because the incentive for a student loan borrower to refi goes down as the difference between their current loan rate and the new refi loan rate gets smaller."

Of Wells Fargo's two biggest competitors in in-school lending, only Discover offers refinances loans, and the company declined to provide origination volume for the product, which has been available to all of its customers since March 2017. SLM Corp., better known as Sallie Mae, has repeatedly downplayed the threat of refinance lenders, despite the fact that student lending is by far its biggest line of business — and refinance lenders are cherry-picking some of its best borrowers.

Sallie Mae executives reiterated on the company's second-quarter earnings call that margins on refinance lending are thin and eroding, noting that lenders have started to raise their interest rates. The amount of loans originated or serviced by Sallie Mae that were refinanced by other lenders fell by $3 million, or 1%, in the second quarter to $221 million.

Cherry picking the best borrowers

Refinance lenders are cherry picking the best borrowers from in-school lenders and the federal government. Monthly charge-offs for all securitized refi student loans tracked by DBRS averaged 0.02% of the outstanding principal balance in the second quarter. That was unchanged from the first quarter, but up from 0.01% a year earlier.

Loans at least one month behind on payments averaged 0.19% in the second quarter, while loans at least two months behind on payments averaged 0.09% .

Refi delinquencies are significantly lower than delinquencies on traditional private student loans or federally funded student loans. For example, 3% of private student loans and 6.9% of FFELP loans were at least two months behind on payments in the second quarter. **ASR**

Pick Up in Demand for Sterling Tranches of CLOs

New deals from PGIM and Barclays are the first GBP-denominated CLOs in five years, giving investors currency diversity options

By Glen Fest

Until recently, collateralized loan obligations denominated in pounds sterling were a tough sell.

European CLO managers have long expressed an interest in issuing sterling tranches of notes, if only because this would make it easier to find enough assets for deals. The alternative – issuing euro denominated notes backed by assets denominated in pounds – requires hedging against changes in exchange rates, which is expensive. But there just weren't enough buyers for sterling notes to make issuing them, and saving on hedging expenses, worthwhile.

That appears to be changing. In July, PGIM priced a £325 million deal, dubbed Dryden 63 GBP CLO that is the first pound-sterling CLO that S&P Global Ratings has rated in five years. All of the notes being offered are denominated in pounds, as are the loans and bonds used as collateral. (Assets denominated in other currencies may be added in the future, however.)

Also in August, Barclays priced Sirius Funding, a CLO that will issue securities denominated in three different currencies, pounds and euros and dollars, totaling £4.5 billion. The notes are backed by assets in all three currencies. It is the first pound CLO that Moody's Investors Service has rated since 2014.

Interestingly, demand for the pound CLO securities comes primarily from Asian investors, not U.K. investors, according to Aidan Canny, a managing director in BNY Mellon's corporate trust business for Europe, the Middle East and Asia.

Asian investors are the largest purchasers of CLO paper in the European market, and Canny said that many of them are looking to diversify their portfolios by buying assets denominated in different currencies. "There is obviously a significant amount of pension funds, insurance companies and banks that purchase this type of paper, and I think it's just currency diversification strategies," he said.

These strategies could be based on a long-term view of U.K. macroeconomic fundamental or potential concerns over how Brexit may impact pound- or euro-denominated securities, according to Canny.

Of course, pound-denominated CLO notes could also appeal to U.K. investors, who would not need to worry about foreign exchange risk, as the do with euro-denominated CLOs. However, it seems that this natural buyer base was not large enough to justify issuing sterling notes.

Multicurrency deals rare

Multicurrency deals themselves are unusual, those with a pound tranche even more so. The vast majority of outstanding deals have notes denominated in either dollars or euros, and the circa 160 CLOs totaling $87.9 billion are nearly six times the size of the 45 euro CLOS totaling €22.56 billion.

Multicurrency CLOs were more common before the financial crisis, and were commonly backed by loans and bonds denominated in both pounds and euros. Hedging was unnecessary since pound-denominated CLO securities were backed by pound-denominated loans and bonds, while euro-denominated CLO securities were backed by euro-denominated loans and bonds.

That's the strategy Barclays is using with Sirius, which is issuing three tranches of notes in three difference currencies that all carry the same Aaa credit ratings. The pound notes are backed by pound assets, the euro notes are backed by euro assets, and the dollar notes are backed by dollar assets. However, should one or two tranches of the tranches be redeemed early, the principal and interest proceeds from the corresponding currency will be converted to pay off the remaining tranches.

These strategies could be based on a long-term view of U.K. macroeconomic fundamentsl or potential concerns over Brexit

The euro and dollar tranches issued by Sirius were sized to match the equivalent of £1.125 billion and pays 140 basis points over the appropriate interbank lending benchmark; there is also a subordinate tranche of notes denominated in pounds that will be retained by Barclays.

For now, Dryden 63 GBP CLO does not need to be hedged, since both assets and liabilities are denominated in pounds. But the deal permits PGIM to add future assets in non-pound sterling denomination - presumably euros - which can make up to 80% of the pool of loans. According to an S&P presale report, no more than 5% of those assets can remain unhedged.

The AAA rated tranche on Dryden 63 pays Libor plus 125 basis points. **ASR**

CLO Investors Gear Up for Turn in Credit Cycle

Execs at two firms say expectations for an eventual rise in defaults are driving their strategy to extend reinvestment periods

By Glen Fest

Corporate defaults are still near historic lows, but some investors in collateralized loan obligations are preparing for the inevitable.

Eagle Point Credit Co. and Oxford Lane Capital are both closed-end investment funds that focus on the riskiest securities issued by collateralized loan obligations, and so are highly exposed to potential defaults on leveraged loans. And both are gearing up for an eventual turn in the corporate credit cycle.

"We do agree it's a when not an if," Eagle Point CEO Thomas Majewski told analysts on an Aug. 14 conference call. The firm has over $2.3 billion in assets under management in 70 CLOs, primarily in the "equity," or most subordinate tranches of these deals.

Oxford Lane Capital CEO Jonathan Cohen expressed a similar view on a conference call held the previous week. "I'm not sure we're at the beginning of the end or the end of the beginning," he said. "But we are certainly closer to the end."

Eagle Point and Oxford Lane have something else in common: Rather than take a defensive stance, both are taking steps to stay invested in the leveraged loan market for as long as possible. They are either buying stakes in CLOs with extended reinvestment periods or, in the case of CLOs in which they have a controlling interest, are voting to extend the reinvestment periods. The idea is that managers of deals that can be actively managed for longer will be in the best position to pick up troubled loans on the cheap.

This is unlikely to happen soon. The trailing 12-month U.S. leveraged loan default rate finished July at 2.2%, according to Moody's Investors Service. That was down from 2.4% in June but up from 1.5% in July 2017.

