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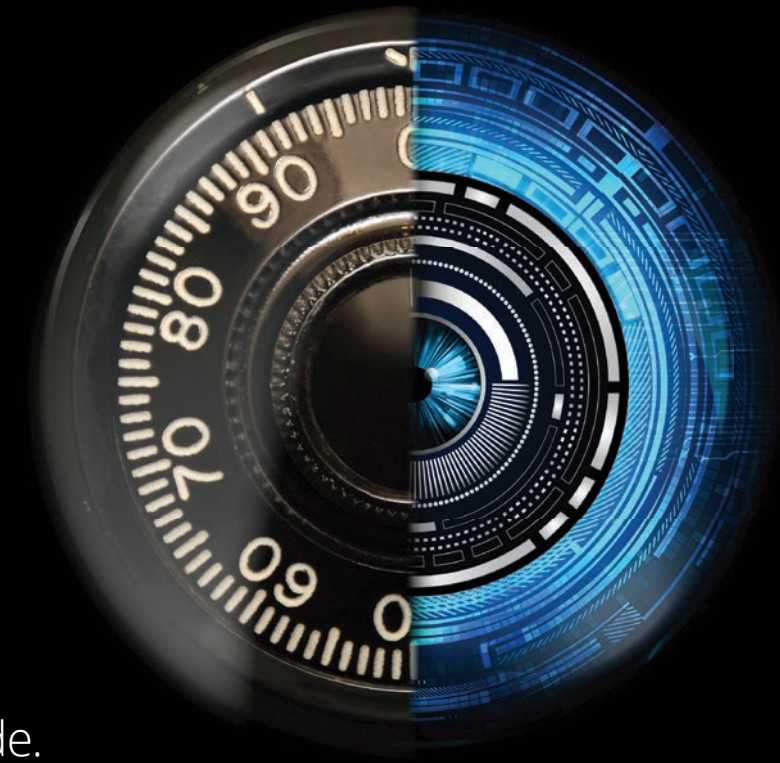
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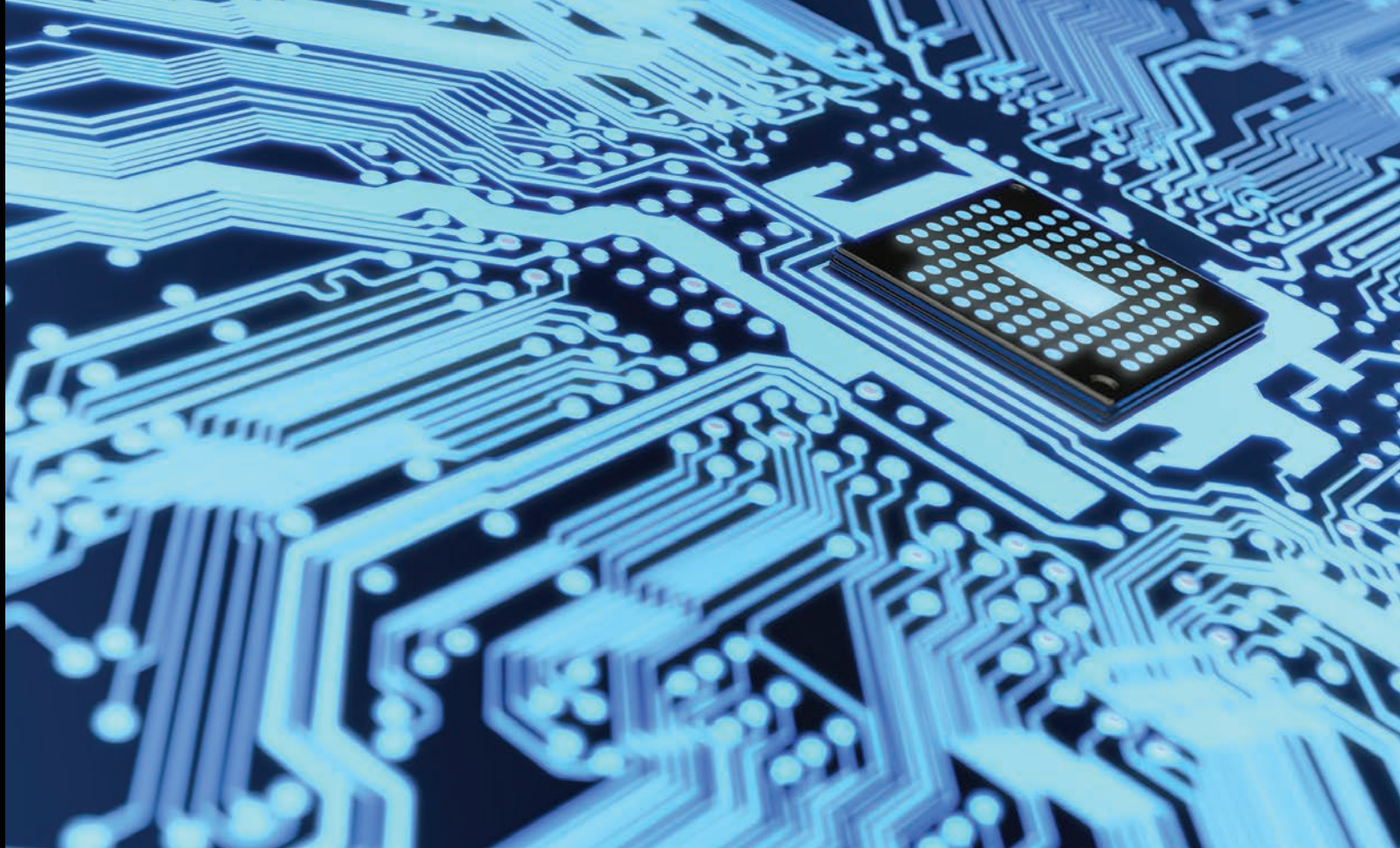
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BUILD TO RENT

Single-family homes are scarce and capital is cheap, so investors are extending their reach with 'infil' projects





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EDITOR'S LETTER



Land Grab

When institutional landlords started snapping up foreclosed homes after the financial crisis, they were accused of displacing tenants and locking families out of homeownership.

But the big land grab is long over.

After consolidating their ranks and fine-tuning their investment strategies, some of these players are starting to buy new construction, or even build homes themselves. It's often the most practical way to acquire the right properties in the right locations.

One of the key reasons this is possible is the cheaper funding now available to them, which lowers their investment hurdle. As Felipe Ossa explains in our cover story, spreads on single-family rental securitization have narrowed dramatically over the past few years. Investors and rating agencies have become more confident about the property management skills of these larger investors. It's also become clear that they have a number of options for refinancing debt, including GSE financing and equity.

To be sure, this is not the most affordable housing. Typically, the new build is marketed to a "higher-caliber" tenant. But it is net new supply, at the margin.

And in some cases, these institutions are building on lots that it would not make sense to develop for sale, at least not right now, because they are in secondary or tertiary markets of a larger metropolitan area. That means they must be more affordable to justify the longer work commute.

Tesla, the electric car maker founded by Elon Musk, is also enjoying cheaper funding, and it couldn't have come at a better time. It is struggling with an ambitious launch of a vehicle designed for the mass market, and burning cash. It found an enthusiastic reception for its first offering of auto lease bonds, despite the idiosyncratic risks.

And after a long legal battle, the CLO market is looking forward to being exempted from risk retention. The DC Circuit Court sided with the LSTA, which claims skin-in-the-game rules should not apply to asset managers who merely purchase collateral on the open market.

We also have a couple of stories about the student loan market. Kevin Wack looks at the challenges facing SoFi's incoming CEO, Anthony Noto, and I explain how Sallie Mae plans to put its windfall from tax reform to work in consumer loans and credit cards.

