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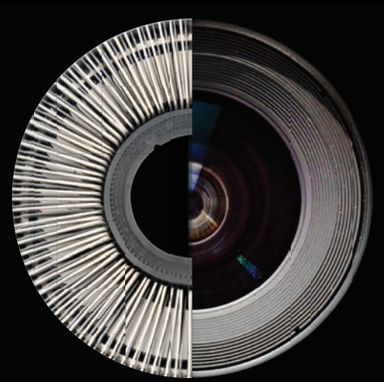

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January/February 2018 | Volume 18, Number 1

PRELIMINARY ASSESSMENT

Carveouts spared CRE-backed assets from tax reform damage; **corporate loans and lease ABS weren't so lucky**

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** ABA Weekly Update, January 13, 2017

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Asset Securitization Report

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EDITOR'S LETTER

Clear Winner

The Tax Cuts and Jobs Act wasn't the thoughtful overhaul many were hoping for. But commercial real estate investors, owners and developers are certainly rejoicing. Not only does the act preserve many of the existing tax benefits for this asset class, it provides a few new perks as well.

If anything, there is some anxiety that the tax rules might prove to be too much of a good thing for the commercial real estate market, which has always been susceptible to over-borrowing and over-building. REIS has warned that corporations benefitting from lower tax rates could put some of the cash freed up to work "overinvesting" in commercial real estate. It takes some comfort that the resulting rise in construction cost will force businesses to reassess the economic prospects of their specific industries, however. So demand for warehouses and distribution centers could rise, but don't look for any new shopping malls.

Other assets classes did not make out so well.

Tax reform is obviously a wrench in the works for the housing market, which is losing the mortgage interest deduction. But funding costs could also rise in the leasing industry, as it could be less economical to securitize financing for autos, construction and agricultural equipment, and aircraft.

There's also little in tax reform to cheer speculative-grade companies - or those who lend to them. Risky companies with heavy debt loads typically pay little corporate tax, so they won't see as much benefit as more profitable companies of the new lower 20% tax rate. And while they achieved a favorable tax deduction allowing an immediate expensing of capital costs, junk-rated companies lost a far more valuable tool with the elimination of fully deductible business interest expenses, which are now capped at 30% of earnings before interest, deductions and amortization.

—Allison Bisbey, Editor in Chief

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Preserve Money Market Rules

The Securities and Exchange Commission should hold steady against calls to roll back post-crisis reforms to money market mutual funds

By Lev Bagramian

One of the most consequential threats the American economy has ever faced arose during the week of Sept. 15, 2008, when the reserve primary fund "broke the buck" as its share price fell below a dollar.

Up until that week, the fund had marketed itself to investors as one of the safest places for Americans to keep their hard-earned money. Yet this "breaking of the buck" panicked large investors into redeeming $40 billion from the fund, forcing the fund to sell tens of billions of dollars in assets immediately.

This fire sale in turn depressed asset values, further weakening the fund. This investor run in this one fund quickly became generalized and spread to much of the MMF industry. Investors quickly withdrew approximately $310 billion (or 15% of the $3.7 trillion industry) from prime money market mutual funds.

The dramatic run on the reserve primary fund stopped only after the Treasury Department established the Temporary Guarantee Program to guarantee money market funds. This backstopped the entire $3.7 trillion industry, putting taxpayers on the hook for any losses. This was the single largest taxpayer-backed rescue program during the 2008 crisis and the largest the financial industry has ever received.

Bloomberg News

SEC Chairman Jay Clayton

In response to the events of September 2008, federal regulators — after a deliberative rulemaking process — implemented much needed reforms to reduce the risk of such catastrophic runs in the future. Specifically, in 2014, the Securities and Exchange Commission finalized a rule requiring certain large MMFs to calculate their share price, the net asset value, so that it "floats," accurately reflecting its true market value, not the artificially fixed amount of one dollar.

The SEC also gave funds additional tools for mitigating run risk, including the authority to impose fees on those seeking to redeem quickly in times of stress and even the authority to halt redemptions entirely for a period of time (so-called gates and fees).

While some are still actively pushing to repeal or substantially weaken these critically important reforms, the good news is that industry's main trade group just announced its opposition to these repeal efforts. It is worth recalling the importance of these reforms, and the need to maintain them.

The 2008 breaking-the-buck episode proved that MMFs are susceptible to runs and, when they do occur, the financial system can experience

major disruptions that cripple the short-term credit markets and the overall flow of credit to the economy. MMFs do not come with reliable capital buffers or government backstops, unlike bank accounts insured by the Federal Deposit Insurance Corp., which can prevent or mitigate the effect of a run. They often rely on discretionary infusions from sponsors to make up for shortfalls.

Compounding the resulting fragility, MMFs are also highly interconnected with other financial institutions, the payment systems and the economy as a whole because they are widely used by individuals, institutions, businesses, and state and local governments as cash management vehicles or as sources of credit. And finally, in times of stress, sophisticated and vigilant investors are the first to flee the fund (the so-called first-mover advantage), exposing the less-alert investors to greater risk of loss.

The SEC's reforms aimed to solve these issues. First, investors would no longer think that MMFs were like a stable bank checking account that can't lose money. Instead, they would see that these are indeed investment products that go up and down in value on a daily basis. Investors accustomed to seeing share prices fluctuate are less likely to panic when the prices fluctuate.

Second, investors will have little incentive to pull their money out (i.e., run) during times of stress, since they will no longer be able to liquidate at an artificially inflated price. And those who decide to exit the fund hastily will pay a fee, thus taking away the incentive to be a first mover and ensuring that those who remain in the fund are not subsidizing the early runner's exit when a market is declining or volatility is high.

These (and other) SEC actions, taken together, are better protecting investors, markets, the financial system, our economy and taxpayers by requiring the disclosure of accurate market price information and by increasing the transparency of MMF risks. It has also reduced the potential for systemic contagion by taking away the incentive to be a first mover, reducing the likelihood and intensity of future runs, another financial crisis, and the need for more taxpayer-backed bailouts.

Money market funds do not come with reliable capital buffers or government backstops.

But, as mentioned above, some are still seeking to roll back these critical protections, and it is worth rebutting them here. These suggestions — which are opposed by some prominent sponsors of MMFs, including the industry's main trade group — would replace substantive reforms with certain additional disclosure requirements in fund prospectuses or sales literature.

However, disclosure alone simply will not eliminate the first-mover advantage born of the artificially fixed NAV. Nor can disclosure alter investors' inflated and misplaced confidence in the stability of MMFs. In fact, the very same reserve fund that nearly failed catastrophically made similar disclosures in its technical and legal fine-print disclosures, which were often overwhelmed by marketing and promotional language leaving the investors confused at best, and misled at worst.

Furthermore, the money market fund industry has now adapted to the SEC's rule, institutional investors have also adjusted, and the impact on municipal financing overall has been negligible. The rules have bestowed enormous benefits on the markets, investors and the public at large: greater stability, increased investor confidence, transparency and fairness, and above all, less likelihood of triggering or inflaming another financial crisis.