Still, there are some signs that the credit cycle is turning. For a long time, strong demand llowed speculative-grade companies to reprice outstanding debt at lower interest rates, lowering their funding costs. But repricings in the $1 trillion-plus leveraged loan market have all but dried up, with none occurring during July, Majewski noted on Eagle Point's conference call.

In addition, the percentage of loans trading above par, or face value, on the JPMorgan Leveraged Loan Index had fallen to 46% in mid-August from 70% in May.

In the second quarter, Eagle Point reset the terms of eight CLOs for which it has controlling interest. (Unlike refinancings, in which new notes with lower interest rates are issued and proceeds are used to repay existing notes, resets typically are undertaken to extend reinvestment and non-call periods of deals about to start amortizing.)

In July and August, Eagle Point reset two further deals, bringing the total number of resets to 18 since January 2017.

"The No. 1 thing we're working on in our portfolio is to buy as much reinvestment period as possible," Majewski said.

By extending the period during which deals can be actively managed, Eagle Point is hoping that when "that day of credit dislocation occurs, there will be a commensurate amount, or hopefully even greater amount, of price volatility," Majewski said. This would allow managers to pick up loans on the cheap.

Marketwide, the $74 billion in reset CLO volume in the first half of the year matched the estimated $74 billion in new CLO issuance, Majewski said. "CLO equity remains reasonably well-bid despite the liability widening as spread compression has subsided," he said. "We continue to have a robust reset pipeline and expect to direct additional resets in the second half of 2018."

In addition to resets, Eagle Point has stepped up investments in new-issue CLOs and warehouse accumulation facilities; this activity reduced the firm's capital reserves to $2.8 million as of June 30 from $8.3 million at the beginning of the second quarter.

"When credit dislocation occurs, "there will be a commensurate amount, and hopefully an even greater amount, of price volatility."

Oxford Lane boosted its investments in CLO equity by $45.8 million (new investments net of sales and repayments of existing CLO holdings) in the second quarter. It also extended a sale-and-repurchase agreement with Nomura Securities, providing it additional capital to fund opportunistic CLO purchases, the company announced.

Cohen said Oxford Lane will focus on building out longer reinvestment periods for its CLO equity holdings. Because of the "long-term, relatively low-cost leverage facilities" the firm has in place to acquire the positions, he said, Oxford Lane's CLO stakes will be "well positioned to perform during an economic dislocation or a widening spread environment." **ASR**

OCC's Door Officially Open, But Fintechs Not Rushing In

Fintech firms have the federal option they have long sought, but meeting the agency's application requirements will not be easy

By Rachel Witkowski

Fintech companies now have the federal option they have long sought after the Office of the Comptroller of the Currency green-lighted firms to apply for a special-purpose bank charter. But winning OCC approval on charter bids will not be a walk in the park.

One day after the OCC's July 31 announcement, some fintech firms signaled clear interest in the charter. But the agency's decision also prompted a slew of additional questions, including whether firms would be able to meet the regulator's tough criteria, and whether state regulators would continue to fight the charter concept in court.

"There are no short cuts here for prospective fintech charter applicants," said Julie Williams, managing director and the director of domestic advisory practice at Promontory Financial Group LLC. "The OCC very much reaffirmed they will be looking at applying all of the safety and soundness expectations they would apply to a traditional bank."

Still, fintech firms reacted to the news positively, and indicated some may test the waters.

David Klein, CEO and co-founder of CommonBond, said companies would be seeking additional "clarity" from the agency, but he added that the more financially sound fintech firms will likely consider applying despite having remaining questions.

"For many capital-intensive fintech firms, it's probably less a question of whether to get a charter and more about when to apply for one," he said. "This is a conversation I'm sure many capital-intensive fintech companies are having right now."

The OCC's statement, along with an accompanying supplement to the agency's licensing manual for fintech applicants, did address some questions the industry had about what would be required to get a charter.

For example, the OCC said applicants would have to meet similar capital, liquidity, stress testing and financial inclusion requirements as traditional banks.

However, the OCC also left some wiggle room by not explicitly defining the needed capital ratios or what "financial inclusion" requirements with which charter recipients must comply.

"The expectations for promoting financial inclusion will depend on the company's business model and the types of planned products, services, and activities," the OCC said in its press release. The OCC also appeared to provide some flexibility in how an applicant would craft its "contingency plan," which is akin to the stress tests conducted by large banks.

The OCC "left the financial inclusion part pretty open," Klein said.

But Williams pointed out that both requirements go beyond what regulators typically expect from a de novo bank applicant. The contingency plan and financial inclusion "are additional to the requirements that we see in the standards and application processes for a traditional bank charter," said Williams, who was a former senior deputy comptroller and chief counsel at the OCC.

The overall level of interest in an OCC charter among the fintech industry is somewhat of an open question amid signs that firms' enthusiasm about the idea may have dwindled since the agency first proposed it under former Comptroller Thomas Curry.

Speaking to reporters in May, the current comptroller, Joseph Otting, said some companies are less interested after discussing the process with the OCC and learning what is involved. "They began to learn about national banking versus state banking and operating across state lines and then they come talk to us, and we explained the issue … of capital, liquidity and serving your community," Otting said.

Sam Taussig, head of global policy at Kabbage, said the OCC appeared to communicate that it will tailor the charter to how each firm operates.

"The charter is certainly on the table as one of many options and we're certainly excited about it," he said. **ASR**

Gary Gensler, chair of Maryland's Financial Consumer Protection Commission Bloomberg News

Can State AGs Really Serve as 'Mini-CFBPs'?

Several pledged to compensate for a slowdown in enforcement at the Consumer Financial Protection Bureau under Mick Mulvaney

By Kate Berry

Late last year, 17 state attorneys general pledged to fill the gap if the Consumer Financial Protection Bureau slowed its enforcement activity under acting Director Mick Mulvaney. But their efforts to compensate for a less aggressive CFPB have so far been a mixed bag.

Only a handful of states, such as Pennsylvania and New Jersey, have announced plans to create so-called "mini-CFPBs". In other states, budgets have been too constrained to expand enforcement operations beyond what AGs were already doing to assist the CFPB under former Director Richard Cordray.

Meanwhile, with the CFPB actually accelerating enforcement actions of late, some argue that the void left for states to fill may not be that big. Indeed, many observers say not much has changed in how states and the CFPB investigate financial firms for potential wrongdoing.

The creation of mini-CFPBs "hasn't been as necessary as some would have thought," said Richard Gottlieb, a partner at Manatt, Phelps & Phillips.