—Allison Bisbey, Editor in Chief

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A New Way to Refinance CLOs

Traditional refinancings are document intensive, time-consuming and costly; the SEC has greenlighted a more efficient mechanism that resets coupons at periodic auctions

By Gregory Cioffi, Olga Chernova and Asif Khan

At a time when much of the CLO market's creative energy has been concentrated on developing structures to facilitate compliance with the U.S. risk retention rules, another innovation has emerged: Applicable Margin Reset (AMR), a mechanic designed to address certain inefficiencies in traditional CLOs.

Traditional Refinancing

The right to direct—or, in certain cases, approve—the refinancing of one or more classes of rated CLO securities after a specified noncall period through the issuance of replacement securities at market-clearing interest rates is a fundamental structural feature of the most subordinated class of CLO securities (commonly referred to as the CLO “equity”). Fueled by compressing spreads and increased investor demand for floating rate debt, refinancings of this “traditional” nature rose to unprecedented volumes in 2017.

Despite their prevalence and value to equity investors, traditional CLO refinancings are not without structural shortcomings. The replacement securities issued pursuant to a traditional refinancing, like the original securities being replaced, must be structured, newly offered and rated, thereby requiring the re-engagement of an underwriting bank, rating agen-

cies and legal counsel. Traditional refinancings are document intensive, time-consuming and costly, with transaction expenses typically hovering in the mid six figures.

Moreover, it is generally accepted that issuing replacement securities pursuant to a traditional refinancing constitutes an “offer and sale of asset-backed securities by an issuing entity,” thereby necessitating compliance by the related CLO manager with the retention and disclosure requirements of the U.S. risk retention rules.

Consequently, traditional refinancings occurring after the Dec. 24, 2016, effective date of the U.S. risk retention rules are generally required to comply with such requirements, including in cases where the original CLO to which the refinancing relates was itself in compliance with the rules on the original closing date.

The AMR Alternative

Conceived by Sancus Capital Management as a means of repricing certain rated CLO securities while reducing the time and cost of a traditional refinancing, AMR mechanics allow for the reset of the coupon of one or more designated “AMR Classes” of rated securities after the noncall period through a Dutch auction. To facilitate the auction process, Sancus established the first AMR auction service

provider platform, which was subsequently spun off to an independent company.

AMR procedures may be initiated at the direction of a majority of the CLO equity and/or the CLO manager, or, if permitted by the underlying indenture, may occur automatically, subject in each case to certain objective conditions precedent. The indenture specifies each date on which an AMR auction may be conducted. AMR procedures generally operate as follows:

- Prior written notice of each AMR date is given by the CLO trustee to the holders of each AMR Class and certain other transaction parties, which notice includes, among other things, the auction procedures.
- The auction is convened on a platform established by an AMR auction service provider for the submission of bids by platform member broker-dealers, which are also preapproved trading counterparties of the AMR settlement agent.
- Communication of confidential bids representing a commitment to purchase up to a specified principal balance of a particular AMR Class at a spread (margin) to Libor not higher than a predetermined maximum margin are facilitated by the auction service provider.
- If sufficient bids not exceeding the

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maximum margin are received, the lowest margin at which such bids fully account for the aggregate principal balance of all securities (other than securities held by holders of risk retention interests), i.e., the “clearing rate,” of the relevant AMR Class becomes the new applicable margin for such AMR Class.

- After the new applicable margin is established, the securities comprising each relevant AMR Class are mandatorily tendered pursuant to DTC protocols (in the case of book-entry securities) to the CLO securities intermediary, who in turn free delivers such securities through DTC to the winning bidder(s).

- If bids are insufficient to establish the clearing rate for an entire outstanding AMR Class, the auction fails and the applicable margin remains the same, it being understood that a failed auction for one AMR Class does not impact the new clearing rate of any other AMR Class for which the auction was successful.

- On any subsequent AMR date, the foregoing procedures are repeated.

To the extent that an AMR Class contains risk retention securities under the U.S. or European risk retention rules, such securities can be excluded from the AMR procedures, with the clearing rate being applied to such securities automatically.

The structural efficiencies of AMR procedures are numerous. Unlike a traditional CLO refinancing, AMR procedures obviate the need for engaging an underwriting bank or procuring a rating for new securities. Moreover, the AMR auction process is both transparent, with the results being

made publicly available, and fundamentally democratic, providing access to investors who might otherwise be excluded from a traditional refinancing underwriting.

Streamlining matters further, AMR procedures require neither the cancellation nor reregistration of any securities, nor are new CUSIPs required to be obtained. In contrast to a traditional CLO refinancing, a

AMR procedures require neither the cancellation nor reregistration of any securities.

transfer of AMR securities takes the form of an uncomplicated and inexpensive secondary market transaction between buyer and seller.

AMR and Risk Retention

In response to a request letter on behalf of Sancus Capital Management, the SEC confirmed in a Sept. 1, 2016, no-action letter that resetting the applicable margin of an AMR Class using AMR procedures would not constitute an “offer and sale of asset-backed securities by an issuing entity” and would therefore be unlikely to require compliance with the U.S. risk retention requirements.

Importantly, the SEC guidance applies solely to the AMR procedures outlined in the request letter, which procedures provide, among other things, that neither CLO security holders nor any other transaction party will have any discretion to call for or cause an auction date to occur.

In order to minimize the chance an AMR Class reset might trigger risk retention obligations, AMR procedures must therefore be structured to adhere to the specific conditions of the request letter.

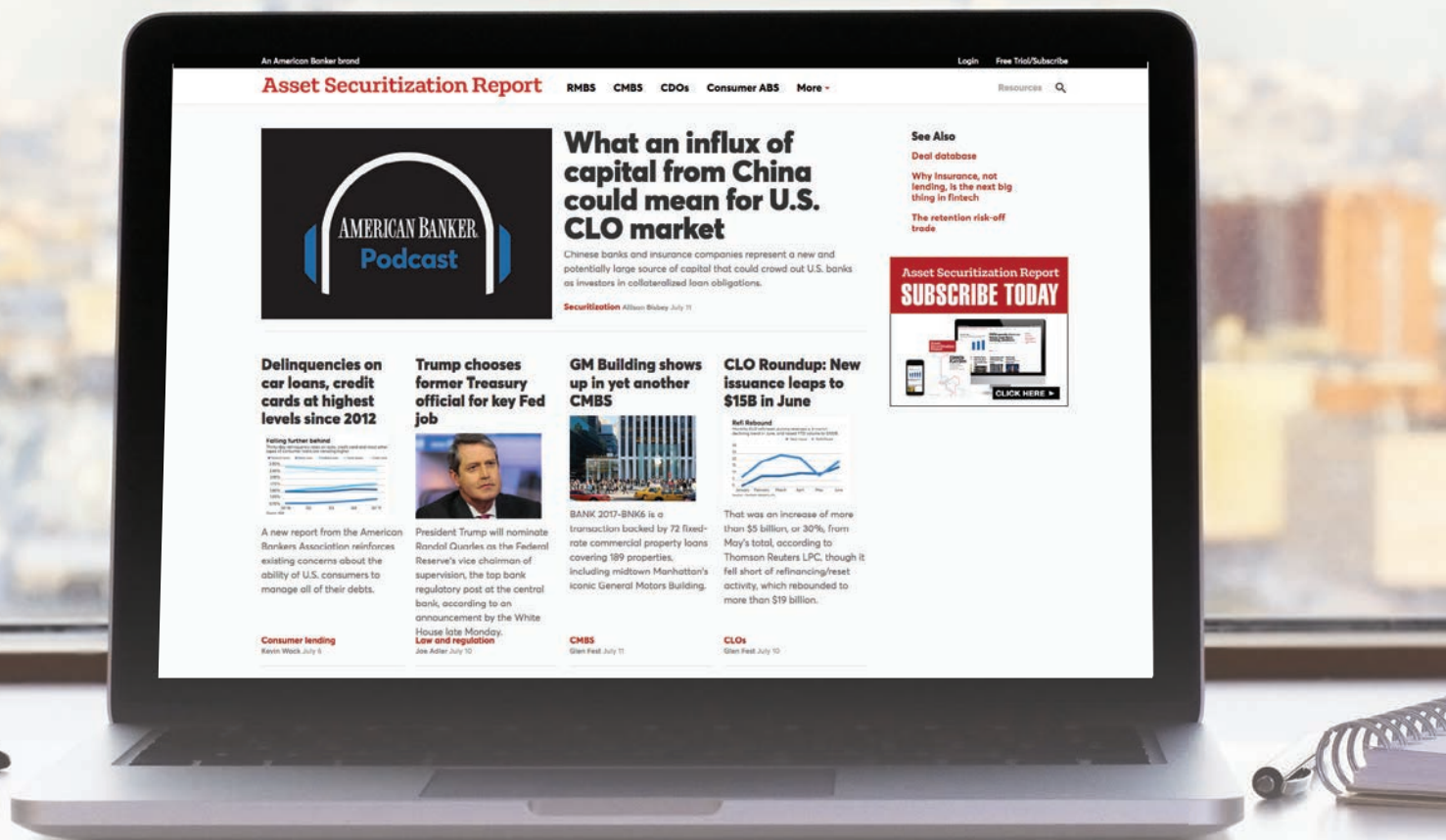
For newly issued CLOs where the manager holds its U.S. retention interest in “horizontal” form by purchasing CLO equity equivalent to at least 5% of the fair value of all related CLO