Fortunately, SEC Chairman Jay Clayton agrees and believes that repealing the floating-NAV approach would be premature. Last week, Better Markets wrote to him, urging him to stay the course.

We are also encouraged that the MMF industry at large has decided to support those reforms as well. We hope that others in Washington won't be shortsighted, and won't succeed in sacrificing the many benefits of these reforms to appease a small but vocal segment of the financial services industry.

Lev Bagramian is senior securities policy adviser at Better Markets.


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PRELIMINARY ASSESMENT

Tax reform preserved most existing benefits for CRE-backed assets and provided some new perks as well corporate loans and lease ABS weren't so lucky

By Allison Bisbey

THE COMMERCIAL REAL ESTATE industry clearly came out on top in the tax law overhaul.

In addition to preserving most of the existing tax benefits for investors, the Tax and Jobs Cut Act provides a few new perks as well.

Early drafts of the legislation limited the deductibility of interest – of key importance to a market that relies heavily on debt to fund purchases. Legislators were also looking at eliminating so-called like-kind exchanges, which allow sellers of commercial property to postpone paying tax on any capital gain if they reinvest the proceeds in a similar property.

The exceptions for real property and businesses in the final bill President Trump signed into law at the end of December were lauded as a triumph at the Commercial Real Estate Finance Council's annual conference in January, according to participants.

The CRE Finance Council and numerous other real estate-oriented organizations had lobbied Congress intensively, warning that losing either provision would damage valuations and capital availability, this slowing overall economic activity.

"What's important is the continued ability for commercial and multifamily real estate transactions to act as major drivers of U.S. economic growth," Lisa Pendergast, the trade group's executive director, said in a November statement.

Now, the in addition to benefitting from a lower corporate tax rate, business can continue to deduct all of their interest, with an important condition. They may elect instead to depreciate their assets at an accelerated rate. And the taxes for so called pass-through businesses — a common real estate investment vehicle — were also reduced. So instead of restricting investment, the new tax code is likely to attract more capital to commercial real estate.

Interest Deduction

The Tax Cuts and Jobs Act limits the deduction for net business interest expense to 30% of adjusted taxable income, but real property trades or businesses are eligible to elect out of the limitation. The exception is defined broadly to include any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. "The congressional report describing the law makes clear that the exception is not limited to rental businesses and that it applies to the management of real estate," the tax practice group of law firm King & Spalding said in a Jan. 12 client alert.

There's a catch, however.

Businesses that make this election are required to use the generally less-favorable alternative depreciation system for most types of real property and certain improvements. And in the case of a partnership, the net interest expense disallowance would be determined at the partnership (and not the partner) level.

And it's unclear if so-called corporate blockers that hold nothing but a direct or indirect interest in a real estate investment trust will qualify, according to King & Spalding. To ensure that the election out of the interest deductibility limits is available, these investors will want to invest below the REIT level. Even in that case, it is somewhat unclear whether the real estate exception will allow partners to be attributed the real estate business of their partnerships.

"This is an issue where additional guidance from the Internal Revenue Service and Treasury will be needed," the report states.

Accelerated Writedown

The reason that real estate businesses may not elect out of the 30% limit for interest deduction is that they may instead choose to immediately write-off of the cost of many asset purchases – generally tangible property that has a depreciation recovery period of 20 years or less under current law.

So there is a big tradeoff.

"You have to make a calculation, based on whether you are a low leveraged or highly leveraged business, what's worth more," said Jonathan Talansky, a partner in the tax, real estate and mergers & acquisitions practices at King & Spalding.

The accelerated depreciation is available for property acquired or placed in service after Sept. 27, 2017 and before Jan. 1, 2023, with a gradual phase-out of expensing after that. After five years of 100% expensing, the rate will phase out at to 80%, then 60%, then 40% and then 20% rates over the ensuing four years.

(It is still unclear a whether a partner of a partnership that does not use accelerated depreciation schedule can still benefit from the exemption if the partner itself depreciates its property using the accelerated depreciation schedule, according to King & Spalding.)

REIS, predicts that allowing business to immediately expense many asset purchases could spur new construction over the next few years. "There is the possibility that cash-rich corporations may choose to overinvest in real assets and development in the next five years, stimulating supply growth in moribund sectors like office and retail," the commercial real estate data and analytics company warned in a December.

"Cash-rich corporations may choose to overinvest in real assets over the next five years."

REIS thinks that this could raise construction costs, which will force businesses to reassess the economic prospects of their specific industries. "With the threat of e-commerce still [damping] demand for brick and mortar retail space, for example, it seems unlikely that there will then be a rush to build or buy new malls just because businesses can now deduct asset investments in the first year," the report states.

"However, e-commerce companies that were contemplating building their own warehouse or distribution facilities could accelerate their plans."

Like-Kind Exchange

While personal property is no longer eligible for tax-free exchanges, this perk is still available to real commercial property that is not held primarily for sale - a clear win for investors who

frequently use this technique to exit investments while deferring the tax gain.

Like-kind exchanges are particularly important to real estate investment trusts, which both invest directly in commercial real estate and underwrite mortgages for sale to CMBS conduits. REITs are required to distribute their taxable income in order to avoid corporate tax, so like-kind exchanges permit them to reallocate and grow their portfolios without being required to distribute capital.

Like-kind exchanges also allow REITs to manage the recognition of a capital gain under the Foreign Investment Real Property Tax Act (FIRPTA), which requires a buyer to withhold a portion of the sale price of a property acquired from a foreign holder.

Pass-Through Deduction

The biggest real estate developers and investors rely extensively on limited liability corporations and partnerships. These entities, which don't pay income taxes at the corporate level, but pass them along to individual members, benefit from a new 20% deduction — another boon to the industry.

Ordinary REIT dividends qualify for the same 20% deduction, resulting in an effective maximum income tax rate of 29.6% on such dividends. What's more, the deduction for REIT dividends is not subject to the same limitations as the deduction for pass-throughs. So while both pass-throughs and REITs are better off, REITs are still relatively better off.

In fact, the tax changes could prompt restructuring as investors convert to what is now the optimal structure for them. More owners may opt to form LLCs or other partnerships to benefit from the deduction, for example.

"It used to be prohibitively expensive for a business structured as a corporation to covert to another structure," Talansky said. "Any deemed gain on the sale of assets by the corporation was be taxed at the 35% corporate rate."

"It used to be prohibitively expensive for a business structured as a corporation to convert."

Now, exiting a corporate structure is less costly in light of the new, flat 21% rate, especially if the corporation has accumulated net operating losses, he said. Conversely, businesses that do not distribute earnings may wish to convert into a corporate structure as a result of the more favorable corporate tax rate.

