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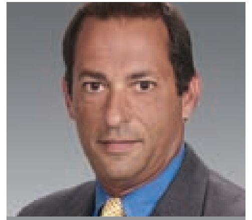

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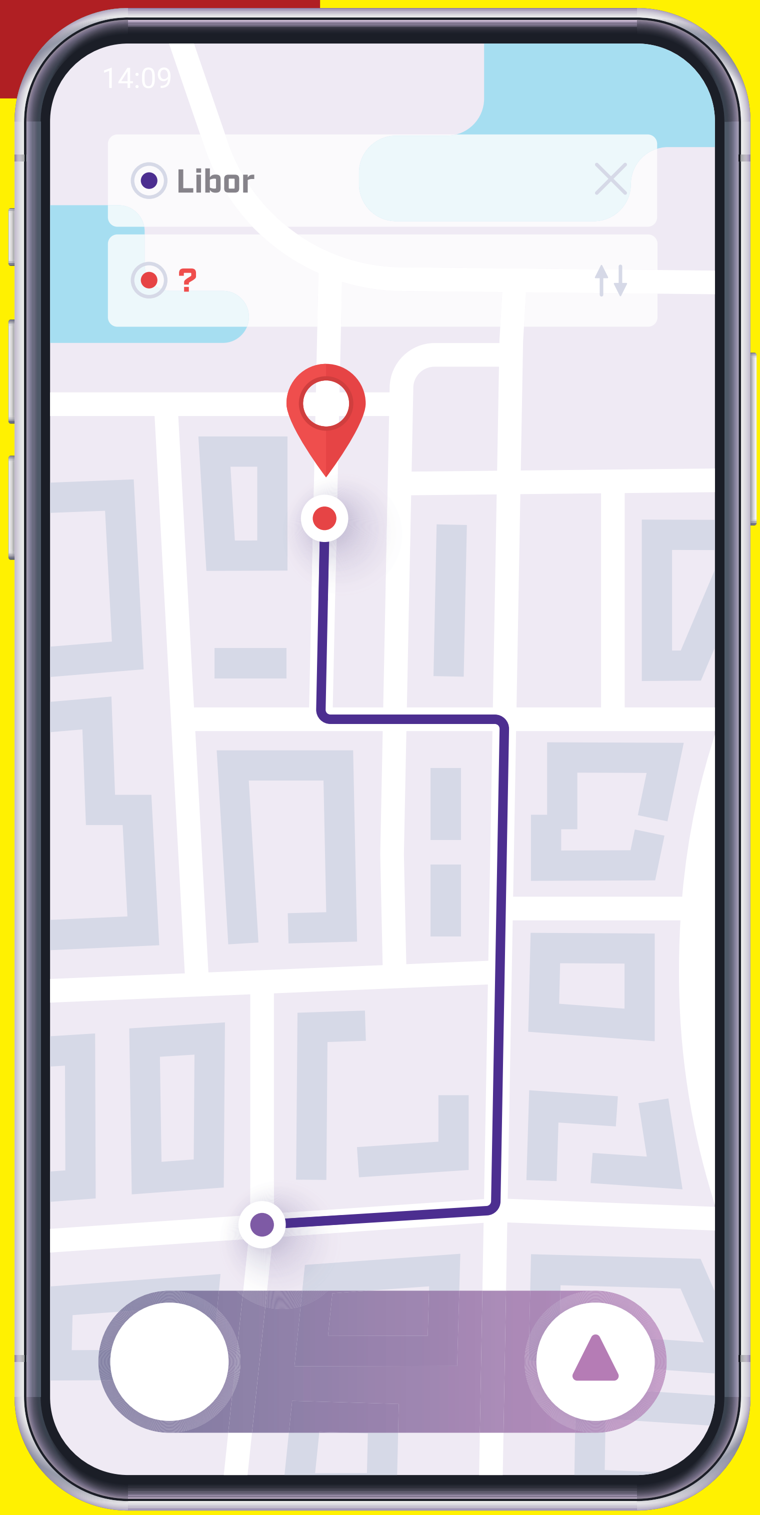

Which Way Forward?

A year after regulators announced that Libor would be phased out, it's unclear what will replace it as a benchmark for loans

May/June 2018 | Volume 18, Number 4

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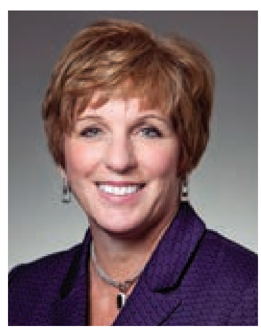

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* As of June 30, 2017. Source: M&T Bank
** Asset-Backed Alert, December 31, 2017

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Not Dead Yet

The London interbank offered rate is supposed to measure what large banks charge each other for short-term loans. The problem is, banks rarely engage in these transactions anymore.

This means that the benchmark index is calculated using what one observer calls "a bid on something that doesn't occur."

Despite its faults, however, Libor still compensates lenders (and investors) for at least some of the credit risk of dealing with different counterparties. Perhaps not enough of this risk or perhaps too much. But at least it provides compensation.

As Brian Reynolds, a strategist at Canaccord Genuity, put it in a report published as we went to press, fixed income portfolio managers "love" Libor, because it is the only interest rate that goes up in a crisis, allowing managers who own floating-rate debt based on it to outperform in difficult times because of exposure to corporate credit.

This is something that regulators failed to take into account in phasing Libor out and attempting to replace it (in the U.S.) with the Secured Overnight Financing Rate (SOFR), which is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities That means SOFR is essentially free of any credit risk, reflecting only interest rate risk. It may be an appropriate benchmark for derivatives and swaps, but not corporate or consumer loans.

As Glen Fest explains in our cover story, there are two parallel efforts underway to address this problem. On the one hand, the Intercontinental Exchange (ICE) Benchmark Administration, since 2014 the administrator of 35 Libor rates of various tenors and currencies, has vague plans to continue to publish some of the indexes, relying on voluntary submissions by banks.

At the same time, the International Swaps and Derivatives Association is developing a methodology that would essentially add a credit-risk spread premium to a SOFR-derived rate to make it work more effectively as a fallback standard for legacy Libor products.

At this point, it appears to be anyone's guess which approach will prevail.

— Allison Bisbey

Asset Securitization Report

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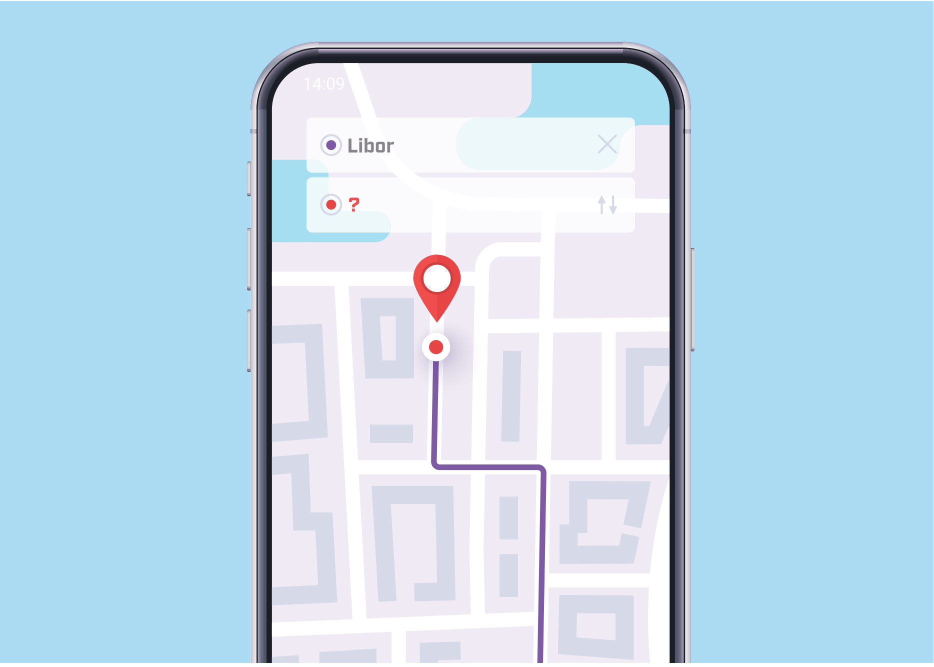

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Which Way Forward?