securities, the advantages of AMR procedures meeting the criteria set forth in the Sancus request letter can be substantial. Horizontal risk retention requires the manager to conduct a fair value analysis on its horizontal strip.

Since CLO equity is likely to be lower in value after the noncall period than on the original closing date, AMR procedures not only eliminate the costly process of refreshing the closing date fair value assessment, but also avoid the risk that the manager will be obligated to retain additional CLO equity.

Notably, in cases where the manager has retained a “vertical” risk retention interest at the original CLO closing, departures from the conditions described in the Sancus request letter are inconsequential, as such manager will continue to retain its mandated 5% interest in each applicable AMR Class even if the auction is successful. **Continued on page 26**

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Build to Rent

Single-family homes are scarce and capital is cheap, so investors are extending their reach with ‘infill’ projects

By Felipe Ossa

THE RANKS OF RENTERS HAVE swollen since the financial crisis, but there are few foreclosed homes left to pick up on the cheap. So some of the biggest landlords are buying, or building, new single-family homes to pad their portfolios.

While the initial yields for new construction tend to be lower, these firms have access to cheaper capital than they did when they started out a few years ago; some have raised equity or obtained GSE financing. Consolidation has also created experienced property managers with huge economies of scale, another factor making new build more economical.

Though it will be awhile before these new homes show up as collateral for asset-backed securities, their low maintenance costs and the higher-quality tenants that they attract should tend to reduce the overall risk in the pools.

Strategies vary among institutional landlords. Those hunting yield have

kept their focus on older homes with, on average, lower-income tenants. But others have targeted relatively new homes. These include Progress Residential, Tricon American Homes, Invitation Homes and American Homes 4 Rent.

And more recently, players have been moving into new build, with American Homes 4 Rent the most vocal about this shift.

“You’re starting to see build-to-rent because they’re able to do it at a price that makes sense to rent it out, which had not been the case before,” said Beth O’Brien, the CEO of Corevest Finance, a shop that provides mortgages to small but professional landlords who generally manage 50 to a few hundred homes. Institutional investors “tend not to be building it themselves but buying from people selling small pools and aggregating them,” O’Brien said.

Bruce McNeilage is one of those people. He’s the CEO of Kinloch Part-

ners, a Southeast-focused real estate firm that buys single-family homes and has a building unit as well.

“Of the top 10 [institutional investors], we’ve sold to a number of them,” McNeilage said. The company is most active in the metropolitan areas of Nashville and Atlanta but also has been ramping up its business in the corridor in South Carolina from Greenville to Spartanburg.

While declining to give names, McNeilage said growing appetite from the large players in the market will help double Kinloch’s revenue this year. “Not only are we selling more; these investors are saying, ‘Hey, when you have the next 50 houses, call us.’ We, in essence, have outstanding orders from three or four of the large companies. Literally, as many houses that we can get them, they’ll buy.”

Dennis Cisterna, CEO of Investability Solutions Inc., a business unit of Altisource Portfolio Solutions—which provides a variety of services to the single-family rental sector—said the firm in late 2017 closed on its first purchase of a portfolio of new builds.

Besides AH4R, Tricon and Streetlane are also moving in the direction of new builds, Cisterna added. Progress Residential is also reportedly active in this space.

Neither Tricon nor Progress—both of which regularly tap the securitization market for funding—responded to requests for comment.

While sourcing newer properties from third parties is the most common approach, American Homes 4 Rent has actually started to build its own homes. It appears to be taking it slow, having built 13 homes in the third quarter, according to a tran-

scription of a third-quarter conference call published by Seeking Alpha. Still, this was a fraction of the 111 newly built homes that AH4R acquired through its National Builder program.

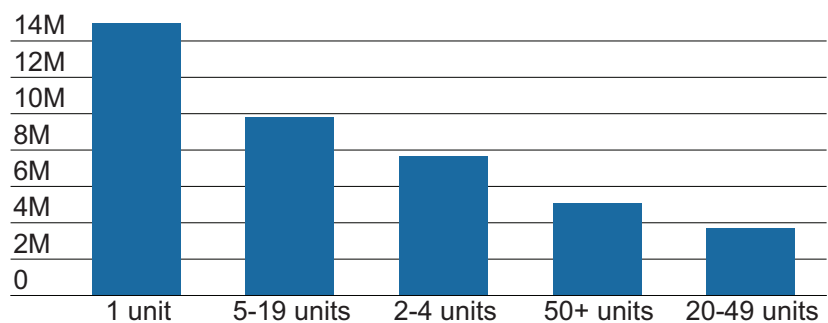
On the call, AH4R management projected spending \$393 million in the

Certain geographies naturally lend themselves to new construction because foreclosures are exceedingly low, but there’s still heady demand for housing and plenty of space to build it.

“In Arizona, Texas, Georgia and Florida, there are tens of thousands

Credit void

A GSE program along the lines of the financing Fannie and Freddie provide for multifamily housing would help make single-family rental housing more affordable



Source: Amherst Capital estimates based on U.S. Census Bureau surveys

build-to-rent space in 2018, with \$261 million going to the National Builder program. The company’s total investment in build-to-rent for the third quarter amounted to \$27 million.

“Evidencing the tremendous demand for newly constructed rental homes, many of our third-quarter ... development deliveries have been leased and are now cash flowing at estimated yield premiums of 100 basis points over traditional channel acquisitions in comparable markets,” AH4R Chief Executive David Singelyn said on the call.

The company did not respond to a request for comment.

of undeveloped lots that don’t make sense being developed as owner-occupied developments,” Cisterna said. “A lot of this is due to their location in secondary or tertiary markets of larger metro combined with tight credit markets for mortgages.”

Cisterna explained that these “further-out” locations must be more affordable to justify the longer work commutes. The lower home prices attract those who don’t have the income or credit to obtain better-situated places.