However, hedge funds and private equity funds, also important investors in commercial real estate, can continue to treat carried interest as a capital gain, rather than income, though there is now a three-year holding period to qualify. This new rule applies to partnership interests received in exchange for services performed as part of an investment management trade or business.

No Relief from FIRPTA

There's one change the commercial real estate has been lobbying for that did not make it into the Tax Cuts and Jobs Act: relaxation of restrictions on foreign investment. FIRPTA, which was put in place in the '80s, made real estate investment for non-U.S. investors particularly expensive for tax purposes. It requires purchasers of a property from a foreign seller to withhold a percentage of the amount realized on the sale.

Over time, the restrictions have been relaxed, and a significant amount of commercial real estate has been purchased by foreign investors over the last 25 years for investment purposes, despite the act, providing a fillip for the market. Still, some people are hoping for more comprehensive relief.

"There's been talk about repealing FIRPTA for a while," Talansky said. " FIRPTA has its roots at a time when there was sensitivity about foreign investment in U.S. real estate. The market has changed, people are not only more comfortable with foreign investment in U.S. real estate, a lot of developers depend on foreign money," he said.

Still, "that does not mean that there is sufficient political will to completely repeal FIRPTA. Plus, various amendments to FIRPTA have been made over the past two to three years that broaden some of the exemptions and generally facilitate inbound US real estate investment."

Junk Penalty for Loans

The loss of full corporate debt interest deductibility could encourage speculative-grade companies to deleverage, reducing the supply of collateral for CLOs

By Glen Fest

Tax reform may be designed to benefit Corporate America, but there's little in it to cheer speculative-grade companies - or those who lend to them.

Risky companies with heavy debt loads typically pay little corporate tax, so they won't see as much benefit as more profitable companies of the new lower 20% tax rate. And while they achieved a favorable tax deduction allowing an immediate expensing of capital costs, junk-rated companies lost a far more valuable tool with the elimination of fully deductible business interest expenses, which are now capped at 30% of earnings before interest, deductions and amortization (EBITDA).

In a letter to Senate leaders in December, a coalition of technology, health care and other firms with below-investment grade corporate ratings – including Dell Technologies, whose debt is one of the most widely held in U.S. collateralized loan obligations – warned that the Senate's version of the bill represented a $300 billion tax increase on corporate borrowers over the next decade.

CLOs, which are some of the biggest investors in the loans of speculative-grade companies, themselves could find their portfolios impacted because of the likelihood that tax cuts could reduce the amounts of borrowing by speculative-grade rated companies as leveraged loans lose the tax advantage from uncapped deductibles.

"Because speculative grade companies now pay relatively little taxes, the curbing of interest deductibility, as envisioned in the tax bills, could outweigh the benefits of the legislation for many obligors in the CLO market, a credit negative," said Jian Hu, a managing director for Moody's Investors Service, said in a report issued in December.

Barclays research has indicated that more than 32% of firms with corporate debt (most of which are speculative-grade) have interest expenses that exceed the cap of 30% of earnings, and that lower tax rates "tend to reduce corporate leverage, as debt becomes more expensive relative to equity."

In a newsletter, the Loans Syndications & Trading Association cited the Barclays research in questioning . "how big is that universe of companies and ... will their increase in taxable income be counterbalanced by lower corporate taxes and capex expensing?"

Speculative-grade companies that were acquired by private equity firms could be hardest hit.

Speculative-grade companies that were acquired by private equity companies may be among the hardest hit, since they are among the most indebted, according to the LSTA.

The final bill went easier on highly leveraged companies than the GOP's original 2016 plan to eliminate the deduction altogether. But the bill adopted a provision in the original Senate proposal that greatly concerned spec-grade companies. Beginning in 2022, interest on corporate debt will remain at 30% but will be calculated against earnings after amortization and deduction expenses (or EBIT) - a higher figure that will raise companies' tax bills even further.

The LSTA was also originally concerned that under the Senate bill, the tax rate would not be in effect until 2019 even through interest-rate deductibility caps would be enforced in 2018. The final version enacted both measures for 2018.

New Economics for Lease ABS

In a lobbying effort prior to tax reform passage, SFIG argued that the tax reform will make securitization more costly for auto and equipment lessors

By Allison Bisbey

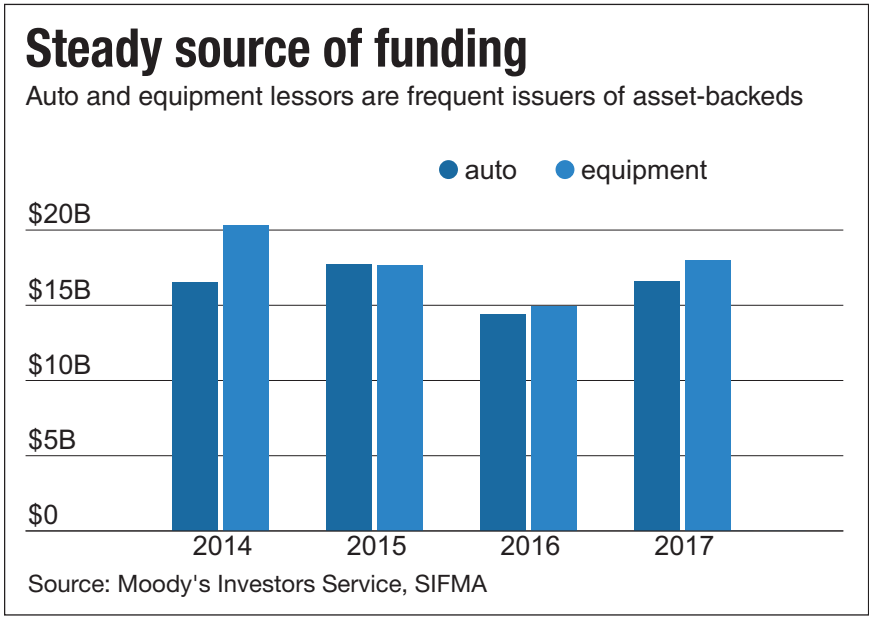
Tax reform could make securitization uneconomical for auto and equipment rental companies, according to the Structured Finance Industry Trade Group.

In a Dec. 11 letter to Senate and House tax reform conferees prior to reform passage,SFIG warned that depriving auto and equipment leasing firms of an efficient cost of funds via securitizations would increase lease cost on consumers and businesses.

At issue is the limit introduced on the deductibility of interest. In a securitization, assets such as loans or leases are sold by the lender or aggregator to a bankruptcy remote, special purpose vehicle; this securitization trust issues bonds that are backed by the loans or leases. P&I payments on the assets are used to pay interest and repay principal on the bonds.

This financing method allows some lenders and lessors to access financing more cheaply than through bonds.

Here's why limiting interest deductibility creates a problem for bonds backed by auto and equipment leases – and not other kinds of assets such as consumer loans, according to SFIG."In most securitizations, the amount of interest income (from, for example, a pool of mortgage loans) is closely aligned with the amount of interest expense on the securitization debt," the letter states. "In these cases, there would be little impact from the proposed limits on interest deductibility."