The AGs sent Mulvaney a letter in December warning the Trump administration appointee that they stood ready to ramp up efforts if the CFPB let down its guard.

"If incoming CFPB leadership prevents the agency's professional staff from aggressively pursuing consumer abuse and financial misconduct, we will redouble our efforts at the state level to root out such misconduct and hold those responsible to account," they said.

In the time since, the agency has certainly shown signs of a less aggressive approach. After Mulvaney decried the agency's enforcement apparatus as overaggressive, it took months before the agency revived public actions against companies. But since mid-June, enforcement actions have accelerated.

Observers say state AG offices that had participated most willingly in Cordray-led investigations have continued to operate at full tilt in the Mulvaney era, pursuing fraud allegations and other claims.

But with no general drop-off in investigatory activities, state budgets in some cases are too tight to establish mini-CFPBs around the country more broadly. "All the states were already at capacity in terms of their ability to ramp up their enforcement activity," said Christopher Willis, a consumer finance practice leader at the law firm Ballard Spahr. "The states are doing as much as they can with constrained budgets and staff, and those constraints have not changed."

However, in some states, the Trump administration's pro-business, deregulatory posture has been seen as an opportunity for AGs to cast themselves as more aggressive consumer watchdogs.

"The states are asking, how do I maximize my deterrence effect, if I'm a state AG with limited resources?" said Allyson Baker, a partner at Venable and a former CFPB enforcement attorney. "Since this administration came into power there has been a collective concern among attorneys general across the country that there would be receding enforcement power and one of the things the AGs have tried to do is compensate for that or address that."

Pennsylvania announced its initiative before Mulvaney took the reins of the CFPB, with state Attorney General Josh Shapiro creating the Consumer Financial Unit to field consumer complaints and target predatory lenders. He tapped Nicholas Smyth, a former CFPB enforcement attorney, to head the new unit.

Earlier this year, New Jersey picked Paul R. Rodriguez, a lawyer in New York City Mayor Bill de Blasio's office, as director of the division of consumer affairs.

Other states have eyed similar moves, but it is unclear whether they can devote enough resources to compensate for any perceived slowdown in CFPB activity.

Maryland has created a new Financial Consumer Protection Commission chaired by Gary Gensler, a former Goldman Sachs executive and head of the Commodity Futures Trading Commission in the Obama administration. The state legislature is expected to set aside $1.2 million to create 10 positions for the unit.

Some states, meanwhile, already ramped up their financial consumer protection efforts before President Trump came to office. In 2015, Virginia Attorney General Mark Herring created a special unit targeting predatory lenders. Virginia has doubled the number of attorneys focused specifically on consumer protection to 10 from five, and added 18 additional personnel including dispute resolution specialists and paralegals.

Some states also are reassessing how best to deploy their resources in reaction to what the CFPB does. The added funds allow states to conduct more investigations against bad actors, typically involving fraud. Attorneys generally also hope to get a political boost by broadcasting their aggressive stance to fill in the void.

"Prior to the election of Trump, it was a way for the states to follow on with what the CFPB was doing," said Catherine Brennan, an attorney at Hudson Cook. "With the election of Trump, I think those state mini-CFPBs have taken on more importance at the state level — and for those attorneys general organizing these mini-CFPBs, it's a good issue if you are planning on running for higher office."

Brennan has specifically advised online lenders to be cautious about doing business in Virginia, claiming that a company can "do everything right and still find [themselves] on the receiving end" of an inquiry or enforcement action.

Other observers note that, even where budgets are constrained, state-backed efforts in the Trump era should not be dismissed. "We all have capacity issues and there's plenty for us to be doing and there always has been," said John Ryan, the president and CEO of the Conference of State Bank Supervisors.

He said efforts at the federal level always draw "greater attention." But even a state like Maryland allotting $1 million for its initiative should be applauded.

On the legal front, however, little has changed for the states. Every AG's office has a consumer protection division with express statutory authority to enforce federal consumer protection laws including unfair, deceptive and abusive acts and practices, known as UDAAP.

States are trying to respond to the changes at the CFPB with Mulvaney focused more on confidential supervisory resolutions while issuing fewer consent orders and enforcement actions.

Mulvaney also has put a priority on criminal actions and fraud, as opposed to going after big pots of money or providing restitution to borrowers.

But the states also are less likely to take action against companies for violations of fair-lending laws or disparate impact, which are resource-intensive, require expensive statistical analysis and could lead to more litigation.

Many observers say the dynamic between states and the CFPB has not changed much since the agency's new leadership took the helm. "It's not like enforcement went away," said Gottlieb.

"All of the states were already at capacity in terms of their ability to ramp up their enforcement activity."

States have often argued that they are a better venue for enforcement of consumer protection laws, claiming that federal preemption and regulatory authority handed to agencies like the Office of the Comptroller of the Currency and the now-defunct Office of Thrift Supervision helped lead to industry abuses that were a major cause of the financial crisis.

In addition to state AGs, banks and financial firms also have to contend with reinvigorated state banking regulators, who continue to flex their muscles.

New York's Department of Financial institutions and California's Department of Business Oversight have stepped into the breach on several fronts, including signing a consent order against Equifax with six other states.

New York also is creating data security rules. California is seeking information from a dozen unlicensed student loan servicers and is cracking down on lenders trying to avoid state interest rate caps.

"There's an endless supply of real bad actors for [the states] to go after," said Willis. "For financial institutions, in terms of the level of compliance scrutiny and risk from the changeover at the CFPB, the world is not that different today than it was two years ago." **ASR**

Why CleanFund Held Out for an AAA

Bragging rights were a key benefit for the commercial PACE provider, which was the second to bring a deal to market

By Allison Bisbey

Providers of property assessed clean energy financing have tended to shoot for relatively modest credit ratings when they initially tap the securitization market,

But CleanFund, a San Francisco-based firm that provides PACE financing for commercial property, went a different route, achieving an AAA from DBRS on its inaugural securitization of $115 million of PACE assessments. The firm did it in part because of a key benefit: Bragging rights.

"We were looking for a little distinction to set ourselves a bit apart," CleanFund CEO Greg Saunders said in an interview.

The deal is not the first commercial PACE securitization ever — that distinction belongs to Greenworks Lending, which completed a private placement in 2017. Still, "we like that it's the first AAA, and not just the first 144a," Saunders said, referring to the securities law rule that allows for the sale of unregistered offerings to certain types of investors.

Bonds backed by PACE loans are one of the few types of asset-backeds with long tenors — the underlying assessments, which finance energy efficiency upgrades, can last 20 years or longer. So these investments are particularly attractive to insurance companies, which generally try to put their money to work in assets with terms as long as their policies.