A year after regulators announced that Libor would be phased out, it's unclear what will replace it as a benchmark for loans

By Glen Fest

In March, the U.K.'s top financial regulator, Andrew Bailey, addressed an issue that has plagued investors, consumer and corporate lenders and borrowers since plans were announced last July to move away from the benchmark for over US$200 trillion in loans and derivatives by 2021.

At a finance-industry confab in London, Bailey asked – rhetorically – what is to be done about the $36 trillion in legacy bonds, securities, derivatives, swaps and other Libor-based financial instruments that will mature when contributor banks are no longer required to submit quotes for the index?

Bailey, the head of the Financial Conduct Authority, acknowledged it may not be "practical or economic" to change reference rates on outstanding long-term, floating-rate instruments, and said the FCA supported the creation of a Libor "proxy" to stand in for the benchmark approaching its three-year exit window.

But can a "synthetic" rate be created that emulates Libor, derived from secured and potentially less-volatile benchmarks that the U.S. and U.K. are developing?

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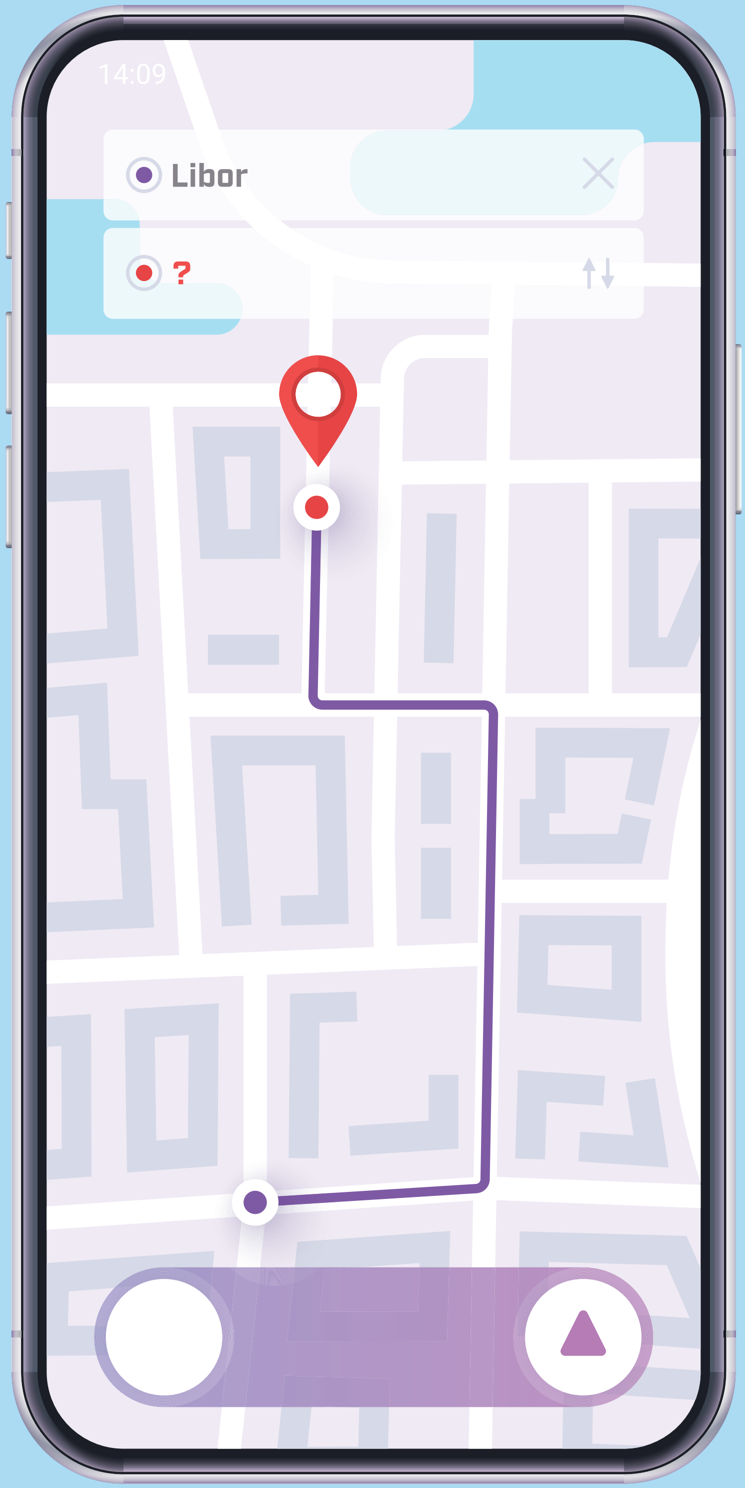
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Libor
?

"I'm not sure," Bailey said, answering his own question.

With just over three years to go, a shrug of the shoulders is about as good a response as any as to how financial markets will adjust.

The FCA is unwavering in its plan to stop requiring contributor banks to submit quotes.

In April, the U.S. Federal Reserve started publishing a new overnight repo funding rate designed to replace Libor for the swaps and derivatives market, but it is not suitable for longer-term assets. There are plans to develop a term rate replacement that is derived from the Secured Overnight Financing Rate (SOFR), but it will not be ready until the end of 2021.

The Intercontinental Exchange (ICE) Benchmark Administration, since 2014 the administrator of 35 Libor rates of various tenors and currencies, has vague plans to continue to publish some of the indexes, relying on voluntary submissions by banks.

"There is a lot of planning, a lot of modeling, a lot of thinking," said Adam Schneider, a partner with the research firm Oliver Wyman who has consulted with financial institutions on plans to replace Libor as a benchmark for their long-term assets. "Not a lot of deciding at this point."

Each alternative has its shortcomings.

A term rated derived from the SOFR passes a crucial test that the FCA has applied to a benchmark's credibility: reality. SOFR is based on the nearly $800 billion in daily clearing activity in the overnight Treasury repurchase agreement market. By comparison, Libor is a benchmark derived from opinions, and increasingly less reliant on actual interbank, overnight lending transactions that have all but disappeared in the post-crisis era.

But any benchmark based on transactions that are essentially risk-free would not compensate lenders for the counterparty risk they are taking on when they lend to each other, to companies or to consumers. That's a particular concern during times of market volatility, when Libor (or a suitable replacement) would be expected to experience bigger moves than an index based on U.S. Treasurys.

Oliver Wyman ran a comparison of spreads on the new U.K. overnight rate – the Sterling Overnight Index Average (or SONIA) – to the pound-based Libor, and found a wide-ranging difference in stressed periods of more than 400 basis points.

A possible fix is in the works. The International Swaps and Derivatives Association is developing a methodology that would essentially add a credit-risk spread premium to a SOFR-derived rate to make it work more effectively as a fallback standard for legacy Libor products. There appears to be broad support for these efforts. Advisory firm Chatham Financial managing director Todd Cuppia said the consensus is that the new SOFR-derived index "is going to be the one that wins the day" as the expected fallback language that most investors and issuers will agree to.

Even after such an index is developed, however, it must gain wide acceptance from both buyers and sellers before the market for securities linked to it becomes liquid. It remains to be seen how long that will take, even once it is published.

BlackRock, which has $6.3 trillion of assets under management, has described this as a "chicken or egg problem." In an April client newsletter, it said that "investors will not adopt" alternative reference rates "if liquidity is insufficient, but sufficient liquidity will not develop if investors do not adopt ARRs."