In securitizations of auto, equipment and aircraft leases, however, the income is not treated as interest but instead as lease payments. The inability in a lease securitization for the issuer to offset lease income with interest expense would make such securitizations uneconomical.

In an example provided by SFIG, suppose an equipment manufacturing company securitized leases on construction equipment which produced $100,000 in equipment-leasing income in year one (and the company had no other net income) and the company issued a single class of debt (backed by these equipment leases) which paid $80,000 in interest in year. Under the (then current) proposal, the company's business interest deduction would be limited to the sum of (A) the business interest income of the company (here they have none), plus (B) 30% of the adjusted taxable income of the company (here, 30% of $100,000 = $30,000). As such, despite paying $80,000 in interest on the debt in year, the company would only be permitted to deduct only $30,000 of the interest. As a result, the company would owe tax on $70,000 of income ($100,000 minus $30,000) but only have $20,000 in net funds ($100,000 minus $80,000).

New Risk for Loan Investors

Issuers have started to introduce carveouts to change of control provisions, which would normally require the debt to be repaid when a company changes hands

By Allison Bisbey

Leveraged loan investors have a new risk to worry about: They could end up lending money to an entirely different company.

Broadly syndicated loans to below-investment-grade U.S. companies typically have what's known as a change of control provision. In the event they are acquired by another company, it must refinance or repay the debt. Recently, however, several new issues have come with "portability" provisions that subvert this assumption, according to Covenant Review, an independent credit research firm. This could result in investors suddenly holding the paper of a company with a different owner and/or management team, and, potentially, a different credit profile.

Referred to alternatively as portability (because the capital structure can be carried from owner to owner) or "precap" (because the new owner buys the company already capitalized), the concept "boils down to carveout in the change of control provision," Covenant Review warned in a report published in January.

Though still fairly unusual, such provisions were included in five leveraged loan offerings in the fourth quarter of 2017. "Unfortunately, due to the overall rarity of precaps, many investors continue to lack the basic understanding of what to look for in change of control provisions," the report stated.

> **"Many investors lack a basic understanding of what to look for in a change of control provision."**

One important reason that a change of control normally results in prepayment of loans is that it is normally considered to be an event of default under a traditional New York law-government credit agreement. (That's in contrast to an indenture for a typical high-yield bond, in which a change of control is considered an offer to prepay.)

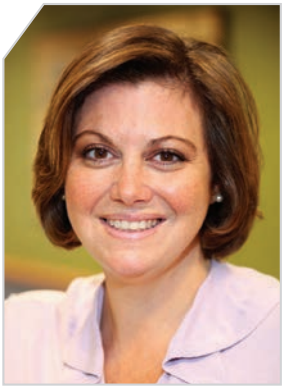
For now, at least, precaps are not a free-for-all. They come with terms generally intended to protect investors by ensuring that a sale carved out from change of control does not reduce the overall credit quality of the company and that the new owner is substantially comparable. These include a sunset, which restricts a permitted change of control to a limited time period; a leverage compliance test, which limits the amount of debt a company can have on its balance sheet; and provisions that the buyer meet certain conditions.

In addition to evaluating the terms and conditions of precaps, Covenant Review recommends that investors consider how a precap may affect other kinds of covenants deal documents may contain that are designed to protect them.

Strong demand for leveraged loans has allowed issuers to remove covenants or significantly erode them; precaps can further erode these investor protections, Covenant Review warned. In some cases, for example, precaps will alter the conditions required for an allowed exception to covenants known as a "basket" in a way that is favorable to the borrower.

While precaps are still a relative oddity in the U.S. loan market, Covenant Review believes that the practice bears watching. "Unlike many of the more esoteric provisions negotiated by issuers where flexibility is theoretical or academic, borrowers and [their private equity] sponsors have actually exercised the precap in a number of cases," the report stated.

A Future without LIBOR?



MODERATOR

Danielle Fugazy
contributing editor,
SourceMedia

As 2021 fast approaches, the burning question of what indices will replace LIBOR comes to the forefront. *Asset Securitization Report* brought together leading industry experts to discuss the different options and ideas being presented by various industry groups. Wilmington Trust sponsored the event. And while there are still more questions than answers at this point, what follows is an excerpted version of the conversation where many different possible outcomes were discussed. The event took place in ASR's New York offices and included representatives from Wilmington Trust, Kroll Bond Rating Agency and Dentons.

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Danielle: What effect has the LIBOR scandal had on global financial markets today?

Steve: It's mainly had an impact on institutions that are affected by litigation because of their specific roles in calculating LIBOR. But in terms of the bigger markets' perception of LIBOR, it does not seem that the LIBOR scandal has had a marked effect on borrowers willingness to incur debt that's indexed to LIBOR, or on investors willingness to hold securities with interest rates that are calculated based on a LIBOR index. The main effect has been on the financial institutions properly producing the rates.

Patrick: It has also highlighted how LIBOR was calculated or had been calculated in the past—and that it was not based on actual rates, but on indications from participating banks. It's also brought out a cottage industry of potential other indices that may be used going forward.

Rosemary: There's been a big focus to move from "expert judgment" or what the experts think the rate should be to actual transactions to make sure that it's being tied to real transactions in the market.

Danielle: Is LIBOR a tainted index?

Alan: From an investor perspective? No. It's still used as the reference rate in many existing transactions and new

transactions. But from a contributing bank perspective? Yes.

Steve: It's viewed as risky to contribute to the rates because of the perception now. From the regulatory and policy side, it's not an exaggeration to say it is viewed as a tainted index. Regulators are very concerned about finding new rates that are really fundamentally different: mainly being based on actual reported transactions in the capital markets.

Patrick: There's going to have to be a lot of analysis done to see how in the past it was calculated versus this new rate. And then look backs to see if there were any potential differences. At the end of the day, in the eyes of regulators, perhaps it has been tainted. Probably in the eyes of some investors there are questions about whether it's been manufactured or altered in an improper way. It also highlights the fact that there needs to be transparency about how best to do this going forward.

Danielle: What are the alternatives to using LIBOR?

Rosemary: There have been a number of alternatives discussed. The Federal Reserve formed an Alternative Reference Rates Committee ("ARRC") in late 2014 to identify a set of alternative U.S. dollar references interest rates and to determine an adoption plan for their use. The ARRC has recommended a broad treasure repo rate called Secured Overnight Financing Rate ("SOFR"). In

"The Federal Reserve formed an Alternative Reference Rates Committee ("ARRC") in late 2014 to identify a set of alternative U.S. dollar references interest rates and to determine an adoption plan for their use."