Since insurance regulators assign the same risk weighting to securities with a credit rating of single-A-minus or higher, there's less of an economic incentive for PACE providers to provide the additional investor protections necessary to achieve the top credit rating of AAA.

Insurance companies may not be as inclined to accept the lower yields on these super-safe securities as would other kinds of investors, such as banks or money managers.

Unlike Greenworks' $75 million deal, which was rated AA by Morningstar Credit Ratings and was placed with a single investor, TIAA Investments, CleanFund's transaction was placed with a total of four investors, three insurers and a money manager.

CleanFund did have to make a concession to its investors, some of whom were not quite as comfortable with the collateral as DBRS; the sponsor increased the amount of excess collateral available to protect noteholders in the event of losses or late payments, to 10% of the balance of the notes from 5% originally. (DBRS was willing to assign an AAA based on 5% overcollateralization.) Doing so meant reducing the amount of notes issued to $103 million from $109 million originally.

"Five percent overcollateralization seemed light to some investors on calls; now that it's at 10%. It was received well for sure," Saunders said.

CleanFund also opted not to squeeze the last dollar of borrowing in the deal, which closed July 31; the sponsor did not issue any subordinated tranches with lower ratings and fewer investors protections.

The deal, CleanFund Commercial PACE 2018-1 refinances $115 million of PACE assessments on 82 properties in six states in the West Coast, Midwest and East Coast, or roughly two thirds of the financing that the CleanFund, which was founded in 2009, has arranged to date.

Commercial PACE providers have been slower to tap the securitization market than residential PACE providers; in part because it takes longer to underwrite the financing and assemble a diverse pool of assets. Now that CleanFund has completed the process, it has important feedback that can help it to price future funding more efficiently, knowing how potential investors view the various kinds of collateral. "Eventually this will help us [as we] feed it into more precise pricing and structuring of individual deals to credit factors that seem to matter to investors," Saunders said.

"Five percent overcollateralization seemed light to some investors on calls; 10% ... was received well."

While "it's OK to have a golf course or a community center and factory as part of the collateral pool … we can't get carried away with alternative asset classes," he said. Instead, they need to be balanced with more traditional types of commercial property.

Commercial PACE securitizations are somewhat analogous to commercial mortgage securitizations, where investors are used to seeing a broad diversity of assets. So CleanFund also fielded questions from investors about the heavy exposure to California and Texas and to the five largest assessments. However investors seemed to feel more comfortable once they understood that the lien created by an assessment is senior to that of a mortgage, and moreover cannot be extinguished upon default, since it does not "travel" with the borrower. **ASR**

The Role of the Trustee

MODERATOR

Danielle Fugazy
contributing editor,
SourceMedia

Trustees play a critical role in any asset securitization transaction. They are there to protect the interests of the investors. However, over the years the role of the trustee has in some cases grown and in other cases changed. *Asset Securitization Report* brought together leading industry experts to discuss the various types of trustees that can be needed for an asset securitization transaction, the different roles they can play, and why they are a crucial part of the transaction process. Wilmington Trust sponsored the event. What follows is an excerpted version of the conversation where various scenarios were discussed. The event took place in ASR's New York offices and included representatives from Wilmington Trust, Chapman and Cutler LLP, Richards Layton & Finger, and Laurel Road.

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Danielle: What is a full trustee and why would you need one?

Pat: The "full service" trustee will take on the role of the indenture trustee, as well as other related roles, including the paying agent, calculation/verification agent, document custodian, as well as backup servicer. These roles aren't all under the trustee umbrella, but nevertheless they are usually intertwined with the indenture trustee. Issuers and their counsel may find that it's cost efficient for a transaction to have one entity providing the full range of services. However, the structure of the deal may mandate a specific type of trustee. For example, if you use a Delaware statutory trust or a New York common law trust—you may likely need an owner trustee.

Additionally, we are not always the paying agent in an owner trustee structure. But more often than not, we are asked to hold title. If there is a title requirement within the structure, and both an owner and indenture trustee are engaged, it is typically (but not always) the owner trustee that takes title. The requirement to hold title stems from a concern that the only way to avoid licensing requirements at the state level is to have a federally or nationally chartered bank hold title to the assets as trustee.

It used to be that the trust could hold title, but there has since been concern that the trust itself would then have to qualify in the states where the loans were originated. This would be a real headache for the transaction if it occurred post-closing. So structures started to incorporate the requirement to hold title at the trustee level on the

front end of structuring the transaction. During the financial crisis, many banks, who were at the time holding title as trustee, were stuck with foreclosures and were exposed to a lot of reputational risks and liability, which resulted in these banks unwilling to hold title in transactions post-crisis. With strong client relationships and with the proper protections in place, Wilmington Trust will consider holding title in its name as trustee.

Doneene: Full service trustee means you are not only acting as a trustee, but are you also handling some of the administrative functions like paying agent and registrar. In some transactions, those roles are bifurcated or separated among institutions. That said it certainly provides efficiency when you have one- stop shopping. One institution that can do the trustee plus the administrative functions—that's how I think of a ful service trustee. And it can also include the various other services that can be provided like custodian, backup servicer, etc.

Danielle: Can a single provider play all the roles? Are there conflicts?

Ben: Since we are a Delaware-based shop, we can offer the whole plethora of trustee services. Within those trustee services there are layers of different obligations and roles. Regarding the indenture trustee role, we also offer the calculation agent, where we will model the waterfalls and we have a whole analytics group that does that work.

Anna: The baseline difference between the various types of trustees involves

The baseline difference between the various types of trustees involves asking who the trustee is representing and which party's interests the trustee is acting at the direction of.

Anna Anderson
Partner, Chapman and Cutler LLP

asking who the trustee is representing and which party's interests the trustee is acting at the direction of. Another factor to consider is the level of the trustee's involvement in the transaction; whether the trustee has a passive role in the beginning—prior to events of default—or a more active role after the occurrence of an event of default. It's important to note that a particular type of trustee's role can change across asset classes. Ultimately it is a question that should be answered at the beginning of the transaction and depends on the situation, what the client needs, and what services the trustee has to offer.

Ryan: We actually prefer to have a one-stop shop. We have enough counter parties as an issuer as it is. But it's been suggested to us by counsel that we should bifurcate the indenture trustee and the owner trustee role, even though we prefer to have everything consolidated in place.

Pat: If it's a public deal, it's likely governed under the TIA, and in that case it may make sense to have each trustee role (owner and indenture) handled by separate entities. However, usually if it's not a public deal, people are comfortable with a bifurcation within the same institution. When we do serve as both indenture trustee and owner trustee in the same transaction, we have a different administrator handle the indenture trustee and another administrator work with the owner trustee. And from a legal perspective, we'll have a different lawyer represent us as an indenture trustee and then another lawyer within the same firm represent us as owner trustee.