Adds Schneider, "You can't determine a number without trading volume, which is a core problem."

There's a parallel movement to keep Libor alive after 2021, in some form.

In February, ICE President Timothy Bowler said there is an overwhelming preference in the loan market to keep Libor ongoing using voluntary bids from contributor banks for new as well as legacy debts (albeit for not necessarily all 35 indexes currently published by ICE). The ICE has been encouraging lenders, investors and borrowers to lobby contributor banks to continue reporting quotes on a voluntary basis.

And in April, the index administrator announced a "gradual" transition to a new bid system that asks for interest rates on actual wholesale financial transactions (if available) rather than solely in-house opinions.

"Most people are comfortable that, halfway through 2018, nothing has been done. The closer we get, the less it becomes a reality that [Libor] is phased out by 2021."

Many have reservations about any ongoing use of Libor, however. Joseph Forte, a partner at Sullivan & Worcester, says that contributor banks would prefer to bow out of Libor submissions, which "is a bid on something that doesn't occur."

Participant banks may also find themselves in a legal stew with investors and issuers if the new or synthetic version of Libor doesn't comport with existing rates. "My fear of keeping Libor alive is the borrower has something to point to" for a class action, said Forte.

David Knutson, head of credit research in the Americas for the U.K. asset manager Schroders, agreed that "expert judgment, I think is risky" with Libor but said he is concerned that there is embedded risk in a SOFR-derived rate, risk that is not garnering enough attention.

The potential for a SOFR term rate to perform more steadily in a stress period may tame volatility, but Knutson wondered whether that is a good thing. "There's been some discussion how some of that volatility can be damped," he said.

"I, on the other hand, think damping is dangerous."

"Risk isn't something that moves in a predictable-step function – it is emotional, it is flexible, it is a surprise," said Knutson, a co-leader on the advisory board of The Credit Roundtable, an advocacy forum for institutional investors. "As a research analyst, I need to see these 'risk pops'. If you go from one day, 'everything's fine,' to the next day 'everything is collapsing,' I think that's a worse outcome."

Paul Norris, a managing director and head of structured products at the global asset manager Conning, argues that extending Libor is likely the best outcome for the fixed-income market, including CLOs. "I think the reality is, most people are comfortable with the fact that halfway through 2018 that nothing has been done," said Norris. "The closer we get, the less it becomes a reality that it's phased out by 2021."

Until the path to the new rate is more established, the sum of corporate loans, residential and commercial mortgages, student loans, bonds and securities indexed to Libor that mature after 2021 will only continue to mount. As of April, the total was $1.9 trillion, according to the Federal Reserve.

Three and a half years might seem like plenty of time, but problems arising from the upcoming absence or change in the benchmark are already manifest.

Oliver Wyman warned in a February report that the transition from Libor will bring considerable costs and risks for financial firms. With new payment reference rates, firms must undergo a risk management overhaul to calculate any long-term changes in asset value, which will require new market-risk profiles and interest-rate hedging strategies.

More immediate is the risk from gaps in how deal documents will govern the transition to a Libor replacement or extension.

Shrink to survive

Libor is currently produced for five currencies in seven maturities ranging from overnight to 12 months

- **CHF (Swiss franc)**
- **EUR (euro)**
- **GBP (pound sterling)**
- **JPY (Japanese yen)**
- **USD (US dollar)**

Source: ICE Benchmark Administration

"Prior fallback provisions [to replace Libor] just assumed a temporary interruption," said Oliver Wyman's Schneider. "Not that it was potentially going away."

Indeed, fallback language in securitization, loan and derivatives contracts "are all over the map," said Gary Horbacz, a principal for PGIM Fixed Income's structured products team. "Unfortunately, there was no standard," even within asset classes, such as CLOs and commercial mortgage-backed securities, he said.

Some contracts call only for the most recent Libor rate – which would affix a final published Libor rate (presumably Dec. 31, 2021) as a perpetual fixed rate for the duration of a note. Others might convert to the Fed's prime lending rate, or abide by the federal funds rate on U.S. Treasury securities. Some allow for lenders to claim a new Libor rate based on self-polling of London or New York banks. Still others, according to an April report from PGIM, lack of any fallback language.

According to Oliver Wyman, the risk in having either specified or undetermined fallback options is that, as a new rate option is deployed, "the economic impact is likely to be significant, with one side a winner and the other a loser."

Chatham's Cuppia points out that even should the ISDA derive the compensating spread to SOFR, it could still "create a lot of operation difficulty with respect to payment invoicing" for borrowers, lacking the "transparency of what your debt service costs will be over a certain period," he said. "That's not a problem with Libor; it's a forward-looking index."

Investors are sensitive to these changes since, by and large, they can represent a loss of long-term expected yield over what Libor rates would have provided. "Even in cases where there is fallback language," said Cuppia, "there's oftentimes no consideration for the change in the [Libor] spread" through maturity.

How best to reach an agreement is a question that, like most issues surrounding Libor's evolution or its endgame, is still awaiting an answer. **ASR**

It's a bank thing

Laurel Road faces a lending constraint its nonbank competitors do not; a novel transaction got the servicing rights associated with student loans off its books

- Total assets: $600M
- Student loan origination: $3B
- Student loan securitization: $2.5B
- Notional value securitized strips: $1B

Source: Laurel Road

Novel Solution to a Uniquely Bank Problem

Student lending was putting pressure on Laurel Road's capital ratios; a securitization got servicing strips off its books

By Allison Bisbey

Success often comes at a price, and for Laurel Road Bank in Darien, Conn., explosive growth in student loan refinancing has put a strain on its capital ratios.

Basel III causes a bank's Tier 1 capital to take a haircut for any servicing rights held on its books. Laurel Road, formerly known as Darien Rowayton Bank, has only $600 million in assets, and over the past five years it has made more than $3 billion in private student loans.

The loans themselves are an easy sell; Laurel Road has bundled some $2.5 billion into collateral for bonds. It also sells packages of loans to other banks.

The market for excess student loan servicing fees, or what's left over after collections and payments are outsourced to a subservicer, was nonexistent. So Laurel Road created one. In late March, it closed on a novel transaction securitizing the excess servicing "strips" on student loans. The transaction gets the rights associated with $1 billion of loans off the bank's books, reducing the haircut to Tier 1 capital and allowing the bank more capacity to fund loans. It may be the first securitization of servicing strips on any asset other than a mortgage.

"Servicing is very punitive from a capital ratio standpoint," Gary Lieberman, the bank's chairman, said in an interview. The transaction "does give us the present value of the capital, but that's not so important to us; it's really the fact that regulators require us to keep so much capital against servicing … this gets it off of our books."

Capital ratios are something that Laurel Road's fintech competitors, which include Social Finance, CommonBond and Earnest (now part of the student loan servicing behemoth Navient), don't have to worry about — at least not yet. SoFi, which has made some $14 billion in student loans, has explored becoming a bank in the past.

Lieberman said that getting both banking regulators and rating agencies comfortable with the transaction was a lot of work. (DBRS assigned a low investment-grade rating of BBB to the single tranche of certificates issued in the transaction.) Finding investors was not so difficult, however. "Clearly there is an interest from a variety of parties," Lieberman said. "The risk profile is pretty amazing; we've done over $3.5 billion in loans, and probably have $1 million in defaults."

Like other refinance lenders, Laurel Road wants to expand the range of products it offers to high-earning millennials. In March it launched a digital mortgage. "There's a correlation between refinancing student loans and buying a first home," Lieberman said. "It's a natural extension to offer them to our student loan borrower base." **ASR**

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EdSouth Does Homework On Student Loan Refis

It garnered a triple-A from two credit rating agencies, S&P Global and DBRS, for its inaugural securitization

By Allison Bisbey

Doing the homework paid off for SouthEast Bank. The $1.4 billion-asset community bank based in Knoxville, Tenn., garnered a triple-A from two credit rating agencies, S&P Global Ratings and DBRS, for its inaugural securitization of loans refinancing the debt of borrowers with advanced degrees and high-paying jobs.