Rosemary Kelley
Senior Managing Director and co-head of the ABS Group,
Kroll Bond Ratings

August 2017, the Federal Reserve put out a request for comment on three potential alternative rates. The potential rates include the Tri-Party Collateral Rate, the Broad General Collateral Rate and the SOFR. SFIG has reviewed these proposed rates and recently commented on which rate they thought would be most useful, which is the SOFR as it is based on the broadest dataset.

Patrick: From a European perspective, different rates are being looked at as potential replacements for LIBOR. One is called SONIA, which is a Sterling Overnight Interbank Average. There's going to have to be a lot of work done to decide which one ultimately gets accepted into the marketplace. It will evolve over time. 2021 is the implementation timeframe, but there's going to need to be some lead time so that market participants can (a) understand it, (b) implement it, and (c) make sure that regulators are comfortable with it.

Steve: From the policy side, the goal appears to be to move to one or more rates that are based on actual reported transactions in the market and where there's transparency as to how it's being captured and reported. They will also be trying to avoid an index that is tied to a policy rate rather than a market rate. It could be an index based on treasury yields, but I don't think that's really desired either. The goal is to arrive at a risk-free rate, but one based on market lending transactions, not a treasury rate.

Alan: They want a risk-free rate that is truly independent of the contributing banks—that is the improvement they are trying to make with the new rate.

Danielle: How is Europe versus the U.S. impacted?

Alan: The difference between the two jurisdictions is where the new rate will come from. In the past LIBOR rates were collated and issued by one organization—ICE. In Europe, LIBOR has rates related to various different currencies (GBP LIBOR, CHF LIBOR etc.), while in the U.S. there is only USD LIBOR. What do those particular jurisdictions see as the replacement rate? In the U.S. there is a lot of discussion about what the USD LIBOR rate will be. In Europe, there is also alot of discussion about what the LIBOR rate will be and how it will be calculated. The replacement rates will probably not come from a single source anymore.

Patrick: It will be interesting to see how the rate gets calculated and what time it gets released. Even if it were done in the U.S. at 3:00 am eastern time, that's almost too late for Europe, depending where you are in the jurisdictions. That will have to be addressed.

Danielle: Will any banks be willing to quote rates after 2021?

Alan: That's one of the concerns for the regulators. In the past, the banks were contributing rates—regulators thought they were real rates based on transactions—but it appears in some instances they were hypothetical rates and there was some judgement involved by the contributing bank.

Rosemary: There was also a decline in activity in the interbank unsecured lending markets—so there weren't transactions to quote. That was part of the problem. It is hard to predict whether banks will be willing to quote those rates after 2021.

Patrick: The way a lot of transaction documents worked, one had to fall back to a previously reported rate, which may not have been a good reflection of what was happening at that time.

Danielle: What does this mean for ABS transactions?

Patrick: There will be a period of potential confusion in the marketplace around 2019, 2020; because people are going to start wondering on which index they're going to need to focus. There will be some deals that are going to last for a while that will have LIBOR in its index and others could potentially be another index. Wherever there's uncertainty, there's potentially less activity, or there are wider spreads because people will demand a little bit more return for the potential uncertainty. Another impact could be on transaction documents themselves and how they get crafted. I also look at it from our own perspective on the trustee side—how will we prepare cash flow models and other types of analysis that we have to do to pay bonds?

Steve: The legal community is working with some of the trade associations trying to put together language on the changes. And it's pretty important; because every month that goes by we're putting out new transactions that incorporate LIBOR at the asset level or securities level, which may not have provision to convert to an alternate index. There ought to be some standardized language enabling a shift to an alternate index, which would be triggered by a defined LIBOR discontinuance event, would define criteria for a recognized alternative index, and would enable a change to be made with majority investor consent.

The difference for ABS transactions is you have your bondholders and note holders who are a disparate group with various different interests."

Alan Geraghty
Group Vice President, Global Capital Markets - Europe, Wilmington Trust

Alan: The difference for ABS transactions is you have your bondholders and note holders who are a disparate group with various different interests. When the documents don't deal with a new index instead of LIBOR, then getting them to come along on the journey with you will be difficult as well.

Patrick: It'll definitely be a new risk section in the documents, talking about the potential uncertainty, and another thing investors will have to take into account.

Rosemary: It will be important for it to be an orderly transition in terms of rates used and there is a lot of work being done in the U.S. and in Europe to develop alternative reference rates and to determine how to incorporate these rates.

Danielle: What is the impact on existing deal documents?

Steve: A lot of the existing ABS documents that contain a definition of LIBOR have a typical fallback approach that says that if LIBOR is no longer published at a specified page or location, then the administrator or other party is required to "create

your own" LIBOR by obtaining from reference banks their offered rates for U.S. dollar deposits for the relevant tenor (one month, three months, etc) and averaging them. If those bids are not available, then the definition simply freezes the rate at whatever it most recently was. These definitions are designed to deal with short term disruptions, not a permanent phasing out of LIBOR. If LIBOR were to continue beyond 2021, that would be dependent on reference banks being willing to continue to provide these bids. If banks are not willing to voluntarily continue to provide bids to support LIBOR, then it would seem that these banks would also not be willing to provide bids on an as requested basis as contemplated in this fallback language. Therefore the existing language for a lot of deals just does not work for a full phase out of LIBOR.

Alan: One of the important points is that existing deal documents are not all standard and the language isn't the same in all the deals. You have to look at each particular transaction and review the language to determine the impact on that transaction.

"There will have to be some discussion and agreement with new transactions going forward so there's less uncertainty."

Patrick Tadie
Group Vice President for Structured Finance, Wilmington Trust

Danielle: How will trustees handle the changes?

Alan: I don't think it's all down to trustees. It comes back to the particular deal documents and what is included. It isn't always the trustee that has responsibility for fixing or calculating the interest rate. There may be other parties that are responsible. In many transactions it is the calculation agent who are the responsible party for calculating the rate at each interest period. The trustee may be involved on particular transactions where bondholder/noteholder approval is required for changes in the documents related to the replacement of LIBOR as the reference rate.

Patrick: We'll see if some of the industry organizations, like SFIG, trying to get some consensus among all the different transaction parties, especially trustees and certificate administrators to come up with a potential solution to which everyone would agree. There will have to be some discussion and agreement with new transactions going forward so there's less uncertainty.

Danielle: 2021 is the deadline, but is there expected to be a phase in period?

Rosemary: It's going to need to be phased in over time. That's why it's important to look at that timeline of the New York Federal Reserve laid out. It expects to start to publishing daily rates in the middle of 2018 so the market can get comfortable with it and begin to incorporate this rate into transaction documents.

Patrick: I still think it's going to come down to larger investors expressing a preference on timing after they've

looked at different indices. If I were an investor I'd certainly want something that's settled more quickly than potentially 2020-2021. I would want to know in 2018 or 2019 to base decisions going forward. One of the worst things you could do is have a bifurcated market. You have one index for a while and then another index, and there's overlap. I know, as a trustee, I don't really want that because then we're looking at two different rates for an extended period of time. We live with the transaction until it settles. It could be a couple years or 15 years depending on the underlying assets.