The internal rate of return necessary for development is too low for firms looking to sell the homes. “[But]

as rental communities, the time to lease up ... is much faster—usually three to four times faster—than selling the homes to potential homeowners, so the builder can move through the projects much faster,” he added.

An important advantage of newer rentals over older ones is much lower maintenance costs.

“You’re getting a high-caliber product,” Cisterna said.

And while the tenants for new homes may not have credit as pristine as that of homebuyers, they tend to be higher caliber than those renting older homes.

Investors have found “that the new-est tenant is easier to manage,” said Gregory Rand, CEO of OwnAmerica, a platform for trading portfolios of single-family rentals.

He added that “the cost of capital going down opens up new geographies and newer vintages.”

Of course, the strength of build-to-rent in the single-family rental sector will be shaped by the strength of the rental market in general. And that, in part, hinges on whether people can or want to buy. The homeownership rate took a beating in the aftermath of the financial crisis, falling to 62.9% in the second quarter of 2016 from a peak of 69.2% in the fourth quarter of 2004.

The number of renters soared over this period thanks to an overhang of student loans and much tighter credit.

But more recently, homeownership appears to be edging back up. The figure for the fourth quarter of 2017 was 64.2%.

Rand, for one, believes that homebuyers will soon be competing with investors for new construction homes “in a big way,” even as the investors

continue forging relationships with homebuilding companies.

This view is based on the fact that millennials, who have been taking longer than previous generations to get married and settle down, are starting to buy homes in larger numbers. Rand also expects that more confidence around employment should nudge up the homeownership rate.

The new tax law might also

investors in single-family rentals as of August of 2017 amounted to \$33 billion, dwarfed by the estimated value of \$26 trillion for the overall single-family rental market.

“Versus the mom-and-pop landlords, the lower cost of capital has gotten more pronounced,” said Sandeep Bordia, head of research and analytics at Amherst. He added that the big institutional investors have other ad-

“Versus the mom-and-pop landlords, the lower cost of capital has gotten more pronounced.”

strengthen the hand of first-time homeowners, according to Fannie Mae Chief Economist Doug Duncan. By increasing the standard deduction, the law “could allow renters to save more and pay down their debts and potentially become owners sooner,” he said in a video interview.

On the flip side, there’s a compelling argument to be made that institutional investors have plenty of room to increase market share in single-family rentals. In total, they owned about 200,000 single-family rentals at the end of 2016, about 2% of an estimated nationwide total of 15 million, according to a report issued by Amherst Capital Management in August 2017.

In the multifamily sector, by comparison, institutional investors own over 50% of rentals, suggesting that there is room for the big landlords to grow in the single-family segment.

The overall investment of large

vantages as well stemming from their economies of scale, such as securing bulk discounts on appliances.

Bordia said that there is evidence that in the wake of Hurricane Harvey, the large investor landlords generally repaired homes faster than small landlords because they tended to have insurance even for places outside the traditional flood zone.

To date, few newly constructed homes have been used as collateral for asset-backed loans. The rare examples have loans backed by multiple new homes that were included in multiborrower transactions. Six loans originated by CoreVest for Camillo Properties, a homebuilder in Texas, served as collateral for three securitizations issued in 2015 and 2016, at which time the homes were 3 years old, according to Kroll Bond Rating analyst Akshay Maheshwari.

The Camillo loans initially repre-

Continued on page 26

Challenges for SoFi's New CEO

Twitter's Anthony Noto needs to overhaul the corporate culture, lay the groundwork for an IPO and determine whether to renew SoFi's pursuit of a bank charter

By Kevin Wack

Anthony Noto, the Twitter executive who has been tabbed to take the helm at Social Finance, is diving into the deep end in his first stint as a CEO.

Not only will he replace the entrepreneur who built San Francisco-based SoFi, he will do so in the wake of a sexual misconduct scandal

that cast a dark shadow on the firm's corporate culture.

He will also be responsible for managing a demanding set of deep-pocketed investors and determining when the time is right for an initial public offering.

And he faces other tricky decisions,

including how best to position the company, which has expanded beyond its roots in the refinancing of student loans, for continued growth.

Noto served most recently as chief operating officer at the social media platform Twitter. He previously did stints at Goldman Sachs and as the Na-

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tional Football League's chief financial officer. He is scheduled to take the reins at SoFi on March 1.

"SoFi has a significant opportunity to build on its leadership position in student and personal loans to revolutionize consumer finance and build a next-generation financial services company," Noto said in a Jan. 23 press release.

Here is a look at five big challenges that Noto will face.

Reforming SoFi's culture. Former CEO Mike Cagney's tenure ended quickly in September amid a hail of allegations involving sexual misconduct. Cagney's background was as a

trader and he was accused of fostering an atmosphere that resembled a Wall Street-style boys' club.

After Cagney's departure, interim CEO Tom Hutton announced a new companywide initiative called One SoFi, the purpose of which was to define the culture and values that the firm wanted to embrace. The initiative was announced in early November. Since then, SoFi has not made public any information about what progress has been made. One former SoFi employee noted on Jan. 23 that office beer kegs have been removed.

"SoFi still has some cultural baggage to deal with due to the

circumstances surrounding Cagney's departure," James Wu, CEO of the data analytics firm MonJa, said in an email, "and that's tough to solve for any incoming CEO."

Determining when to go public. Cagney long teased the possibility of an initial public offering — he floated the idea as early as 2014 — but never pulled the trigger.

SoFi has a number of key shareholders who might like to access wealth that is tied up in the company's shares. That list includes the Japanese conglomerate SoftBank, which led a \$1 billion equity financing round in 2015, and the private equity firm Silver Lake

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Partners, which led last year's \$500 million round. That round reportedly valued the privately held company at more than \$4 billion.

The list of anxious shareholders also likely includes SoFi employees who last year endured a brutal stretch of negative headlines about the company.

Noto will need to counsel patience while laying the groundwork for a successful IPO. That will entail convincing Wall Street that SoFi is still in the early stages of its growth.

Todd Baker, a former banker who is managing principal of Broadmoor Consulting, said that Noto looks like a good choice. "I think you need a very sharp financial mind there and someone with a no-BS style. He fits the bill. They have some large, sharp-elbowed investors," Baker said in an email.

Deciding how to grow. Under Cagney, SoFi's growth plan was to become a key financial partner for an upscale segment of the young adult population dubbed HENRYs — high earners, not yet rich. That strategy was laid in the company's blunt 2016 Super Bowl ad, which suggested that only the most solvent consumers should bother applying for a SoFi loan.

SoFi, founded in 2011, initially offered to refinance student loans and later added mortgages, personal loans and wealth management options to its product suite. But while student loan refinancing proved to be an excellent way to find new customers during a period of low interest rates, that opportunity is now shrinking, as rising interest rates reduce the spread between what borrowers pay the federal government and what SoFi can offer.

In consultation with the company's

board, Noto will have to decide whether to remain focused on a fairly small, though lucrative segment of the U.S. population.

"Obviously that's limited," said Adrian Nazari, CEO of the personal finance company Credit Sesame, in reference to SoFi's target audience. "If they want to build a very large business, they need to become a lot more mass appealing."

"You need someone with a sharp mind and no-BS style. ... They have sharp-elbowed investors."

Yes or no on a bank charter? Before Cagney stepped down, SoFi filed an application to open a Utah-based industrial loan company. The application was withdrawn in the wake of the CEO's departure.

A source familiar with SoFi said on that the application was pulled because of the turmoil involving the company's management. "When you have a huge shake-up like that, you can't go forward," the source said.

A bank charter would allow SoFi to offer deposit accounts to its customers, an important step in making SoFi their primary financial institution.