By comparison, Social Finance, which started lending in 2012 and did its first student loan securitization in 2014, didn't get a triple-A rating until 2015. CommonBond, which started lending a year later, did its first triple-A deal this year. Earnest achieved a triple-A only after being acquired last year by Navient, a financial institution with a much larger balance sheet and longer servicing record.

It didn't hurt that rating agencies – and asset-backed investors – are already familiar with SouthEast Bank's parent company, EdSouth, which is a regular securitizer of federally guaranteed student loans. But Barbara Thomas, SouthEast Bank's executive vice president and head of its Education Loan Finance (ELFI) division, also credits the build-out of the student lending platform over the past year.

"We're not an unknown entity; people are very familiar with the name, but this is a new product under that name," Thomas said.

SouthEast Bank started offering refinance student loans in December 2015 and it initially outsourced origination. In 2016, the bank hired Thomas, who formerly managed the student loan banking group at Morgan Stanley. Over the past year it has brought origination in-house, in which a borrower works with the same representative throughout the refi process.

Thomas has a deep background in student loans. While at Morgan Stanley she advised on over $75 billion of financing for clients including SoFi, CommonBond and Laurel Road (formerly Darien Rowayton Bank), all of which are now competitors. In 2008, she was appointed as lead advisor to the U.S. Treasury and the U.S. Department of Education in the development and execution of the $40 billion Straight A Conduit Program to fund the student loan industry during the credit crisis.

The new transaction securitizes the bulk of the $250 million of refinance loans that the bank has made to about 3,455 borrowers since launching its two refinance products, one for borrowers with advanced degrees, high credit scores and high incomes and the other for parents. Having access to the capital markets allows SouthEast to accelerate the pace of refinance lending, even if the bank doesn't have to rely on it. "I went through the credit crisis," Thomas said. "I know there are times" the securitization market "won't be there. That's why having a bank balance sheet is so attractive. **ASR**

Bringing a Trader's Eye to a Top CLO Manager

CIFC adds a Citi deal-desk veteran to manage real-time, daily risks and opportunities in its structured products group

By Glen Fest

Investing in collateralized loan obligation securities used to be primarily a "buy and hold" business, says Jay Huang.

The new structured products head at CIFC Asset Management should know; he spent 16 years at Citigroup, were he helped create and operate one of the first CLO/CDO trading desks. In the early days, before the financial crisis, a clients (typically insurance companies) might trade once every two weeks.

Not anymore. Now a typical trading desk might handle dozens of transactions a day with a wider swathe of investors, including other asset management firms, international buyers and private wealth. This creates opportunities for a firm like CIFC, which both manages CLOs and invests in them to enhance returns. But it is also requiring enhanced risk management to track the rapid changes occurring to underlying loans.

Huang was hired by CIFC in January to bring his structured product trading expertise to bear at the firm. He reports to CIFC's co-CEOs Oliver Wriedt and Steve Vaccaro. In his new post, Huang says he will be tasked with almost a daily trading, investing and underwriting of the firm's structured product investment holdings, including third-party CLO mezzanine and debt securities.

At the moment, that might be a challenging enterprise, given the challenging market for acquiring loans. But Huang is confident that firm's relationships across the credit and capital markets, combined with a focus on strengthening the trading desk's technology to analyze the risks and opportunities of individual loans, will keep the growth of CIFC's buy-side arm on track.

Huang discussed his new role building out CIFC's trading operations, which focus on mezzanine debt and equity, as well as his views on how the repeal of risk retention will impact the CLO market (the interview took place prior to the Feb. 9 federal court ruling exempting CLOs from the requirement they maintain a 5% stake in the credit risk of their deals).

ASR: Discuss your background with Citigroup.

Huang: I was with Citi for 16 years. For the last 10 I served as managing director and global head of CLO, CDO and distressed structured investment vehicle (SIV) trading. When I first started out at Citi in 2000, CLOs rarely ever changed hands after issuance; CLOs were, for the most part, known to be buy-and-hold investments. That would change quickly in the next two years.

In 2002, I was part of a two-person team at Citi that launched the firm's first dedicated CDO/CLO trading business. Back then, there was 1 BWIC [bid wanted in competition] every two weeks. Now it is common to see 10-20 in a single day. When

I joined Citi in 2000, I spent two years in CLO and CDO structuring. All in all, I spent two years creating the product, and the next 14 trading it.

What will be different with the opportunity at CIFC?
My primary interest has and continues to be proactive value creation in long-term investment portfolios, as opposed to market making. What I plan to bring to CIFC is a trading-oriented strategy buoyed by the firm's crown jewel strengths in fundamental credit and capital markets relationships. The marriage of all those dimensions will give us the edge to proactively trade our portfolio and improve our risk profiles constantly. Now, that doesn't mean we need to trade every day, but I guess you could say that every day we will be looking to re-underwrite our portfolio against the rest of the market.

Has trading become a more important skill set for a CLO manager?
Trading has always been an important element of maximizing the value of a portfolio of CLOs, particularly when you have the benefit of detailed credit analytics into the underlying loans. The flood of outstanding CLOs in the market has never been so large, and it's constantly growing. Post-crisis, I would estimate secondary trading volumes have been anywhere from five to 10 times what they were pre-crisis. I think that number surprises a lot of people — that's because the vast majority of CLOs issued pre-crisis were sold into buy-and-hold type levered vehicles/accounts. Nowadays, the account base is much more diverse.

What changes do you have in mind for CIFC's CLO business?
We plan on building an in-house custom analytics system that will integrate external data sources with the firm's existing credit analytics platform and apply them to CLO investments as well as other structured products as we expand beyond CLOs. Data science will be a central part of our risk management systems here.

Do you plan on increasing deal sizes or raising more funds for third-party CLO investments?
My main effort at CIFC will be further building the infrastructure for and AUM of our structured product investments business. The vast majority of our structured product portfolio is effectively mezzanine debt and equity.

If risk retention ends, how do you think it will change deal structures?
I believe the risk retention money that has been raised will stay in place and be invested. I do not believe that the market can keep up the issuance pace of 2017 without the risk retention money. I know from my experience as a dealer that the current depth of buyers for majority CLO equity stakes (which is what the market would need to fully replace if risk retention capital went away) is not as deep as most market participants believe.

Will smaller managers emerge, or will CMVs be spun off or liquidated?
I think most managers, now that they have the option to sell some of their equity from previous deals, will at least explore that post-risk retention appeal. Now, that doesn't mean there is going to be a flood of equity supply in the market. I would guess most asset managers aren't in the business of prop trading their own balance sheet; they're effectively in the fee business.

In terms of newer, smaller asset managers, I do expect more to come to market and try to underwrite deals the "regular way," by going to a dealer and having them place most or all the debt and equity tranches. But, if the current buyer base of the market stays where it is right now, I again don't think the buyer base for those types of managers is as deep as people think it is.

Is the sheer volume of deals out there making it more difficult to market or arrange a CLO?
Generally speaking, over the past year cash balances within CLOs have declined. Prudent managers will take the time they need to ramp a solid portfolio as opposed to "buying the market" to fill a CLO or a CLO warehouse. When we invest in managers, we look for those managers who are not in a rush to fill out their entire CLO portfolio right away.

What do you make of the trend toward shorter reinvestment and noncall periods in resets and some new deals?
The credit curve for CLO debt was steep enough in the first quarter of 2018 for many more shorter deals to be created. Many debt investors are willing to take a lower spread, or the shorter noncall, for the shorter-tenor debt. It's also beneficial for the equity holders, who are very confident that ... the credit environment will still be benign. So, they have the option after one year to effectively reset, refinance or liquidate the transaction.