Danielle: What impact will it have on underlying loans?

Steve: It's interesting because corporate loans that go into CLOs are pretty short term so they can probably get renegotiated. It's a bilateral situation. To some extent this is true with large balance CNBS loans. Although a lot of CMBS loans actually have a prime rate fall back provision, which is not ideal because prime is so different from LIBOR. But with legacy consumer loans it maybe one of the biggest challenges. There are billions of dollars of residential mortgage loans in the U.S. that are tied to LIBOR. There are also a fair number of student loans that are tied into LIBOR. You need to look at the language in each case, but in many cases, particularly on the mortgage side, where much of the documentation is standardized, it tends to say, if the servicer or lender determines that LIBOR is no longer being published, that they will select an alternate rate based on comparable information. Those four words, based on comparable information, are very significant. To me, it does not seem obvious that a replacement index such as SOFR is based on comparable

"There are billions of dollars of residential mortgage loans in the U.S. that are tied to LIBOR."

Steve Kudenholdt
head of structured finance, Dentons US LLP

information to LIBOR. In fact the two indexes are different in terms of secured vs unsecured, risk free vs bank credit, and overnight only vs various tenors.

Patrick: Some lawyers may say that borrowers have been harmed because borrowers were expecting a LIBOR rate for the life of the loan. Then if the index does get changed maybe the rate is higher than it normally would've been had LIBOR been in existence and you're harming the borrower, you're harming my client. So I could certainly see that as a potential negative fallback down the road.

Danielle: What impact will there be on technology?

Patrick: From the trustee perspective, we will definitely have to work on programming different types of indices into our bond payment calculations. Entities that begin to aggregate this information going forward will have to ensure that programs are written properly, they're tested, there'll need to be a phase-in period, where we can check the information and make sure it is accurate before it goes live.

Rosemary: The market is definitely going to have to know where it can access these rates and it needs to be reported on published sources such as Bloomberg and Reuters.

Danielle: Will LIBOR continue to be produced after 2021?

Steve: There's certainly at least one entity, ICE, that hopes it is and they're trying to make some improvements to make LIBOR more based on actual transactions, and to encourage reference banks to continue to submit rates on a voluntary basis, so that even if LIBOR is not forced upon the market by regulators, there is a potential to have it continue. There's definitely some interest in continuing LIBOR to potentially alleviate a lot of the problems with legacy transactions that we're discussing here today. Whether that ends up happening or not, who knows.

Danielle: What is the best outcome?

Steve: An ideal outcome would be full speed ahead on building out an alternative rate like SOFR, and figuring out how to generate a forward SOFR

curve that gives people the forward looking, short-term rates that they want. But at the same time, letting there be enough space for banks to continue to produce the rates that create LIBOR, so that LIBOR can continue to be used for legacy transactions. It will be a delicate balancing act because you don't want to make it so easy to keep using LIBOR that alternative rates would not take hold, but if there's a hard stop on LIBOR for legacy transactions, then we have a potential wall of litigation and I don't think anybody wants that.

Alan: The idea is to have a reliable and transparent rate that people can understand and interrogate if required. It should be from an independent association or independent source as opposed to from any particular bank so it's really one that the whole market can rely on and use for the future.

Patrick: In an ideal world, LIBOR would continue to be used and we would have a very good backup with SOFR. That is probably not going to happen.

Asset Securitization Report

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Novel Approach to Auto Lending

Rather than jump right away into lending to car buyers, Access National will start by offering commercial real estate and M&A financing to dealerships

By John Reosti

Access National in Reston, Va., aims to be contrarian — yet careful — with auto lending. The $2.9 billion-asset company has created an automotive lending division and hired an industry veteran to run it. But don't expect Access to immediately start making loans to car buyers.

The group will initially focus on financing commercial real estate deals and acquisitions for dealerships, said Michael Clarke, Access' CEO. That will allow Access to become more familiar with the market, while giving dealerships a chance to learn more about the company.

Dealers "don't switch easily in terms of going from one [lender] to another," Clarke said. "It's a notoriously cyclical business, so they want to see a commitment — in good times and bad. Once you establish yourself as a trusted adviser, they're very loyal."

Several factors encouraged Access to make the move. The company recently hired Roy Giese, who has managed dealership lending teams for more than three decades, to lead the venture. Giese was a mainstay at First Virginia Banks, which was sold in 2004 to BB&T. Access plans to use Giese's extensive contacts to get its foot in the door, Clarke said.

The recent purchase of Middleburg Financial nearly doubled Access' asset size and significantly increased its lending capacity, opening the door to courting larger clients such as car dealers. The move will also allow Access, best known for lending to government contractors, to diversify.

Middleburg "has given us the scale and flexibility to consider different types of industry exposures," he said.

"There was a lot of good strategic rationale" for the Middleburg acquisition, Joe Gladue, an analyst at Merion Capital Group, said, though he prefers to observe another quarter of results before declaring the deal a success.

Access' move comes as a time when several major banks are stepping back, ceding market share to credit unions and other nonbanks.

The $23 billion-asset TCF Financial in Wayzata, Minn., recently said it would stop originating indirect auto loans. The $19 billion-asset Chemical Financial in Midland, Mich., and the $4.5 billion-asset Fidelity Southern in Atlanta have de-emphasized auto-related lending as sales have leveled off.

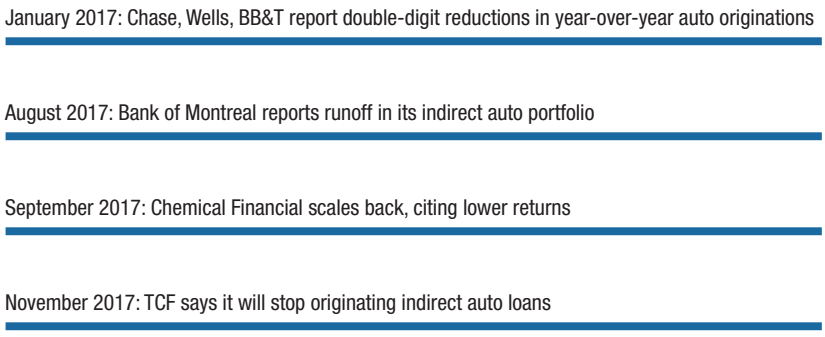
Sales of new cars and light trucks fell about 2% in 2017, to 17.2 million, the first year-over-year decline since 2009, according to Autodata.

Still, it was the third straight year that sales topped 17 million.

Given Access' cautious approach, the initiative doesn't alarm Gladue. "You can't wait until conditions are booming to get into it," he said.

Going against the traffic

Access National is looking into automotive lending at a time when others are stepping back



Source: American Banker

Another Win for Retailers

Merchants have been challenging surcharge bans in numerous states on free-speech grounds; they have the wind at their backs following another court victory

By Kevin Wack

A slew of state laws that bar retailers from imposing surcharges on credit card transactions are poised to be toppled, though the legal process will take some time to unfold.