But it is not clear that SoFi needs a banking license to build that broad customer relationship. In the coming months, the company is expected to start offering SoFi Money, an account offered in conjunction with WSFS Financial in Delaware.

If SoFi does renew its bank application, the company will likely face

opposition from both small-bank lobbyists and community reinvestment advocates.

Some observers argue that SoFi and other fintech firms will have a better luck once President Trump's nominee to chair the Federal Deposit Insurance Corp., Jelena McWilliams, succeeds outgoing Chair Martin Gruenberg.

Proving that he has the right background. Noto does not appear

to have any experience in consumer financial services, which could be viewed as a weakness. But he does have a strong background in technology, which should be helpful at SoFi. He also has lots of experience in the capital markets.

During his first stint at Goldman Sachs, Noto headed communications, media and internet equity research. Later, he spent nearly four years as co-head of the Goldman investment banking unit that specializes in tech, media and telecommunications.

Noto joined Twitter in 2014, first serving as chief financial officer and then as chief operating officer. "As a former Goldman banker and Twitter exec, Mr. Noto checks both the Fin and the Tech boxes and is a seasoned operator," Ram Ahluwalia, CEO of the data analytics firm PeerIQ, said in an email.

"Also, Mr. Noto can sell the promise of SoFi during a potential IPO."

How SLM will spend tax savings

The nation's largest private student lender plans to use \$30 million of its anticipated windfall from tax reform to speed up a move into consumer lending and credit cards

By Allison Bisbey

Sallie Mae is using some of its windfall from the federal tax cut to accelerate its move into personal loans and credit cards.

The nation's largest private student lender, formally known as SLM Corp., says it will invest \$30 million of its anticipated tax savings in three areas: \$10 million each on consumer lending and credit cards and the other \$10 million on several technology projects, including the transfer of tech infrastructure to the cloud.

How financial firms will spend their tax-reform bonus has been a big topic this earnings season. Some lenders have earmarked funds for technology upgrades, while other lenders are pledging to pad the paychecks of the rank and file, increase buybacks and dividends or make charitable contributions.

What makes Sallie Mae's announcement even more interesting is that it's another example of nontraditional lenders deepening their push into online consumer lending. Goldman Sachs, which in short order has lent out more than \$2 billion through a digital platform called Marcus, said the same week that it was expanding into home improvement loans.

Chief Executive Raymond J. Quinlan said that personal loans were a good fit for Sallie Mae, which will be targeting the same kinds of borrowers

it already serves with another type of unsecured loan. Sallie Mae has

Roughly 60% of the personal loans acquired to date have three-year terms;

“We meet customers when they are 18 or 19, and zero percent have a personal loan.”

nearly \$18 billion of assets, primarily private undergraduate student loans. Personal loans do not require a big investment in infrastructure or substantially different credit models, Quinlan said. “We meet customers when they are 18 or 19, and zero percent have a personal loan.” Five years later, when they are 23 or 24, “30% of them do,” he said on a conference call after the company announced its fourth-quarter results.

Sallie Mae has taken what Quinlan described as a cautious approach to personal loans: It recently began purchasing consumer loans that it is keeping on balance sheet to monitor their performance.

On the same call, Chief Financial Officer Steven J. McGarry elaborated that purchases are running at around \$100 million a month and the total balance is just under \$400 million. He described the loans as “high quality,” with a weighted average FICO of 722.

the remainder have five-year terms.

The bank is kicking things into gear: The first “market drop” of 300,000 letters with personal loan offers was set to go out over the next 10 days, Quinlan said. “A reasonable portion of our volume will be two years old by the time we have any [significant] volume,” he said. “2018 is a year of experimentation; going into 2019, the program will be refined [in terms of] market acquisition costs and credit loss expectations.”

Credit cards will follow more slowly. Sallie Mae is working through relationships with a couple of partners. It plans to start offering credit cards in the first quarter of 2019.

The bank has also been expanding the range of offerings in its core private student loan business. It recently launched six products aimed at graduate students working on specific degree programs, including medical doctors, dentists and MBAs.

Tesla taps into securitization

Leases backed by electric vehicles pose unique risks, but the deal's strong reception demonstrates that many investors saw this as an opportunity to pick up some yield

By Allison Bisbey and Glen Fest

Investors snapping up Tesla's initial offering of bonds backed by leases on electric cars had to consider some unusual risks.

The bonds are backed both by lease payments and the resale value of cars coming off lease. And it's unclear how robust of a market there is for used battery electric vehicles. The limited range of these cars limits the potential pool of buyers. There is also the possibility that advances in battery technology will make them obsolete.

Then there's Tesla's big bet on the Model 3. The \$540 million of bonds sold the week of Jan. 29 are backed by leases on Tesla's existing premium Model S sedans and Model X sport utility vehicles; but the company has plans for unprecedented ramp-up in the production and sales of the newly launched Model 3, a car aimed at the mass market. This increases the risk that it might not be in a position to keep servicing existing leases.

None of this seemed to weigh too heavily on investors' minds, however. The market for bonds backed by auto loans and leases is deep and liquid, and spreads are tight. To many, a deal with a few idiosyncrasies just offers a chance to pick up a little extra yield.

"At the end of the day, it's an auto lease deal," said Gil Libling, a portfolio manager at Semper Capital. "It just happens to be Tesla."



Bloomberg News

Tesla has struggled to ramp up production of the Model 3, its first vehicle aimed at the mass market; just 1,542 units were delivered in the fourth quarter.

Libling said that whether Tesla succeeds in its other ventures is a lesser concern, since Semper looks at deals on a pool-by-pool basis.

"They are unique cars," but bonds backed by car leases "do trade actively," he said. "You can look at general prices, or at certain cohorts of cars, and get some comfort as to collateral performance over time."

To be sure, the credit quality of lessees for the Model S and Model X is high. In its presale report on the deal, Moody's Investors Service noted that the weighted average FICO score of the leases used as collateral is 767.

That's lower than that of the auto lease pools securitized by BMW and Mercedes-Benz, which have weighted average FICO scores of around 780, but still high compared with other recent lease pools securitized by Ford, Nissan and Hyundai. (Moody's was the only rating agency engaged by Tesla.)

"It's also a pretty short-dated paper," Libling said. He noted that the leases have original terms of two or three years, and many in this initial pool are seasoned. "That can mitigate some liquidity concerns."

Still, Tesla had to pay up to secure an AAA for its deal from Moody's,

providing higher levels of investor protections than did BMW or Mercedes-Benz.

The senior tranche of notes benefits from 31.25% credit enhancement, consisting of overcollateralization of 10.20% of the initial pool balance, which will increase to a target of 12.20% of the initial pool balance; a nondeclining reserve fund of 0.75% of the initial pool balance; and 20.30% in subordinated notes.

By comparison, credit enhancement was much lower for the most recent luxury auto-lease securitizations for the U.S. captive finance arms for BMW AG (15.65%) and Daimler AG's Mercedes-Benz (14.5%).

Moody's expects only 0.5% of the leases in the pool of leases backing Tesla's deal to default over the life of the transaction, but it has sharply discounted the residual value of any repossessed vehicles.

In its presale report, the rating agency noted that Tesla controls the remarketing process for off-lease vehicles and only a very small amount of Tesla vehicles have been sold at auction. "As a result, retail used vehicle values, rather than auction wholesale values such as the NADA auction data, account for most of the performance data," the report states. "The wholesale value of used vehicles tends to be lower than the retail value."

Tesla had data on only 4,344 used Model S and Model X vehicles sold in 2017 as of Nov. 30, 2017, the rating agency wrote.

Other manufacturers, including Ford, Nissan and Hyundai, have pooled electric vehicle leases together with leases on internal combustion engines, according to Moody's. To

date, however, electric vehicles have accounted for a minuscule percentage of those securitizations and the new-car market (0.6% of overall U.S. vehicle sales in 2016).