Doneene: In a public deal, the trust indenture act controls. It doesn't prohibit the same institution from serving in both roles at the outset. However, it if there's ever a trigger in that transaction from a default perspective, the TIA requires that there be no conflict of interest. That's when one party would need to resign. In some transactions the investors and the issuers may not want to run that risk.

In the private deal context, it's not TIA covered; it's really perceived conflicts of interest. In some deals the parties will use affiliated entities. In deals where the same entity is used, different teams will handle the different sides of the deal. We also add specific language into the deal documents disclosing to the various parties that the same institution is serving in multiple roles, but that the execution of their duties and responsibilities in each of those roles is in no way a hindrance to what they need to do in other capacities.

The efficiency piece of working with a single provider cannot be overlooked. It also makes a ton of sense from a fee perspective as well.

Anna: We draft those documents to expressly state the duties for the different roles such that knowledge in one role is not imputed to knowledge in another role. There has to be actual knowledge of certain events and notice provisions, for example, so that every transaction party understands that there are distinct and separate roles even though the roles may be performed by the same institution.

Danielle: What is the nominal trustee? Why and how did this role come about?

Ben: After the financial downturn there was a ton of litigation surrounding securitizations, especially in the private market. At that point, the trustee, because they are named as the owner of the collateral within the trust, is the first one to be named in all of the litigation. This happened mainly in the mortgage industry. As a result, a lot of trustees made the decision not to be named trustee anymore.

They said they will do all the other work, such as be the securities intermediary, the master servicer, the paying agent, and calculation agent, but they just don't want to be named the trustee for the specific reason of wanting to stay clear of the litigation possibilities. So other banks—including ourselves—saw that as an opportunity. We could enter the business of a nominal trustee role.

In the past three years we've expanded our suite of services so that we now play the full indenture trustee role—this is obviously our preference in transactions—where we can be your named trustee, your securities intermediary, your paying agent, and your calculation agent. We perform the whole suite of services, roles, and obligations while there are still other trustees out there that can't or are unwilling to perform those services due to prior litigation.

Pat: Very few banks are willing to hold title today. They would prefer to take on the "securities administrator" role and bring a nominal trustee into the deal to hold title. But even when serving as nominal trustee, especially on RMBS transactions, there is still risk and liability. As nominal trustee, there are rep and warrant situations that require trustee involvement. Even as nominal trustee, there is still plenty of risk and liability for a role that the industry deems 'nominal.' For these reasons, and others, it is Wilmington Trust's preference to provide multiple services to the transaction that provide additional revenue in support of the risk that we take on. Additionally, borrowers are often referred to the trustee who holds title rather than to the servicer when it comes to questions or concerns about their mortgage. Trustees will direct the borrower to the appropriate servicer, but this is another example of a nominal trustee with more than just a 'nominal' role, especially in situations where the servicer is not being responsive.

We perform the whole suite of services, roles, and obligations while there are still other trustees out there that can't or are unwilling to perform those services due to prior litigation.

Benjamin Jordan
Head of Transaction Management, Wilmington Trust, N.A.

Ryan: That sounds like a really poor risk/reward role to take. Why does all of that rep and warrant risk roll up to Wilmington Trust, why are borrowers calling Wilmington Trust about loan modifications when they should be calling their servicer? Where's the disconnect?

Pat: Sometimes it's the responsiveness of the servicer. In some cases the servicers can change frequently and the borrowers don't know who to call. Meanwhile, titles to the loans remain in Wilmington Trust's name as trustee. Sometimes, it is just easier for the borrowers to go right to who they know 'owns' their loan. They don't necessarily know that their loan has been 'sold' into a securitization, and they likely don't understand the role of a servicer or the role of the trustee.

Doneene: If you think about the mortgage market crisis, a lot of the litigation was brought on by investors against trustees because they had an expectation that the trustees were going to be taking certain actions that trustees actually weren't obligated to do. Across the board, everyone involved in these structures needed some education in terms of roles and responsibilities and who to go to in certain instances. You had many different categories of participants who really didn't understand these structures and it created a lot of the issues. And that resulted in the decision for a lot of the banks to pull back.

Anna: There is always the deep pocket concern. Any institution named in a figurehead role is likely going to be pulled into litigation. So, from a drafting standpoint, we review and revise the indemnity provisions and any related side letters as necessary. Based on relatively recent case law we've had to add language into indemnification provisions to expressly state that amounts can be recovered in connection with any enforcement of its right to indemnification. Indemnification provisions are a critical component of a transaction document, but not something that people generally like to talk about at the beginning of a deal when they're planning on everything going well. Regardless, the documents need to be clear as to what amounts

From my perspective, having one shop that you can go to helps deepen the relationship.

Doneene Damon
Executive Vice President, Head of Corporate Trust and Agency Services Group, Richards Layton & Finger

can be recovered, when, and by which transaction party.

Danielle: What are the advantages of having a full service trustee versus a separate account admin, and paying agent and nominal trustee?

Ben: The main advantage is you're not dealing with multiple parties. Because there are a lot of transactions where there's a nominal trustee, a securities intermediary, paying agent, calculation agent. As a full service indenture trustee we can offer the whole suite of products.

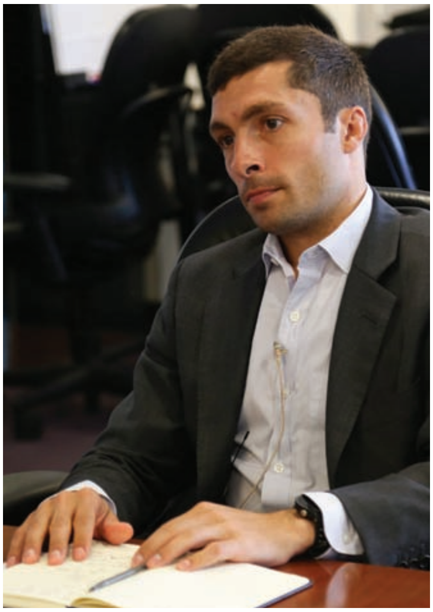
Pat: If Laurel Road were to hire an owner trustee, a nominal trustee, and a securities intermediary, they would be looking to three different institutions, and, potentially three different law firms as well. This all adds to the costs and a lack of efficiency for the transaction.

Doneene: It's also about relationships. From my perspective, having one shop that you can go to helps deepen the relationship. You know one another and you know what services the trustee can provide. The trustee knows what to expect from you as an issuer. It creates expectations going in and you do not constantly have to renegotiate over and over again because you have the same institutions that you are working with all the time. This builds strong relationships which helps create efficiencies.