The latest omen came Jan. 3, when a federal appeals court in California sided with merchants that want to charge higher prices to customers who pay with plastic, since those transactions cost more for retailers to process. They were challenging a 32-year-old state law that banned the cash-register fees.

The California decision built on a U.S. Supreme Court ruling from March 2017 involving a similar law in New York. The nation's highest court found that the New York law regulated speech rather than conduct, casting doubts on its ability to withstand First Amendment scrutiny.

Florida's credit card surcharge ban has already been struck down by the courts, and while similar laws remain in effect in Colorado, Connecticut, Kansas, Maine, Massachusetts, Oklahoma and Texas, the recent court decisions seem likely to spark more legal challenges.

"We're confident that all of these statutes will be wiped out," said Deepak Gupta, the lawyer who spearheaded the court challenges in both New York and California. "And that is the clear trend in the courts now."

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Many of the state prohibitions date back to the 1980s, but they were long considered irrelevant, since card network contracts also banned the surcharges. The state laws became more germane earlier this decade following a legal settlement in which Mastercard and Visa allowed merchants to start levying the fees.

In 2013, there were legislative pushes in 18 additional states to impose credit card surcharges, but they mostly fizzled out in the face of opposition from retailers.

Under California's law, retailers are allowed to offer discounts for cash purchases, but they are barred from imposing a surcharge on credit card purchases. From an economic standpoint, there is no difference between the two. However, research on consumer behavior has found that avoiding a fee is a bigger motivator than receiving a discount.

In the January decision, a three-judge panel of the Ninth Circuit Court of Appeals upheld a district court ruling in favor of an Italian restaurant, a dry-cleaning shop and several other merchants. The opinion does not fully overturn the state law, but it does provide a clear road map for retailers that want to levy surcharges. The state of California could appeal the ruling, but that path looks challenging following last year's Supreme Court ruling.

Chasing Rewards

Credit card use is growing at a faster pace than debit use; in large part this reflects affluent consumers who value rewards like 2% cash back on purchases

By Laura Alix and Kevin Wack

Credit card use has been on the rise for several years, and new data from the Federal Reserve Board shows that the trend is accelerating.

Last year, consumers used credit cards for 37.3 billion transactions, up 10.2% from 2015, according to Fed data released Dec. 21. That compares with 8.1% annual growth between 2012 and 2015.

In contrast, growth in the use of debit cards slowed in 2016. The number of debit card transactions increased 6% last year from the year before, to 73.8 billion, compared with 7.2% growth between 2012 and 2015.

The dollar volume of credit card purchases is growing at a faster clip as well. Total spending on credit cards increased 6.3% in 2016 from the year before, to $3.27 trillion, while the volume of debit card payments rose slightly less at 5.3%, to $2.7 trillion

The accelerated growth in credit card use comes at a time when late payment rates in the industry are rising. In the third quarter of 2017, 2.53% of credit card loans by banks were at least 30 days past due, according to Fed data. That was up from a low of 2.12% in the second quarter of 2015, but still far below the levels hit during the Great Recession.

Brian Riley, director of credit advisory services with Mercator Advisory Group, warned that credit losses in card portfolios may continue to rise.

"A really logical eye has to be on the collection side," he said. "If there's a shift in the economy, if for example, interest rates keep going up, it will start reflecting on household budgets."

To be sure, much of the growth in credit card use is among consumers who pay off their bill in full each month. In the first quarter of 2017, 28.5% of U.S. credit-card holders did not roll over balances, according to the American Bankers Association. That figure was just 19.5% in the third quarter of 2008.

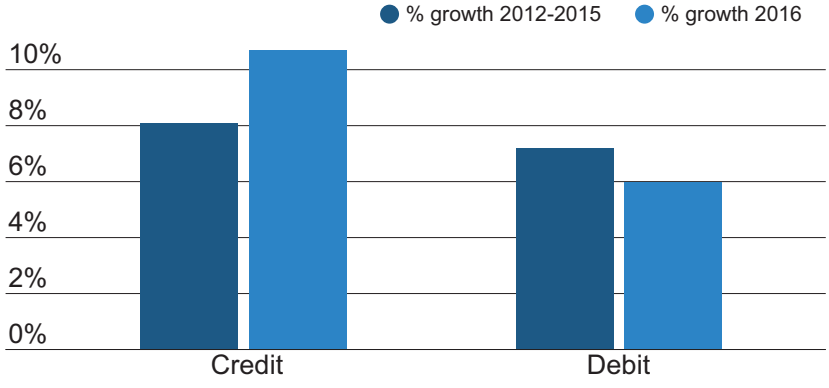
Many consumers are being lured to credit cards by the growing attractiveness of reward offers. With some cards offering as much as 2% cash back on all purchases, shoppers have a strong incentive to pay with their credit cards.

Banks can afford to make these enticing offers because they typically collect higher swipe fees on credit cards than they do on debit cards. Debit card rewards are rare and, when they are offered, less generous.

Riley expects to see U.S. credit card transactions hit another peak this year, even though many banks may tighten their card lending standards, and even as evidence suggests that debt-wary millennials prefer to use debit cards.

Crazy for perks

Credit card usage is growing at a faster clip than debit card usage, according to Fed data. This is likely because credit cards offer better rewards



Source: Federal Reserve

A Tech Edge in Student Loans

ReliaMax is an unusual kind of marketplace lender that says it can help regional and community banks take advantage of business opportunities in private student lending

By Allison Bisbey

Cuts to federally guaranteed student lending programs could create new opportunities for private lenders, and a small insurance company in Sioux Falls, S.D., wants to help community and regional banks get in on the action.

ReliaMax was founded by CEO Michael VanErdewyk in 2006 to acquire Hemar, an underwriter of surety bonds, or triparty insurance contracts, from Sallie Mae (SLM Corp.). It has since expanded into servicing loans, underwriting them and even finding borrowers — marketing itself to institutions that want to acquire a portfolio of private student loans or to start originating them.

"I've got 20 years of data on $12 billion of loans," VanErdewyk said. "After seeing how most of these [loans] performed ... we decided to expand our services, offering our clients origination and servicing about four years ago. It's really made a difference."

This combination of insurance, underwriting and servicing is an unusual twist on the "rent-a-bank" model employed by many marketplace lenders. Typically, marketplace lenders find borrowers and underwrite the loans, send them to a bank to be originated, and almost immediately purchase them. In ReliaMax's case, however, the loans stay on the originating bank's balance sheet — unless the borrower defaults. "When a loan hits 60 days past due, it goes into our default prevention program," VanErdewyk said. "We pay a claim at 180 days." At that point, ReliaMax Surety Co. owns the loan.

To date, the company says it has paid only about $40 million in defaulted claims on the more than $3.5 billion it has insured since 2009.