The broader auto ABS market is off to a strong start this year, with some \$16 billion of bonds backed by loans, leases and rental cars in January, according to S&P Global Ratings. In a report published that month, it

"It's pretty short-dated paper; that can mitigate some liquidity concerns."

noted that quite a few deals had been upsized.

By comparison, auto ABS issuance in January of 2016 and 2017 totaled \$7 billion apiece.

Tesla's soaring fourth-quarter losses, reported the week after its auto-lease deal priced, underscored the challenges facing the company. It lost \$675 million in the final three months of 2017, more than five times the \$121 million it lost in the same period a year earlier, as it struggled to ramp up production of the Model 3.

It was the largest quarterly loss in Tesla's history, but narrower than Wall Street had expected.

"We were probably a little over-confident, a little complacent in thinking that this is something we know and understand," founder Elon Musk said of battery production, according to a transcript of a conference call published by SeekingAlpha.

Tesla continues to predict it will be

able to produce 5,000 Model 3 vehicles a week by the end of the second quarter of this year. But it once hoped to reach that goal by the end of 2017.

"It is important to note that while these are the levels we are focused on hitting and we have plans in place to achieve them, our prior experience on the Model 3 ramp has demonstrated the difficulty of accurately forecasting specific production rates at specific

points in time," the company wrote in a letter to shareholders published the same day.

Tesla delivered 1,542 Model 3 vehicles in the fourth quarter, though demand for its other two cars, the Model S and X, helped push Tesla's sales to \$11.8 billion for 2017, up 55% from the year prior.

Nevertheless, losses for the full year reached nearly \$2 billion, more than double the level reported for 2016.

In the meantime, the strong reception for Tesla's auto-lease bonds suggest it could continue to tap the securitization market for funding as it burns cash.

The transaction was not Tesla's first trip to the securitization market. It obtained an asset-backed platform through its 2016 acquisition of SolarCity, which funds lending for residential and commercial solar-panel installation by bundling loans and leases into collateral for bonds.

A Risk Retention Victory

A ruling by the D.C. Circuit Court of Appeals should make it less costly to issue collateralized loan obligations, leveling the playing field for smaller money managers

By Allison Bisbey

The collateralized loan obligation industry fought risk retention tooth and nail, claiming it was unjustly applied to those who purchase, rather than underwrite, collateral for asset-backed, overly burdensome to asset managers with little balance sheet of their own, and would raise borrowing costs for below-investment-grade companies.

Nevertheless, the CLO industry adapted.

Since late 2014, when the rules were issued, smaller managers have teamed up with larger players and collectively raised billions of dollars from third-party investors to help finance their skin in the game. Issuance of CLOs reached a near-record \$124 billion in 2017, feeding a frenzy for floating-rate debt that allows junk-rated companies to borrow large sums on increasingly favorable terms.

That doesn't make legal victory any less sweet.

On Feb. 9, the Court of Appeals for the D.C. Circuit sided with the Loan Syndications and Trading Association, an industry trade group; it held that Dodd-Frank does not authorize federal agencies to subject CLO managers who acquire collateral for deals on the open market to risk retention regulation, because those managers are not "securitizers."

To be a securitizer for purposes of



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Section 941 of the statute, the court concluded, "a party must actually be a transferor, relinquishing ownership or control of assets to an issuer" of the securitization notes.

As a result, the court reversed the portions of a district court decision that had initially upheld the agencies' rule and remanded the case to the district court with instructions to vacate the rule insofar as it applies to open-market CLO managers.

The decision is not immediately effective; the Federal Reserve and the Securities and Exchange Commission have 45 days to decide whether to seek a review. If they do not seek a review, then there are seven more days follow-

ing the end of the 45-day period before a mandate is issued. At that point, "the decision is all but a formality," said Richard Klinger, a partner at Sidley Austin, the law firm that represented the LSTA.

"The District Court doesn't have to change anything, it simply vacates the rules with respect to open-market CLO managers," he said.

Here are some of the implications.

There could be an immediate pause in new issuance. Managers currently marketing deals or preparing to launch them now have to decide whether to go ahead as planned, retaining a stake in their deals, or hold off in the hopes that the circuit court's

decision becomes effective shortly. And there is certainly pressure on the agencies to show their hand sooner, rather than later, participants say, if only to avoid a market disruption.

Deborah Festa, a partner at Milbank, Tweed, Hadley & McCloy, says that CLO managers will want to avoid taking on a risk retention stake if they don't have to. "There's nothing stopping a deal in the market now from pricing, but until we see some certainty or finality around this decision ... there could be a pause," she said.

Others disagree. "Yields on debt are so attractive, managers will be worried that if they put a deal on hold, it's going to end up costing them a lot more," said Paul St. Lawrence, a partner at Cleary Gottlieb.

He added, "I suspect deals currently in the market are going to modify their disclosures to make sure investor understand this ruling, and that [the managers] may not be required to hold on to the risk retention stakes."

The playing field will be more level. Once the decision takes effect, not only will new issuance pick up, there is also likely to be more competition among managers because it will be easier for smaller CLO managers to put deals together.

"You're going to start to see a lot of smaller managers who never lined up significant capital for risk retention come into market for first time in a while," Festa said. "The removal of barriers to entry will create more competition for larger managers."

This competition should benefit CLO investors. "Anytime there's an artificial reason for a market contraction, it can have a negative impact," St. Lawrence said. "With fewer managers,

you have less diversity in deal terms, and less competition among managers to figure out the best way to put deals together."

David Preston, an analyst at Wells Fargo, says the pace of refinancing of existing deals will also speed up.

CLOs can typically reissue or reprice notes after an initial, noncall period, compelling investors to accept yields more in line with prevailing

remain aligned, Festa said.

Another reason there is unlikely to be a fire sale of the CLO "equity" typically held by managers: Their third-party investors may want to stay put. "A lot of the retention interest purchases were made by funds that managers have some interest in; in many cases a large portion of [funds], if not the majority, come from third-party investors who all have

"Anytime there's an artificial reason for a market contraction, it can have a negative impact."

market rates. But for now, refinancing can trigger compliance for deals grandfathered from risk retention. So managers must weigh the benefit of lowering debt servicing costs against the cost of taking stakes in deals.

If CLOs are no longer subject to risk retention, managers will no longer have to decide between allocating capital to existing deals or new issues, Preston wrote in Feb. 9 report.

CLO managers may pull their skin out of the game. Vacating risk retention rules won't just allow managers to issue new deals without retaining stakes; they may also be able to stop holding skin in the game of existing deals. Their ability to do so could depend on the wording of deal documents, however.

And even if deal documents do not compel a manager to retain a stake in a deal, the manager still might have to contend with a perception on the part of investors that their interests will

their own investment mandates," St. Lawrence said.

Not all CLOs will benefit. The court's decision only applies to open-market CLOs; it clearly excludes what are known as middle market CLOs, in which lenders to small and midsize companies securitize loans they have underwritten themselves.

CLOs structured to comply with both U.S. and European Union risk retention rules are a gray area, however. In order to meet what's known as the originator method of complying with EU rules, some managers or their affiliates acquire loans and hold them for a period before transferring them to the CLO. "Deals structured that way arguably might not qualify as open-market CLOs," Festa said.

Preston thinks that vacating risk retention for U.S. CLOs would likely discourage managers from structuring deals that comply with EU risk retention.