How do you see spread trends developing? Can they get even tighter?
With a large number CLOs waiting to get issued, refinanced or reset post-repeal of risk retention, the supply dynamic is much more likely to push spreads wider in the near term. A potential driver for CLO spread tightening is rising Libor. Let's take as an example insurance companies. One of their biggest valuation metrics is the book yield of their investment portfolio, which is driven off current coupon. As Libor increases, so does the current coupon on CLO debt because of their floating-rate nature; as a result, CLOs will look more attractive because of their improved "book yield."

Some competing products for triple-A CLOs are still significantly tighter than where CLOs are, so that's another signal that CLOs have some ways to go in terms of tightening. **ASR**

Failed experiment

The CFPB's guidance on car-loan pricing had limited impact in part because it was nonbinding. The Senate has voted to repeal the guidance, and the House is expected to follow suit

March 2013: CFPB issues guidance recommending steps for limiting fair-lending risk

Dec. 2013: CFPB finalizes consent order against Ally; agreements with three other lenders follow

April 2014: BMO Harris moves to flat-fee arrangement with car dealers, but most banks do not

Dec. 2016: CFPB says it will stop prioritizing fair-lending enforcement in auto lending

April 2018: Senate votes to repeal 2013 guidance

Source: News, company reports

Crackdown on Auto Lending Crumbles

The CFPB's 2013 guidance carries symbolic weight for both sides of the regulatory debate, but its impact was minimal

By Kevin Wack

The impending repeal of an Obama-era missive that aimed to crack down on discrimination in auto lending carries large symbolic weight for both sides of the debate over financial regulation.

It will also establish an important precedent for Republicans on Capitol Hill who hope to overturn longstanding regulatory guidance from various federal agencies.

But the congressional rebuke will not have much practical impact on the U.S. auto-lending market — a reality that is at odds with the loud cheers and hearty jeers that came in the wake of the Senate's recent vote on the matter.

The 2013 auto lending guidance from the Consumer Financial Protection Bureau is frequently portrayed as either an overdue crackdown on lending discrimination or a case study in regulatory overreach.

The truth is that the guidance was part of a wider CFPB effort — aimed at changing how auto loans get priced — that crumbled even before Director Richard Cordray's departure last November. Banks and other auto lenders generally did not succumb to the agency's pressure to change the way they priced loans originated at car dealerships.

"By and large, the lenders said, 'Thanks but no thanks,' " said an industry official who asked not to be identified.

The episode is an example of how policy fights in Washington can take on a life of their own, with interest groups seeking to notch a win long after the issue has lost on-the-ground salience.

In the spring of 2013, top officials at the CFPB were strategizing about how to curtail pricing practices that resulted in minorities paying more for car loans than whites.

Auto dealers have long had the discretion to charge a higher interest rate than the lender authorizes. If the dealer can convince the borrower to pay the higher rate, the dealer and the lender split the extra profit.

Last decade, the National Consumer Law Center analyzed lending data from more than 30 states and concluded that African-American and Latino car buyers were paying higher interest rates than equally creditworthy white borrowers.

As an initial step, the CFPB issued regulatory guidance in March 2013 that listed various steps that lenders could take to limit their fair-lending risk.

The five-page document sparked an industry backlash — lenders saw it as a precursor to stepped-up enforcement of fair-lending laws — though the agency's supporters maintain that it was never as consequential as critics argued.

"There was nothing mandatory in the guidance," noted Stuart Rossman, director of litigation at the National Consumer Law Center.

Internal CFPB documents from 2013 that have subsequently been made public reveal that agency officials did not believe that the guidance alone would be sufficient to bring about the end of discretionary markups.

So the question inside the consumer bureau became what to do next.

The CFPB considered issuing a new regulation, but that entailed a lengthy process that could open the door to a legal challenge. The agency had no direct authority over the nation's more than 18,000 car dealers, a group that held tremendous clout on Capitol Hill.

Another option was to "attempt to enter into a consent order with several auto lenders, enough to tip the market away from discriminatory practices in particular, or markup more generally," according to an agency memo from April 2013.

This is the path that the CFPB ultimately took. In December 2013, the bureau entered into a consent order with Ally Financial, which was followed by agreements with Fifth Third Bancorp in Cincinnati and the auto-financing arms of Honda and Toyota.

The Ally consent order required the Detroit company to pay $98 million. And it gave the firm the option of either abandoning dealer markups or implementing a compliance program aimed at eliminating racially disparate outcomes. Ally chose the latter option, with then-CEO Michael Carpenter declaring, "We are not going to be the Trojan horse for driving industry change."

The CFPB's warning shots did seem to get a couple of midsize banks to change their pricing policies, though only temporarily.

In April 2014, BMO Harris Bank, the U.S. unit of Toronto-based BMO Financial, announced that it would start paying auto dealers a flat percentage of the loan amount, prompting Cordray to take the unusual step of issuing a press release in praise of a specific bank. BB&T, of Winston-Salem, N.C., followed suit in 2015.

Flat fees were seen as a way to guard against the possibility that equally creditworthy minorities would pay higher prices, since they did not give any discretion to the auto dealers about how much to charge.

But the CFPB's efforts were hampered by the fragmented nature of the auto lending market. No one lender had more than 10% market share, and each lender had reason to fear that it would lose a substantial amount of business if it stopped allowing dealers to charge discretionary markups. So the practice continued at almost every lender.

Then in December 2016, in a blog post that drew little media attention, the CFPB signaled that it was no longer going to prioritize fair-lending enforcement in auto lending. The agency argued that it had made progress, and it cited fair-lending risks in student loans, mortgages and small-business loans as bigger priorities.

Since then, both BMO Harris and BB&T have abandoned the pricing models they had adopted a few years earlier.

"While we had some successes with the flat fee program announced in 2015, BB&T also experienced an overall reduced in volume," bank spokesman Brian Davis said in an email. "We introduced a more traditional auto pricing program in March of this year to provide our dealer clients with more options and better flexibility. BB&T remains firmly committed to the auto finance industry and to the fair and equal treatment of all customers."

Industry lobbyists, most notably those representing auto dealers, have been pushing Congress to weaken the 5-year-old auto-lending guidance since late 2015.

Back when their effort began, the CFPB was still a thorn in the industry's side. But after President Trump tabbed Republican stalwart Mick Mulvaney as acting director of the CFPB in November, auto lenders breathed a sigh of relief.

"I think it is unlikely that the CFPB is going to pursue fair lending in the same way that it was pursued under the Cordray administration," said John Redding, a lawyer at Buckley Sandler LLP.

Nonetheless, the lobbying push in Congress continued.

For the National Automobile Dealers Association, the repeal vote offered an opportunity to flex its sizable muscles and secure a bipartisan vote in support of its agenda, even if the victory was mostly symbolic.

On April 18, the Senate voted 51-47 to repeal the 2013 guidance, with Democratic Sen. Joe Manchin crossing the aisle to vote with Republicans. The House of Representatives is also expected to pass the measure, and President Trump is expected to sign it.

The auto lending industry's show of strength on Capitol Hill could backfire in the long run, some observers say.

"I do think it's an important development in that it really does put Congress on record," said Bill Himpler, executive vice president at the American Financial Services Association, which represents various auto lenders.

But other observers argued that the industry's show of strength on Capitol Hill could backfire in the long run. That is because the nation's fair-lending laws remain in effect, and after the guidance's repeal, the CFPB will no longer have the authority to clarify how those laws apply to auto lenders.

"What is lost is the ability of a future CFPB director to issue new guidance explaining how banks can work with auto dealers to originate car loans without violating the fair-lending laws," Jaret Seiberg, an analyst at Guggenheim Washington Research Group, wrote in a research note.