The regulatory climate has become more favorable for private student lenders and servicers under the Trump administration. And the House is preparing legislation that would curb federally guaranteed lending to graduate students and parents of students, potentially creating a multibillion-dollar opportunity for the private sector.

So far, however, relatively few community and regional banks are involved. Many lack any experience with the asset class, or if they have experience, it was as a lender under the Federal Family Education Loan Program, which ended in 2010.

Yet student loans offer attractive yields. Typically, after servicing and insurance, you can see a net yield of 4%-6% on the average fully insured student loan, VanErdewyk said. "Where else can a bank get that yield?"

It's not uncommon for banks to insure student loans and some other kinds of assets, such as home improvement products, according to Mike Stallmeyer, chief operating officer at LendKey, a company that manages online lending programs for banks and credit unions.

Michael VanErdewyk

"In our experience, some lenders like having insurance on certain assets, when they can get it, the question is, 'is there a provider at an attractive price?'"

Typically, Stallmeyer said, clients will use insurance either because they are new to an asset class or they like the comfort of a third party validating their underwriting box and providing certainty around the risk adjusted returns. Once they get comfortable with asset class and portfolio performance they may decide to self-insure

rather than purchase 3rd party default protection.

ReliaMax works with more than 475 banks, credit unions and alternative lenders. It may be the only insurer of private student loans, but it faces plenty of competition in student loan servicing. This is low-margin business that benefits from economies of scale, and the big players, including Navient (which was spun out of Sallie Mae), Nelnet, and Great Lakes Educational Loan Services, all primarily service federal student loans.

However, ReliaMax's focus on private student loans is a big advantage, VanErdewyk said. "Our platform has things others don't," such as full transparency around co-signers. "The federal government doesn't require borrowers to have a co-signer, but 95% of our [private] loans are co-signed, typically by a parent. We always notify both the borrower and the co-signer of any activity in that account. If the borrower gets behind, the co-signer knows instantly. You can imagine how that can help."

"If someone is servicing private loans on a federal student loan servicing platform, that [ability] doesn't necessarily exist," he said.

The company has built a soon-to-launch mobile app into its servicing platform that allows borrowers to check their balances, change their address, or make a payment — something the Department of Education is only now considering.

While ReliaMax will offer servicing on a stand-alone basis. "We always tell a lender, 'You can make a loan to whomever you want, we will only insure those loans that fit our agreed-upon criteria. If you just want servicing, that's fine'," VanErdewyk said. "But they rarely go that way."

Most lenders also have little experience in borrower acquisition. So ReliaMax has a team that calls on schools, for instance, to get its lender clients on preferred lender lists. It also has its own consumer-facing website, and it works with third-party borrower acquisition sites, like Credible and Lending Tree.

"We know where a lot of loan portfolios are. We insure a bunch of them."

"A lot of banks and credit unions are located in towns where there are major colleges or universities. They have that presence but don't even know how to take advantage of it — or that these preferred lender lists are even out there," VanErdewyk said.

In the case of portfolio trades – loans that have already been underwritten, ReliaMax can assist a buyer by providing insurance on the loans as the trade is completed.

For example, in September, ReliaMax was selected by MetaBank, the federally chartered savings bank of Meta Financial Group, to service and insure a $73 million portfolio of private student loans that it had acquired. And in 2016, MetaBank selected ReliaMax to service and insure a $151 million private student loan portfolio.

ReliaMax has been involved in 12 deals totaling $340 million through its portfolio trade channel, often working with brokers and investment banks to help identify potential buyers. "We know where a lot of loan portfolios are," Van Erdewyk said. "We insure a bunch of them."

The CEO thinks the private sector can lend much more responsibly than the federal government, which offers the same terms to all lenders who meet a needs test, regardless of their credit history, course of study or the school that they attend. Federal lending to graduate students can be particularly problematic, since borrowers can currently obtain loans to cover the full cost of attendance.

"I believe the federal government should be a lender of last resort, not a lender of first resort," VanErdewyk said. "If there are more grants and scholarships, great. If you look at how borrowers get into trouble, it's often with federal loans, not private."

For example, ReliaMax recently paid a claim on a borrower with a total of $100,000 in private student loans, one of which a client acquired through a portfolio trade. When the loan was insured, this borrower was current; six months later, she defaulted, and it turned out that, in addition to the $100,000 in private student loans, she also has over $900,000 in federal student loans.

"In the private sector, that would never happen," VanErdewyk said.

Freddie Debuts Front-End CRT

A group of reinsurers has committed to provide up to $650 million of coverage for credit risk on some $21 billion of mortgages the GSE will acquire over the next two years

By Allison Bisbey

Bloomberg News

Freddie Mac has developed another product that transfers the credit risk on mortgages before they are securitized.

It is an iteration of ACIS (Agency Credit Insurance Structure), a reinsurance contract used to transfer the risk on mortgages that have already been securitized. Like ACIS, the new product, AFRM (ACIS Forward Risk Mitigation), is used to transfer a portion of the risk that would not be transferred through Freddie's flagship product, STACR (Structured Agency Credit Risk).

And like ACIS, the reinsurance covers losses beginning at 50 basis points all the way up to 400 basis points.

This is designed to dovetail with STACR, which are not reinsurance contracts but general obligation bonds whose performance is linked to that of a reference pool of mortgages. Each STACR offering consists of several tranches of notes; Freddie holds on to half of the tranche representing the first-loss position and keeps a small portion of the mezzanine tranches transferring successive losses. The remaining first-loss and mezzanine notes are sold to capital markets investors.

Both ACIS and AFRM are complementary to STACR. The difference is that AFRM transfers this risk as soon as Freddie acquires the loans. Rather than reinsuring an existing pool of loans, the insurers are committing to reinsure a certain amount of loans meeting certain criteria that Freddie will acquire over the next two years.

The first AFRM deal, which was marketed in December, transfers a portion of the credit risk on pools of single-family loans with a combined unpaid principal balance of approximately $21 billion to a diverse panel of reinsurers. The coverage has a maximum limit of approximately $650 million. This covered pool will consist of 30-year fixed-rate loans with loan-to-value ratios between 60% and 97%.

This reinsurance will stay in place for 10 years after the loans are acquired, though the contracts can be called after five years. Eventually, Freddie will reinsure a larger portion of the credit risk on this pool through other credit risk transfer products.

This is only Freddie's third transaction transferring credit risk on loans as soon as they are acquired; in September 2016, it launched a pilot program using private mortgage insurance. However, in that program, insurers only committed to insure loans acquired over the following nine months.

Gina Subramonian Healy, Freddie's vice president of credit risk transfer, called the product "an important milestone" in the expansion of ACIS.

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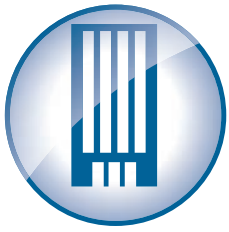

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