Capital Raises Fueling CLOs

Players as small as Oxford Lane and as large as the Carlyle Group have money to put to work funding risk retention and investing opportunistically

By Glen Fest

In early January, Oxford Lane, a \$260 million closed-end investment fund that specializes in collateralized loan obligations, went to unusual lengths to raise additional money to put to work. It entered into a sale-and-repurchase agreement with Nomura Securities, using \$106.2 million of securities in its portfolio as collateral for what amounts to a \$42.5 million, nine-month loan.

Nomura got an attractive return of 335 basis points over three-month Libor for what appears to be a low-risk investment, since it's holding on to the collateral in the meantime.

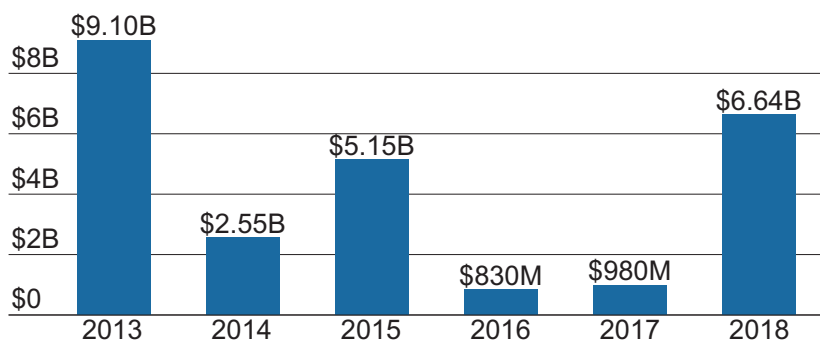
But Oxford used the funds expeditiously: During a furious fourth quarter of refinancings and resets across the market that lowered liability spreads and sweetened CLO equity value, Oxford racked up \$123.1 million in new CLO equity investments. Chief Executive Jonathan Cohen told analysts in an earnings conference call in February that the tightened spreads “presented us with certain opportunities.”

“We think there’s a fairly clear path for a good amount of additional activity over the next several quarters,” Cohen said.

It’s just one example of the innovative ways that money is being raised to invest in CLOs, which are backed by below-investment-grade corpo-

A fast start

January new issuance of collateralized loan obligations was the highest level since 2013



Source: Thomson Reuters LPC

rate loans. In the fourth quarter, the Carlyle Group, itself one of the largest CLO managers, raised (another) \$800 million to put to work in CLOs run by other managers in the U.S. and Europe.

All told, an estimated \$10 billion was put aside in the fourth quarter across the industry for risk-retention capital investments alone (per a JPMorgan survey). Although a federal appeals court ruling overturning risk retention on U.S. open-market CLOs may leave that side of the market in limbo, the appetite for CLO debt and equity is expected to help push the market toward or past the \$124 billion volume level for BSL CLOs in 2017.

The fast start to the year — with \$6.6 billion in primary issuance the largest January volume in five years — appears to strengthen those projections.

Stepping Up the Pace

Wells Fargo expects new issuance to increase slightly this year, to \$125 billion, based on “large-scale” capital raising by managers to finance risk-retention stakes as well as the volume of funds to target third-party CLO investments.

Also buoying the market, says Wells, is the expected increase in first-time managers and a push toward more middle-market CLOs.

JPMorgan's lower forecast of \$115 billion is based on expectations for net new supply of \$250 billion in senior loans in 2018. (Since 2012, the new supply of CLOs has generally ranged from 41% to 52% of the growth in loan supply.) Moody's has a more modest forecast of \$100 billion, based on the expectation that many managers will refinance existing deals, in lieu of printing new ones.

Another \$75 billion in refinancings and resets are expected to take place in 2018, per JPMorgan, far below the \$165 billion level in 2017. As spreads on loans used as collateral keep moving in, CLO managers are increasingly willing to refinance or reset rates on their own securities (even if, at the time, it might have triggered risk retention).

For 2018, the favorable market for issuers (with average AAA spreads compressing to just 106 basis points in the first month of the year), heavy refinancing activity is expected to carry on, as evidenced by January's level of \$11.2 billion in resets and \$2.5 billion in refinancings.

"Almost any deal issued over the past two to three years that's coming up outside of noncall period, the triple-A at a minimum and certainly the mezzanine, is in the money to refinance," said Mike Herzig, managing director at THL Credit Inc.

Credit Quality Challenges

Refinancing isn't just about lowering funding costs, however. It also allows CLO managers more flexibility to deal with deteriorating assets affecting minimum spread tests.

According to Fitch Ratings, 18% of 370 Fitch-rated deals in its CLO Index

were failing to keep up the weighted average spread (WAS) requirement on their portfolios at year's end. That compares to 15% at the end of the third quarter; another 55%, or 204, were within 9 basis points of failing.

All these tightened WAS levels were the product of a nearly \$900 billion refinancing wave in leveraged loans in 2017 that reduced cash flows to CLOs as borrowers reduced their interest

freedom to adjust and modify the test levels themselves, according to Moody's.

How Low Can Spreads Go?

Although managers faced challenges in maintaining deal-quality covenants, they also benefited from the vast tightening of spreads on CLOs — on the senior notes as well as subordinate tranches.

“Almost any deal issued in the past two to three years ... is in the money to refinance.”

rates. CLO managers' only remedies were to refinance the CLO, trade loans for higher-yielding — and usually poorer quality — assets, or adjust the so-called “matrix” of a portfolio's average ratings factor or expected deal tenure (the weighted average life).

Over 40% of deals in Fitch's index reduced their WAS triggers in the fourth quarter, potentially pushing deals out of compliance of collateral-quality, ratings factor and averaged weighted life covenants on portfolios.

Fitch said 18% of deals were also failing the Moody's minimum weighted average rating factor tests.

Moody's believes managers may turn to higher-yielding collateral that provides cushion against deteriorating spreads on the underlying loans. “They may structure CLOs [backed primarily by broadly syndicated loans] to hold more project finance or [small business] loans,” the report stated.

Managers will also seek more

Tighter spreads make life easier for managers who are trying to achieve the right balance between cost of funds and investor payouts, but they also threaten to push away investors.

“Loan spreads compressing for CLO equity investors does have a negative impact,” said Gretchen Lam, a senior portfolio manager at Octagon Investment Partners. “At the same time they're not having huge losses because of defaults and par losses, etc. You can't have it both ways.”

Wells believes spreads will tighten over the first half, despite loans' deteriorating credit and increased competition through more CLOs and investment-grade fixed-income assets.

That normally would lead to a widening spread environment, but demand for floating-rate products may be so great that CLO spread compression might carry through the entire year regardless of the various headwinds.

What CFPB Gained and Lost

A federal appeals court handed it a major victory — and a significant defeat — by upholding its structure while slapping down the practice of making new interpretations of law

By Kate Berry

A federal appeals court handed a major victory — and a significant defeat — to the Consumer Financial Protection Bureau by upholding its constitutional structure while also slapping down the agency's practice of making new interpretations of law through enforcement actions.

The results were similarly mixed for other key players. On the one hand, the ruling, which says the president can only fire a CFPB director for cause, will allow any appointee of President Trump to survive into the next administration should the president not win reelection. Yet it also prevents the president from having greater control over the CFPB once a new chief is installed.

Democrats, too, both win and lose. They praised the decision as a victory because it leaves more power with the independent CFPB. But the ruling may stop a future Democratic president from retaking control of the CFPB swiftly after the election.

"It's a victory for the CFPB in the long long run, but the Democrats may have to wait two or three years to replace a Trump nominee," said Eric Mogilnicki, a partner at Covington & Burling. "I do think that the win on independence is not necessarily a win for those who are guarding the mission of the CFPB because it means someone who is dubious of the bureau



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may be in charge for the next five years."

At issue is the 8-3 decision by the U.S. Court of Appeals for the D.C. Circuit that found the CFPB's structure was constitutional, striking down an earlier ruling that said a president should be able to fire a director at will.