"There will be a CFPB director in the future who wants to bring lending-bias cases on car loans. That means the compliance risk and burden will be even greater going forward." **ASR**

What's old is new again

Though online lenders began as niche providers, they are adding products — and looking more like the traditional banks they sought to beat. Here are some of their offerings

Kabbage: Business loans, credit cards, bill pay

Marcus: Loans, deposits; mulling credit cards, wealth advisory

MoneyLion: Personal loans; plans deposit accounts

SoFi: Student, personal loans; plans deposit accounts

P2P Lenders Adopt Model They Sought to Disrupt

Pressure to develop deeper relationships with customers is leading some to offer to more products, including deposits

By Kevin Wack

It wasn't long ago that Silicon Valley was striving to break the banking business into separate pieces, with venture capital flooding startups specializing in niches such as credit card refinancing, student loans and small-business finance. e

Now the race is on to put banking back together again. At the online lenders' largest annual conference in April, much of the talk was about building something closer to a full-service bank, albeit one designed for the digital age.

"If the only thing you're doing is lending money online, it's going to go the way of the dinosaur," said Rob Frohwein, the CEO of Kabbage, which started in loans but has added more products for its small-business customers. "Our objective is to sit at the financial nerve center of small businesses."

Numerous companies at the Lendit Fintech conference professed the need to build broader relationships with their customers — or what was called cross-selling before that term lost favor in the wake of the phony-account scandal at Wells Fargo. "It's very hard in fintech to be a single-product company," said Andrew Graham, the CEO of Borrowell, a Canadian firm that initially focused on unsecured personal loans but has since branched out.

On April 10, MoneyLion, a New York-based online lender that focuses on consumers who lack a financial safety net, announced plans to start offering deposit accounts. Those accounts will be part of a bundled package of products that already includes investment accounts and small-dollar loans.

MoneyLion's announcement followed similar moves by San Francisco-based SoFi, which targets a more affluent segment. SoFi started out in student loans, but has since added personal loans, mortgages and investment products, and plans to start offering a transaction account in May.

Goldman Sachs, one of the best-known names in finance, said on April 9 that it is considering adding credit cards and wealth management products to its consumer loan and deposit franchise. Despite its 149-year history, Goldman only recently entered consumer banking, and its Marcus platform more closely resembles a startup than an established bank.

Omer Ismail, chief commercial officer for Marcus by Goldman Sachs, indicated that the Wall Street bank plans to move quickly to add new consumer products. "For us, it's just a question of where do we see the most immediate need? And what makes the most sense?" he said.

There are a number of reasons online lenders are now pivoting to become more full-service financial providers. For one, the digital infrastructure these companies have built is expensive, and it only yields profits when it runs enough transactions.

"Transaction costs kill you," said Douglas Merrill, the CEO of ZestFinance, a Los Angeles-based fintech company.

Another reason for the shift is that acquiring customers can be quite expensive for companies that do not have an existing relationship with the consumer. Online lenders have long been at the mercy of aggregator sites such as Lending Tree and Credit Karma, which extract fees for customer referrals.

If the digital upstarts can sell more products to their existing customers, their customer acquisition costs should fall. "Disrupters inevitably start by unbundling individual products because their focused approach gives them a competitive advantage," Todd Baker, a banker turned industry consultant, said in an email. "But they inevitably end up rebundling with a bank-like group of products built around customer needs because the monoline model is flawed and true value in financial services is found in deep customer relationships."

Of course, cross-selling effectively can be a challenge. Some consumers like to shop for the best deals. Others may be turned off by aggressive offers that do not fit their needs. Sameer Gulati, chief operating officer at San Francisco-based LendingClub, which has so far remained focused on loan products, voiced skepticism about about owning customers. "Customers don't want to be owned," he said. "That's not really a need out there."

Kabbage plans to keep adding new products for its small-business customers, but the Atlanta company's CEO acknowledged that building and maintaining those relationships is difficult. "If you want to be in a relationship with your customer, you have to have implicit permission to offer them another product or service," Frohwein said. "That means the customer is genuinely curious, excited and open to trying the new product or service." **ASR**

U.K. LENDER CIRCLES BACK TO ABS

U.K. small-business lender Funding Circle is preparing its second securitization ever.

The GBP 206.6 million deal, which priced on May 4, comes two years after the initial deal closed in 2016.

Funding Circle does not keep any of the loans it originates on balance sheet; all of the loans in this securitization were funded by institutional investors. The transaction allows these institutions to exit their investments by pooling loans into collateral for bonds.

While Funding Circle lends to small businesses in the U.S., the 4,007 loans backing this deal were to 3,928 U.K. borrowers. The average remaining loan balance stands at GBP 51,553, with a weighted average fixed rate of 10.04%, a weighted average remaining term of 44.7 months and a weighted average seasoning of 8.6 months.

Geographically, the pool is concentrated mostly in the South East (24.16%) and London (15.17%). The majority of the loans were taken out by borrowers to fund the expansion or growth of their business and each loan benefits from a personal guarantee from (typically) the owner(s) of the business. At closing, any loan more than 30 days in arrears will be excluded from the final pool.

Six tranches of notes were issued in the transaction, which is called Small Business Origination Loan Trust 2018-1 DAC. All six have a legal final maturity of December 2026.

Moody's Investors Service provisionally assigned an Aa3 to the senior tranche, which benefits from 40.13% credit enhancement, as measured by the rating agency.

Kroll expects to assign an AA- to the senior tranche, though it puts the credit enhancement slightly lower, at 39.75%.

Among the strengths of the deal, according to Moody's is the fact that the pool of collateral is static, which limits the potential performance volatility resulting from new loans with different characteristics being added to the pool.

A short original maximum maturity of up to 60 months, coupled with average seasoning of around eight months results in a short portfolio weighted average life of 1.9 years.

Moody's also takes comfort from the granularity of the portfolio: The largest borrower representing 0.2% of the pool and the 10 largest borrowers representing 1.9% of the pool. The pool is concentrated by industry, however. Borrowers active in the services business and construction and building sectors account for 22% and 17% of the loan portfolio, respectively.

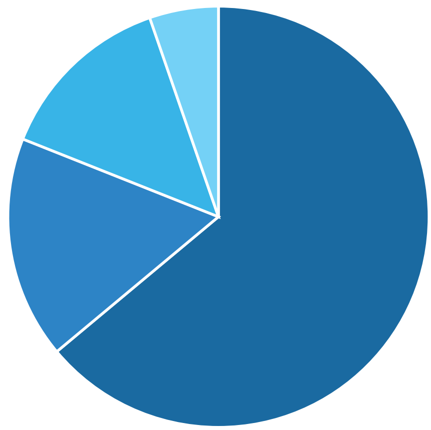
Moody's does see potential for misalignment of interests, since the servicer and originator of the loans (Funding Circle) is not the risk-retention holder (P2P Global Investments) and the servicing fee on the loans may be lower than origination or recovery fees.

Kroll notes that Funding Circle's board and executive management team members have diverse backgrounds, including in the fields of investment banking, venture capital investing, consumer lending and financial regulation.

It also notes that Funding Circle has completed six equity raises totaling approximately $370.5 million, most recently a $100 million raise in January 2017; The firm last year surpassed $5 billion in lending since its 2010 founding.

Port calls

Harley Marine services ships entering port to load or unload or refuel; revenue by type of contract



Source: Kroll Bond Rating Agency

New Kind of Whole-Biz ABS: Marine Logistics

Harley Marine Services has been expanding rapidly; a deal backed by its tugboat and barge fleet lowers funding costs

By Allison Bisbey

Harley Marine Services, a marine logistics company that has been expanding rapidly, racking up a significant amount of debt, is tapping the securitization market to refinance and lower its funding costs.

The $455 million transaction, called Harley Marine Financing 2018-1, is essentially a sale-and-leaseback transaction. Harley is selling its fleet of 122 tugboats and barges to a securitization trust, which will pay Harley Marine Services to operate or manage them, according to Kroll Bond Rating Agency. In addition, Harley's charters, contracts of affreightment, towage agreements, ship assist and management contracts, leases relating to the vessels, certain interests in terminal assets and license to use certain intellectual property – in sum, the vast majority of its assets – will be contributed to the securitization trust.