Ben: Something we recognized after the downturn and prior to offering our full service role, is there's a lot of back and forth between the third parties. We would play the nominal role in a mortgage transaction and someone else would play the securities intermediary or the master servicer. The amount of back and forth with the paperwork and notices between us and that other party results in a lot of lost time as compared to us being able to do it all in house. That's definitely another advantage of having everything in one place. There's also no confusion over who's doing what. Sometimes the securities administrator will say we're not doing that, that's the trustee's role and the trustee says, no, that's a function that you have under the agreement. It eliminates issues.

Anna: It's important to have the structuring conversations early in the planning process and make sure everybody is very clear on whom is doing what, and what are the expectations of each role. This allows us to then draft the initial documents based on the business terms, rather than be required to react and revise documents well into the transaction timeline.

Ryan: I do think when you start reducing and tearing down some of the ancillary legal and other fees that don't really drive a ton of value within the transaction structure—even if it's just consolidating under one counter-party—some of those cost savings do actually end up getting passed to our customers.



The trust is often structured as a statutory trust, but it can also be structured as a common law trust.

Ryan Foss
Senior Vice President, Capital Markets & Strategy, Laurel Road

Danielle: Grantor trustee, owner trustee, indenture trustee, what's the difference between each, and who represents whom?

Doneene: I'll start with the grantor trustee. There are lots of transactions where there's a desire for the trustee to take title to assets for various reasons. And in many of those transactions, a grantor trust is created as the first step in the transaction. The grantor trustee is the party who is brought in to take title to the assets. In many transactions, there is also a desire to have grantor trust tax treatment for federal income tax purposes. The trust is often structured as a common law trust, but it can also be a structured as a statutory trust. In essence, the grantor trust typically refers to a trust treated as a grantor trust for tax purposes in which the trustee takes title to the assets of the trust.

The functionality of the grantor trustee is taking title at the first level. The next step of the transaction typically involves the grantor trust issuing some kind of certificate of beneficial ownership interest that then becomes the asset of the owner trust. The owner trust can also be either a common law trust or a Delaware statutory trust. The owner trustee serves at the owner trust level. The owner trust or owner trustee then enters into an indenture with an indenture trustee pursuant to which notes are issued to investors in the transaction.

It's really all driven by tax, regulatory, and licensing issues.

Pat: It's just the nomenclature that's used and it can add confusion to the market.

Anna: The bottom line is to consider what interests the trustees are representing. And that differs depending on the role. It goes to what I said earlier—that those questions need to be answered at the very beginning of the structuring discussions. In our experience, more often than not trustees may be brought into the deal on the back end of those structuring conversations, and then transaction parties have to react and the trustees themselves have to very quickly try and react to figure out what it is the parties really want and what roles the transactions parties need the trustees to play. ■

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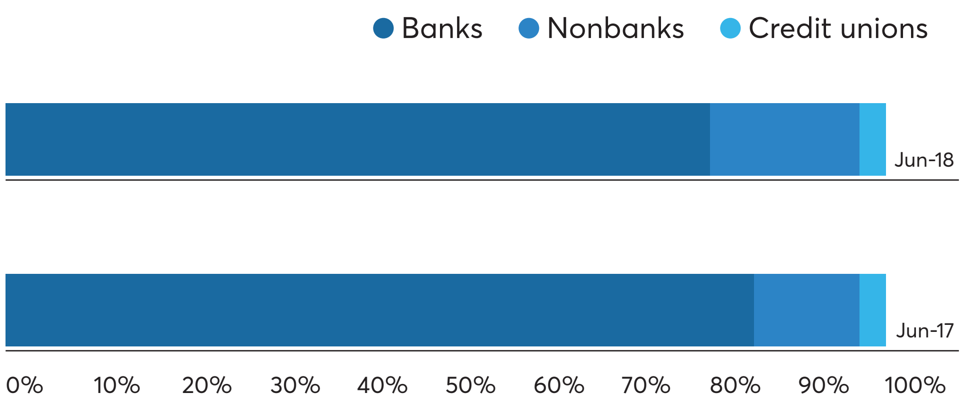
Super product

Nonbanks have widened their share of the market for super jumbo loan purchases at the expense of banks



Source: Optimal Blue

Nonbanks Ease Standards to Compete for 'Super' Jumbos

Originators of these multi-million dollar loans are proliferating, building a new market for high-balance mortgage securitizations

By Brad Finkestein

An uptick in private investor liquidity is bringing more nonbank lenders into the market for super jumbo mortgages, often with weaker credit standards than the banks that traditionally dominate this niche.

Super jumbo mortgages, loosely defined as loans with an original balance of more than $1 million, are often offered by banks to build tight-knit relationships with high-net-worth customers in their private banking and wealth management divisions.

But nonbanks, which in recent years have seen their influence and market share grow considerably, are now starting to gain traction with super jumbos.

The total number of super jumbo originators — nonbanks, as well as banks and credit unions — grew 15% in June 2018 over the previous year, according to estimates by Optimal Blue, a provider of loan product and secondary market data and technology.

Nonbank super jumbo originators, which Optimal Blue estimates number in the "few hundred," grew 10% year over year and now outnumber depositories by a 2-to-1 margin.

Banks that offer super jumbos tend to hold the loans in portfolio. But the rise in nonbank activity is being driven by private-label secondary market investors that are willing to buy super jumbos for both whole loan and securitized investments. The number of nonbank investors and aggregators that offer super jumbos was 60% higher in June than it was a year ago, Optimal Blue said.

Recent loan performance has been strong for mortgages originated at $2 million to $3 million, said Vince Furey, senior vice president, lending solutions at OpenClose, an origination software company. That's emboldened the secondary market appetite for even higher-balance loans.

"The market to securitize those high loan balances is there now, where it really wasn't before. Liquidity drives everything," Furey said.

Small investor universe

The investor universe is still small; Optimal Blue estimates less than 50 investors and aggregators are actively purchasing super jumbos. Banks make up the vast majority of investors, but their market share of loan purchases by dollar volume slipped to 80% in June, from 85% a year ago. Nonbanks' market share grew to 17%, from 12%, while credit unions held roughly 3% of the market, Optimal Blue said.

Nonconforming mortgages accounted for about 11% of loans originated using Optimal Blue's product and pricing engine in June, unchanged from a year ago. However, super jumbos accounted for 13% of all nonconforming lending, down from 17% a year ago.

Nonbanks originate 55% of the dollar volume of super jumbo mortgages. Despite the much lower number of originators, banks and credit unions account for 45% of super jumbo lending by dollar volume because their average loan size tends to be higher than nonbanks, according to Optimal Blue.