"Congress's decision to provide the CFPB Director a degree of insulation reflects its permissible judgment that civil regulation of consumer financial protection should be kept one step removed from political winds and presidential will," the court ruled in a 250-page decision. "We have no warrant here to invalidate such a time-tested course. No relevant con-

sideration gives us reason to doubt the constitutionality of the independent CFPB's single-member structure."

The court cited examples of other federal financial regulators that Congress deemed to be independent, including the Commodity Futures Trading Commission, the Federal Deposit Insurance Corp., the Federal Housing Finance Agency, the National Credit Union Administration and the Securities and Exchange Commission.

But the decision, while affirming the CFPB's independence, did not let the agency off the hook entirely. PHH, a nonbank mortgage lender and servicer, had appealed a 2014 decision by then-CFPB Director Richard

Cordray, who imposed a \$109 million penalty against the Mount Laurel, N.J., company, for allegedly taking illegal kickbacks for mortgage referrals.

The court said Cordray erred in redefining the Real Estate Settlement Procedures Act to take action against PHH, an issue that had been largely overlooked by the case's more controversial constitutional issues.

The court said the CFPB had violated due process by not providing PHH with notice of its new interpretation of Respa. It also ruled that the CFPB is subject to the three-year statute of limitations in administrative cases.

"This is a complete victory for PHH and the mortgage industry," said Mitch Kider, chairman and managing partner at Weiner Brodsky Kider and a litigator for PHH. "The court has clearly said that lenders can do business with someone that may be referring business to them as long as they are paying a reasonable, fair market value for the services rendered."

Acting CFPB Director Mick Mulvaney now must determine whether the premiums that PHH paid to a reinsurer were reasonable. Cordray had thrown out a \$6.4 million judgment by an administrative law judge, setting the stage for PHH to sue the CFPB claiming it was unconstitutional.

House Financial Services Committee Chairman Jeb Hensarling, R-Tex., called for an appeal to the Supreme Court, though it was unclear whether PHH or the Justice Department would challenge the ruling. "I am deeply disappointed with the court's decision and hope the Supreme Court will review the ruling in short order," Hensarling said in a press release. "I take great solace in the fact that Mick

Mulvaney can use his unchecked, unilateral powers to continue the agency's transformation into one that will, as he said, 'exercise [its] statutory authority to enforce the laws of this nation ... execute the statutory mandate of the bureau to protect consumers' and go no further."

Hensarling also said he stands "ready to work with Democrats to reform the CFPB," even as industry

mittee. "This administration should quickly nominate a director with bipartisan support and a track record of holding Wall Street accountable."

Others suggested the decision could affect a separate case challenging Mulvaney's leadership, putting the Justice Department in a bind as to whether it should appeal the PHH case. Last month, the U.S. Court of Appeals for the District of Columbia granted an

The decision could affect a separate case challenging Mick Mulvaney's leadership.

groups called for the bureau to be restructured with a five-member commission.

"While the court ruled the CFPB's governing structure was not unconstitutional, it does not mean the current structure is appropriate for the bureau's long-term credibility," said Richard Hunt, president and CEO of the Consumer Bankers Association. "Congress should create a bipartisan commission at the CFPB, in place of a sole director, to uphold the bureau's mission of consumer protection."

That did not seem likely. Democrats and consumer groups hailed the ruling as upholding the CFPB's independence and called for Trump to nominate a permanent director.

"While this is good news for consumers, the CFPB cannot be fully independent until it has a lawfully appointed leader in place," said Sen. Sherrod Brown, D-Ohio, the ranking member of the Senate Banking Com-

expedited appeal to Leandra English, the bureau's deputy director, whom Cordray named to succeed him when he resigned in November, citing statutory language in the Dodd-Frank Act.

Trump appointed Mulvaney as acting director of the CFPB on the same day, citing his authority under the Federal Vacancies Reform Act. English then sued Trump and Mulvaney, claiming she was the legal interim director. A district court judge denied granting English a temporary restraining order in December against Mulvaney, and she appealed.

"The fact that there is a separate appeal on an expedited schedule makes it difficult for Mulvaney [or the DOJ] to appeal to the Supreme Court without jeopardizing his credibility in the Leandra English case," said Jennifer Lee, a partner at Dorsey & Whitney.

Many hailed the decision specifically for upholding the mortgage industry's interpretation of Respa.

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AMR and CLO Repricings

Those familiar with CLO structures may recognize similarities between AMR procedures and the “repricing” feature, a widely used provision in CLO indentures that, like AMR procedures, permits a reduction in the applicable margin of one or more existing classes of CLO securities after the noncall period without the need for a new issuance of replacement securities.

A number of key distinctions, however, set AMR procedures apart.

For one, while a CLO repricing is customarily subject to consent rights on the part of the affected security holders with a forced transfer if such consent is not obtained, the CLO issuer need not seek the consent of

the holders of AMR Classes. Rather, to the extent that an AMR auction is successful, the applicable margin of an AMR Class resets automatically, without further action by any security holder.

Further, while repricings typically require the preparation of a supplemental indenture documenting the new applicable margin, AMR procedures require only the posting of a pricing supplement to the offering document to the trustee’s website.

Finally, unlike AMR mechanics structured in accordance with the Sancus request letter, there is significant market uncertainty as to whether a traditional repricing would trigger the U.S. risk retention requirements, and, if triggered, how the manager

would obtain the securities necessary to comply with such requirements.

The AMR feature is an effective and efficient CLO innovation. Since the AMR procedures are relatively new to the marketplace, they have yet to gain widespread traction. Such procedures have, however, been included in a number of recent new issuances arranged by MUFG, and it seems only a matter of market education and time before they become a more commonplace CLO feature.

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sented between 13.1% and 15.7% of the total issuance balance for each deal they collateralize. The remainder of loans in each deal are secured by properties that generally have relatively older build-dates. “Most of the Camillo properties were leased at the time each loan was originated,” said Daniel Tegen, another Kroll analyst.

Tegen said the large size of the loans and the nature of the underlying properties made then a “unique case” for a multiborrower securitization. Camillo “owns large plots of undeveloped land, so the majority of the homes in a neighborhood may have been constructed by and are owned by” the company, he said.

It’s considered unlikely that bridge loans used to build new homes will ever be securitized. “The properties that are in the securitization are stabi-

lized properties,” said Kevin Dwyer, an analyst at Morningstar Credit Ratings. To be bundled into a deal they need to be ready to be leased, he said.

“We do offer bridge products and construction products and sometimes we offer them to build-to-rents,” said O’Brien. “But the stuff we’re securitizing is only stabilized assets.”

In the meantime, the cost of funding for institutional landlords continues to decline. O’Brien noted that yield spreads on Corevest’s securitizations—issued under the Colony American Finance name before the company’s acquisition by Fortress Investment Group in mid-2017—have tightened since the first deal in October 2015.

Colony American Finance 2015-1 featured a AAA-rated, \$168.2 million tranche that pays 170 basis points

over swaps. The comparable tranche of a deal completed two years later pays just 90 basis points over swaps. The spread narrowing was even more pronounced for the riskier tranches of the two transactions, which moved in to swaps plus 125 basis points.

And the institutional players in the sector now enjoy a variety of funding options, as underscored by Blackstone Group’s January 2017 IPO of its Invitation Homes unit, which raised \$1.54 billion.

The potential for continued involvement of the GSEs in the securitization space—Fannie Mae guaranteed a deal backed by a \$1 billion loan from Wells Fargo to Invitation Homes in April 2017, and Freddie Mac did the same for a transaction by Corevest—bodes well for reducing the cost of capital for large investors.

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