It's the latest example of the expanded use of what's known as a whole business securitization. This type of transaction is most commonly used to refinance the debt of highly leveraged restaurant franchises, though it has also been used by billboard and coin-counting machine operators and even vacation resort owners.

The idea is that selling a company's assets to a securitization trust (largely) insulates the assets from the risk of mismanagement. So the debt issued by the trust can achieve a higher credit rating than debt issued by the company itself, resulting in lower interest payments.

Unlike most whole-business securitizations, however, this one is primarily backed by hard assets, as opposed to intellectual property and franchise agreements, according to Kroll analysts. Another distinction is that Harley is not committing ships or other assets it may acquire in the future to the transaction.

Kroll's presale report does not provide much information about Harley's balance sheet; it says only that the private company has a "highly leveraged capital structure," which is not unusual in the shipping industry, and that it has several lines of credit and revolving credit facilities, some of which will be extinguished using funds from the securitization.

Harley Marine Financing 2018-1 issued two tranches of notes that are expected to be repaid within five years, by May 2022. Kroll assigned a BBB to the $405 million senior tranche and a BB to the $50 million subordinate tranche.

This is an industry that may not be familiar to many asset-backed investors. Harley provides services to oil majors, ports and harbors and shipping companies, including petroleum transport and bunker service, where HMS will move product from one terminal, such as refineries, offshore platforms, and storage facilities, to another. It also provides marine fuel to ships in port . **ASR**

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New Tactic in Legal Battle Over PACE

A class action alleges that Renovate America and Renew Financial failed to provide consumer protections promised to L.A. County, and that this constitutes elder abuse

By Allison Bisbey

Renovate America and Renew Financial, two of the largest providers of programs that finance energy-saving home upgrades, are facing more legal action from consumers.

Unlike earlier lawsuits, this one does not allege that the providers of Property Assessed Clean Energy financing violated consumer protection laws. A U.S. District Court dismissed those claims last year, ruling that PACE liens are not subject to the federal Truth in Lending Act or Home Ownership and Equity Protection Act because they are not consumer credit.

Instead, twin lawsuits filed by Los Angeles County homeowners on April 12 allege that Renovate America and Renew Financial breached a contract with the county to implement basic consumer protections and ensure "best in class protections" for the benefit of homeowners who participated in the PACE program, including protection from "predatory lending, unscrupulous contractors and poor quality assessment servicing," the complaint states. They also agreed and promised to provide protections for seniors, provide assistance to consumers in multiple languages, and create a "consumer protection measures plan."

PACE financing, which has been enabled under California law since 2007, can be used to finance energy and water efficiency upgrades. It is repaid through a lien on a home that is collected by municipalities along with local tax assessments.

The program has attracted criticism because it was originally underwritten based on how much equity the homeowner has in a property, and not the homeowner's ability to repay. Laws requiring underwriters to verify a borrower's income and ability to repay only took effect this year.

Mortgage lenders also object to the fact that PACE liens are senior to those of first mortgages, increasing the potential for losses in a foreclosure. Both the Federal Housing Finance Agency, which regulates Fannie Mae and Freddie Mac, and the Federal Housing Administration oppose PACE financing, and this can make it difficult for homeowners with PACE liens to sell or refinance.

The new lawsuit, which seeks class action status, also alleges that Los Angeles County is complicit in the failings of the PACE program, leaving thousands of low-income, elderly and non-English-fluent residents exposed to predatory lending practices.

The plaintiffs — represented by Irell & Manella and the nonprofit law firms Public Counsel and Bet Tzedek — also allege that these activities constitute financial elder abuse under California law, because the defendants knew or should have known that elders would be harmed if the companies extended credit without reference to the elders' ability to make the required payments.

"It doesn't matter if [PACE] is consumer credit or not under TILA," Robert Schwartz, a partner at Irell & Manella, said in an interview. "These promises arise as a matter of contract law."

The lawsuits dispute the enforceability of the liens in the subject homes, the underlying PACE loan agreements and the rights of defendants to maintain the liens, and impose supplemental assessments to pay off the PACE loans. The plaintiffs seek restitution of whatever monies the county has collected from them through such assessments and a judicial declaration of their rights.

While PACE is a relatively new asset class, some early indications are that overall delinquency levels have been low, at least relative to property tax delinquencies. In February, the credit rating agency DBRS published data showing delinquencies for liens administered by Renovate America and Renew Financial peak at around 2% to 4% in the first couple of months following installation, then decline to less than 1% within 12 months as homeowners generally past due amounts to avoid penalties and foreclosure.

The new lawsuits, which were filed in the Superior Court of the State of California, allege that a number of elderly and non-native English speakers whose homes are encumbered by PACE liens are facing foreclosure.

One defendant, an 85-year-old who speaks limited English, has poor eyesight and whose only income is a $700-a-month Social Security check, allegedly obtained a PACE loan despite the fact that she had a pre-existing debt-to-income ratio of approximately 135%. "In other words, her monthly debt obligations already exceeded her monthly income before she purportedly promised to pay the county a Renovate America PACE assessment of $4,518 per year," the complaint states.

"Over the last two years, we have been receiving desperate pleas from Los Angeles County homeowners who are facing foreclosure because of a program that was intended to help them. They are usually elderly, and disproportionately either African American or Latino," Jenna Miara of Bet Tzedek said in a statement published April 12.

"These calls are coming in at epidemic levels, and we hear the same tragic story over and over—homeowners who did not understand what they were signed up for, and who are rarely experiencing any energy savings."

"This is like the subprime mortgage crisis all over again for many PACE borrowers," Shamus Roller of the National Housing Law Project, said in the same statement. "The loans are incredibly risky and can result in people losing their homes."

The lawsuits further allege that these activities constitute financial elder abuse under California law, because the defendants knew or should have known that elders would be harmed if the companies extended credit without reference to the elders' ability to make the required payments.

In an emailed statement, Renovate America said that it has administered PACE in accordance with California law and Los Angeles County program requirements, and in many cases provided consumer protections that exceed both of those standards. The complaint faults it "for not historically complying with a law that did not take effect until 12 days ago," according to the April 13 statement.

Renew Financial spokesman Colin Bishopp declined to comment on the

"It doesn't matter if [PACE] is consumer credit or not under [the Truth in Lending Act]. These promises arise as a matter of contract law."

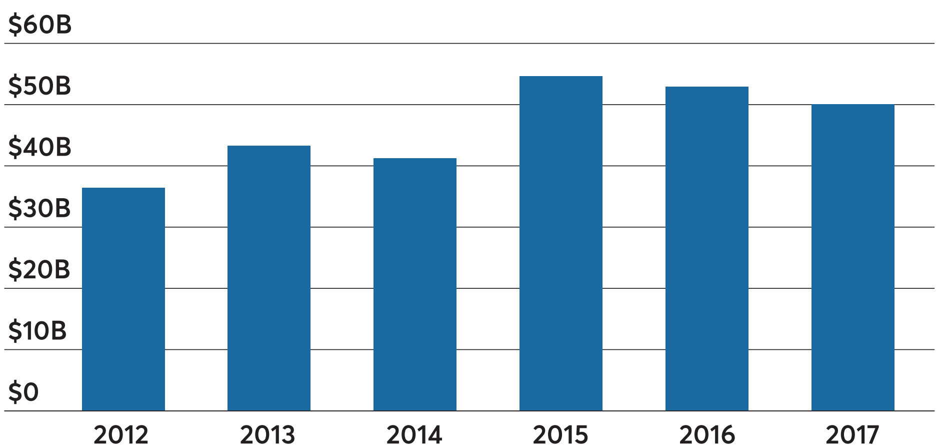
pending litigation. But he said the company's goal is for every homeowner who chooses PACE to have the best experience possible. "We have worked with Congress, state legislatures, local governments and the U.S. Department of Energy to develop, implement and enhance robust consumer protections for the PACE industry," he said. "We are dedicated to serving our customers and proud of our track record."