The number of nonbank super jumbo lenders is in the low hundreds, Optimal Blue estimates. Among them is the Denver-based direct lender Eave, which offers mortgages with a $20 million loan limit, and LoanStream Mortgage, which offers products with loan amounts up to $10 million.

Caliber Home Loans rolled out Elite Access, with a $3 million limit that allows for a 95% LTV with no mortgage insurance and 700 credit score. The Dallas-based lender cited rising home values as one reason for creating the product.

Other niche products, including home equity lines of credit up to $3 million, are also hitting the market.

"But home values don't mean anything if there's no marketable liquidity for the product. The marketable liquidity is being driven by confidence in the values," Furey said.

Relaxed underwriting standards

In addition to raising maximum loan balances, lenders are easing other terms as well, including going up to 95% loan-to-value ratios. If a borrower has a large enough nest egg of liquid assets, some lenders are also willing to forgo traditional employment and income verifications.

"Overall, these specialized products that didn't exist three years ago have expanded dramatically, as rates rise and refinance volume shrinks," Furey said. "These unique niche products are picking up a segment of purchasers that may have been locked out of the market."

The relaxed standards mirror activity in the traditional prime jumbo market, as evidenced by recent securitization pools. In July, mortgage aggregator Annaly Capital pooled lightly seasoned prime and jumbo loan originations with an average balance of $664,560 that had meaningful levels of low-documentation income loans (37%). The high percentage of non-qualified and higher-priced qualified jumbo mortgages also "fell outside the credit box," Fitch Ratings noted in a presale report.

And in a recent $1 billion prime jumbo pool, JPMorgan increased its level of riskier third-party originations through correspondent and broker channels. That factored into a Moody's Investors Service downgrade of the bank's prime jumbo origination ratings assessment in August.

Some lenders are mitigating risk through cross-collateralization of the borrower's properties, Furey said. For example, a borrower can use their equity in other properties or assets as collateral for the new super jumbo loan.

Despite the looser underwriting and large loan balances, lenders and investors don't appear to be particularly concerned about taking on the additional risk. Rather, they view the product as a strategy opportunity to reach a borrower segment unserved by banks.

Verus Mortgage Capital, a correspondent aggregator headquartered in Washington, D.C., is offering loans up to $5 million for borrowers previously locked out of jumbo financing.

"Their alternatives are cash or private money loans," said its president, Dane Smith. "We've seen the borrower demand. They're great loans, great borrowers, they have really attractive credit risk profiles."

The higher loan amounts even apply to credit-impaired borrowers, where the previous limit was $2 million. Verus purchased a few of these loans on a test basis, liked the borrower profile of the applicants and decided to offer the program on a broader basis, Smith said.

There are a number of factors for the recent popularity of these loans, he said. "People that are doing well, the economy's doing well, they're looking to buy a house but they recognize or are surprised when they don't fit into a traditional box. They may not have assets to qualify for super jumbo bank financing."

As a result, money-center banks are not Verus' competition for these loans.

The growth has been all along the credit spectrum. "There are a lot of common-sense loans out there, and if we can find a common-sense loan to buy in the super jumbo space, we will do that," Smith said.

Luxury Mortgage, a Stamford, Conn.-based subsidiary of Tiptree Financial, just expanded its guidelines for the nonqualified mortgage jumbo offerings, moving to a $4 million loan limit from a $3 million limit established when the program was rolled out in January.

"There are just things you can do in a non-QM product to make the mortgage process more convenient and less cumbersome for the borrower."

More loans being securitized

On the prime jumbo side, it will do up to $5 million, but it will go above those amounts in both programs on an exception basis, said CEO David Adamo.

"There's been a proliferation of expanding guidelines to accommodate these larger loan balances, particularly the ones that fall outside of traditional prime jumbo credit guidelines in the non-QM product categories," Adamo said. "There are just things you can do in a non-QM product to make the mortgage process more convenient and less cumbersome for the borrower than if they were to go through the traditional route of a typical prime credit jumbo product."

These loans are being bundled in securitizations with those under $1 million, he said. But with each deal there are more and more super jumbo loans included and as a result of the successful execution the origination community has gotten comfortable with increasing the loan amounts. **ASR**

What the FHFA Scandal Means for GSE Reform

The biggest impact may be to focus the administration's efforts on selecting a nominee to succeed Director Mel Watt

By Hannah Lang

The Federal Housing Finance Agency has faced a barrage of negative headlines lately, from a sexual harassment probe of Director Mel Watt to a court ruling declaring the agency's leadership structure unconstitutional.

But will the flood of bad news affect policy related to oversight of Fannie Mae and Freddie Mac?

Analysts say the biggest impact of all the attention — albeit negative attention — may be to elevate the profile of a relatively obscure agency that poses significant personnel and policy questions that the administration will have to address sooner or later.

"It's kind of turning D.C.'s attention to the future of housing finance a little bit more than it has been for some time," said Ed Mills, a policy analyst at Raymond James.

In July, a three-judge panel for the U.S. Court of Appeals for the Fifth Circuit ruled the agency's leadership structure, in which a single director is shielded from presidential firing without cause, violates the Constitution.

But a more explosive story broke 10 days later in a report by Politico about an investigation into allegations that Watt, an Obama appointee whose term ends in January, made inappropriate sexual advances toward an employee. On Aug. 2, Politico also reported an investigation into the FHFA's inspector general, Laura Wertheimer, for allegedly taking steps to undercut her office's oversight of the agency in response to pressure from Watt.

Mills and others said the effects of the recent scandals on the agency's current leadership — and how it handles the conservatorships of the government-sponsored enterprises — are likely limited, mainly because Watt is near the end of his term and attention has shifted to naming a successor. (The FHFA declined to comment for this story.)

"This would have a huge impact if this was in the first six months of the tenure, not in the last six months," said Mills.

But if the administration had not been focused on selecting a new nominee to run the agency, the recent scandals may be accelerating that process. Attention to the agency could grow next month; the House Financial Services Committee plans an FHFA oversight hearing for no later than Sept. 27.

"Each one of these headlines ... brings more focus to the transition ahead more so than necessarily defining the transition," said Isaac Boltansky, the director of policy research at Compass Point. "So at a minimum it's just getting more attention within a White House that I think at times has not prioritized financial regulatory nominees in its to-do list."

Still, Boltansky agreed that the recent developments likely will not impact broader discussions about FHFA reforms with Watt's exit at hand.

"If we were at a different point in the five-year term, I think that there would be more of a window for legislative consideration of the FHFA's governance structure, but given that we're a few months and possibly even less from President Trump getting to tap the next head of the FHFA, I seriously doubt that either chamber of Congress is likely to focus on this issue," he said.

And analysts widely agreed that the agency being cast in a more negative light likely won't have much bearing on efforts to reform the GSEs. Reform of the housing finance system has already been intractable enough.

"GSE reform has many complex economic and political moving parts and thus won't be materially impacted by any one or two individuals," said Mark Zandi, chief economist of Moody's Analytics.

Some suggested the ultimate outcome of the court case over the agency's constitutionality is a bigger factor in determining the agency's future. "If we see any rethinking about the agency's leadership structure, it won't be because of" this pair of scandals "but because of the constitutional questions raised by the Fifth Circuit or the choice of a deeply ideological successor to Director Watt," said Jim Parrott, a fellow at the Urban Institute.

The agency has had a full workload in Watt's last year as director, such as a proposal to establish minimum risk-based capital requirements for Fannie and Freddie. But some items on the agency's policy agenda are not tied to Watt's leadership. For example, the second phase of a common securitization platform for the GSEs has been delayed to the second quarter of 2019, after Watt's term has expired.

Boltansky said the elusiveness of GSE reform is unchanged by the recent scandals.

"The reality is the system works as is, it's a significant driver of the economy and any of the substantive reform proposals that we see being considered carry considerable execution risk," he said. **ASR**

FHFA Halts GSE Pilots in Single Family Rental Market

The agency said the market for larger rental investors may not need additional liquidity from Fannie and Freddie

By Elina Tarkazikis

The Federal Housing Finance Agency is ending single-family rental pilot programs that were aimed at testing the need for greater involvement from Fannie Mae and Freddie Mac in the market.

"What we learned as a result of the pilots is that the larger single-family rental investor market continues to perform successfully without the liquidity provided by the Enterprises," FHFA Director Mel Watt said in an Aug. 21 press release. The existing single-family rental programs will remain in place and the move does not preclude future proposals on addressing housing needs using SFR strategies, the agency said

The pilot programs run through the government-sponsored enterprises were launched two years ago in response to growth in the single-family rental market.

Fannie and Freddie provided data and other assistance for the test runs, while the FHFA administered its own impact analysis from a range of investors, lenders, rating agencies, data providers and consulting firms. The agency also held a single-family rental workshop in June 2017, where it collected additional feedback from stakeholders.

"Workshop participants noted a potential liquidity need for midsized investors to preserve affordability of current single-family rental properties, a lack of financing options for properties valued under $100,000, and the need for standardization in asset and property management practices," according to an FHFA document.

Workshop attendees also proposed changes to Fannie and Freddie's existing programs, including underwriting cash flows and offering non-recourse loans.

The FHFA said while it recognizes a potential need for long-term financing for midsize investors owning affordable single-family rental assets, it is "premature" to allow GSE involvement in this segment of the rental market. "The effects of their participation on rent growth, long-term affordability, for-sale assets, and homeownership is insufficiently understood without significantly more extensive research and analysis," the agency said.

The Community Home Lenders Association also expressed concern about the pilot programs in a March 2017 letter to the FHFA responding to reports that Fannie Mae was providing $1 billion in financing to the Blackstone Group unit Invitation Homes. The association questioned the transaction's mission, risk, lack of transparency and impact on communities and consumers.

The CHLA issued a statement saying it was "pleased" with the FHFA's decision. The GSEs "can now go back to focusing on smaller investor loans for affordable single family rental properties," it said. **ASR**

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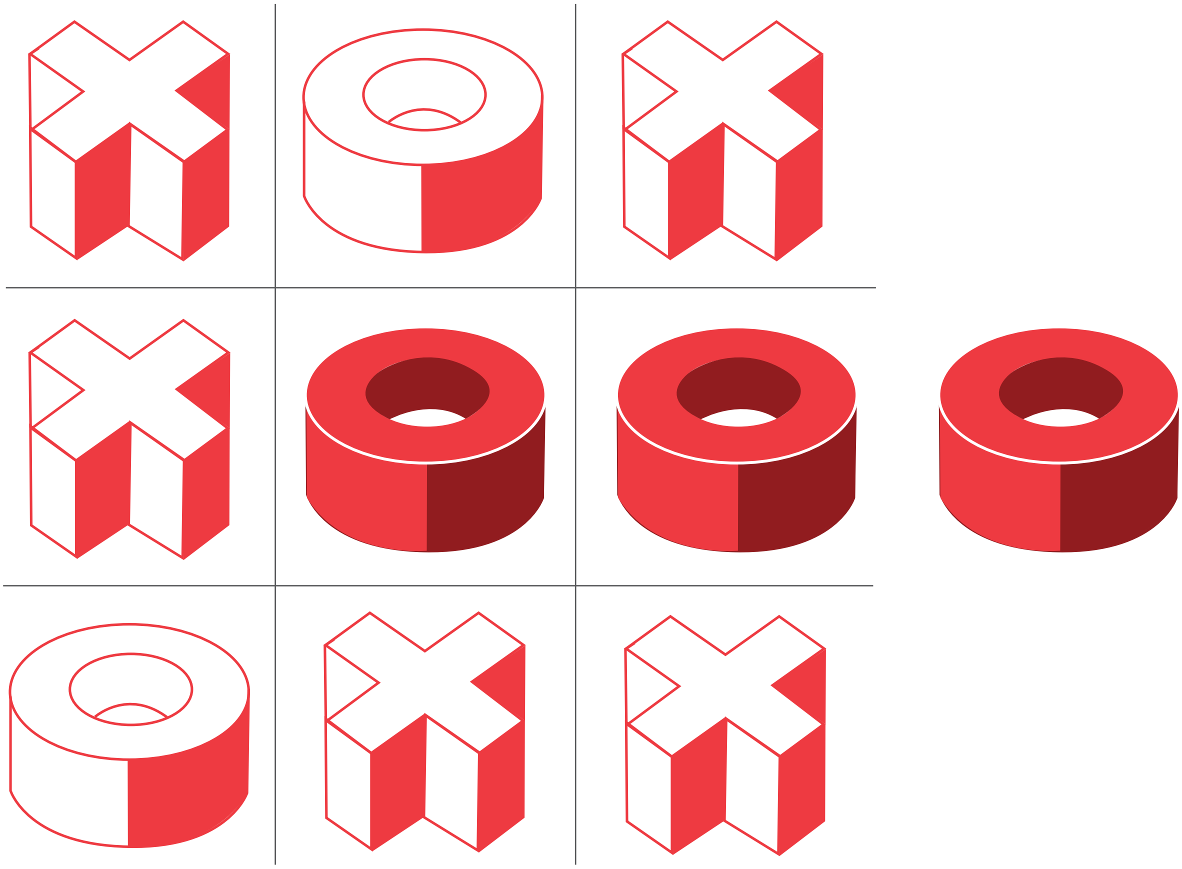

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