The latest legal action does not appear to have damped interest in bonds backed by PACE assessments, an important source of financing for this relatively new asset class. On April 20, Ygrene Energy Fund, a PACE administrator that was not named in the class actions, launched an offering of $340.57 million of bonds backed by a mix of commercial and residential PACE assets in both California and Florida.

It was Ygrene's first transaction with a prefunding period, during which up to a third of the target collateral balance may be acquired by the issuer within the three months following the closing date (by July 27, 2018) or until the first default occurs, according to Morningstar Credit Ratings. **ASR**

Nonbank competition

Though it has fluctuated, CRE lending by insurance companies has risen 37% in the past five years. Some of these borrowers used to be bank customers



Source: CoStar

CRE Borrowers Are Repaying Banks Early

They can get better rates elsewhere, and many have lots of cash piled up, allowing them to deleverage

By Andy Peters

A growing number of commercial real estate borrowers are apparently paying off their loans early and taking their business elsewhere — and many bankers either can't or won't stop them.

Banks do not break out early loan payoffs in their quarterly results, but bank executives have warned of an uptick in payoffs in the past several weeks, especially among CRE credits. Data that shows insurance companies are making significantly more CRE loans than they did earlier in the decade only reinforces the notion that the business is migrating.

The trend takes its toll in two ways. While banks charge fees for prepayments, income is lost because those fees typically total less than the interest they would have collected over the life of the loan. Moreover, early payoffs are contributing to anemic loan growth figures at many banks because bankers are having a hard time replacing the lost loans.

"It is definitely a factor in the slower loan growth across the banking industry, in the fourth quarter of last year and again in the first quarter," said FIG Partners analyst Chris Marinac.

Many bankers agree that the payoffs have put a squeeze on lending. "We are facing headwinds when it comes to loan growth with the high paydowns in our portfolio," Kevin Thompson, chief financial officer at the $7 billion-asset Opus Bank in Irvine, Calif., said during an April 23 conference call.

Loan balances have shrunk at some banks as a result of aggressive paydowns. Net loans declined 1.4% to $32 billion from the fourth quarter to the first quarter at the $44 billion-asset People's United Financial in Bridgeport, Conn. "Strong loan payoff activity" was a major reason, Sandler O'Neill analyst Mark Fitzgibbon wrote in a research note.

Commercial real estate investors and landlords have found they can get a better deal from nonbank lenders such as insurance companies and pension funds. Yearly originations of CRE loans by insurance companies rose 37% to $50 billion from 2012 to 2017, according to the real estate data provider CoStar.

Borrowers are trying to reduce exposure to the five-year Treasury, a common rate used for CRE loans, as it continues to rise, said Alexander Twerdahl, an analyst at Sandler O'Neill. The yield on the five-year Treasury increased 97 basis points to 2.84% between April 25, 2017, and the same date this year, according to the Federal Reserve Bank of St. Louis. "People are trying to pay those off and lock in better funding elsewhere," Twerdahl said.

Borrowers also have of cash piled up, in part because of the new federal tax law, which is allowing them to deleverage their balance books, SunTrust Banks said in a press release. **ASR**

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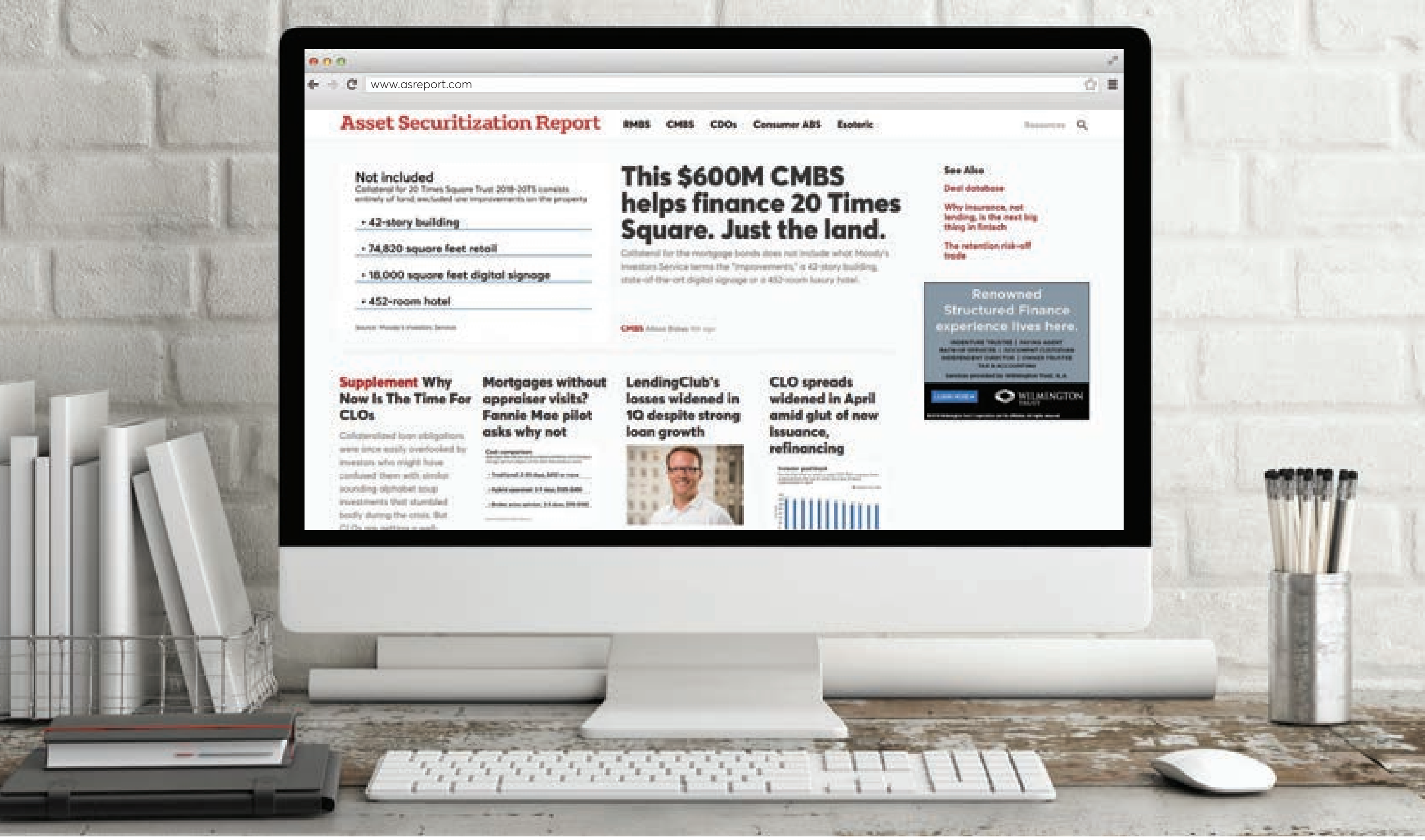

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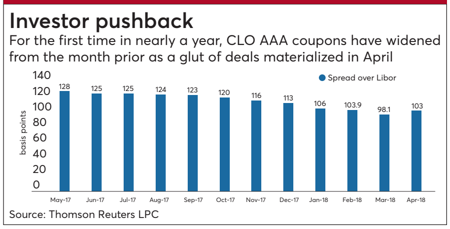

CLO Spreads Widened in April Amid Glut of New Issuance

The average AAA note coupon was 103 basis points over Libor, compared with from 98.4 basis points in March, which had been the tightest level in approximately five years.

People are talking about …

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May 23-24
IMN Investors Conference on CLOs and Leveraged Loans
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June 5-7
AFME/IMN 22nd Annual Global ABS
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