Solvas™ for the CLO and leveraged loan market

www.SolvasSoftware.com

Industry leading control

Solvas™ for the CLO and leveraged loan market

Deloitte.

We offer a number of programs for the CLO and leveraged loan market:

Solvas|Portfolio™ is a multi-asset class portfolio administration and reporting solution for asset managers, alternative investment funds, trustees, fund administrators, and agent banks. Already a leading collateralized loan/debt obligation (CLO/CDO) administration solution for the asset management and trustee market for over a decade, Solvas|Portfolio (together, with Solvas|Compliance formerly known as CDO Suite™) has evolved into comprehensive software for the asset management and financial institution community.

Solvas|Compliance™ is a rules-based compliance engine that provides flexible, user-configurable calculations for collateralized loan obligation (CLO) collateral managers/trustees, alternative investment managers, and fund administrators. The system provides collateral managers and trustees the ability to model deals without programming and robust compliance test and hypothetical trade scenario analysis capabilities. Alternative investment managers and fund administrators can also utilize this compliance engine for calculating credit agreement covenants.

Solvas|PoP™ is a rules-based priority of payments module that provides flexible, user-configurable priority of payments calculations for CLO collateral managers/trustees, alternative asset managers, and fund administrators. Solvas|PoP provides the capability to design priority of payments as a complement to the Solvas|Portfolio and Solvas|Compliance collateral administration and compliance functionality.

Solvas|Level Yield™ is a calculation module for use with Solvas|Portfolio to help support level yield calculations related to FASB ASC 310-20 (formerly FAS 91). Solvas|Level Yield brings a flexible and user-friendly level yield calculation technology to CLO collateral managers/trustees, alternative asset managers, and fund administrators.

Solvas|Performance™ provides performance reporting capabilities as a complement to the Solvas|Portfolio collateral administration system. Constructed to seamlessly integrate with Solvas|Portfolio, Solvas|Performance offers interactive, cross-portfolio, and multicurrency performance reporting for collateral managers, trustees, and alternative investment managers.

Solvas|Agent™ is an administration and reporting system to support the activities of loan administrative agents. Solvas|Agent provides the ability to create agent reports and notices from loan administrative activity tracked in Solvas|Portfolio. The extensive loan administration support of Solvas|Portfolio coupled with Solvas|Agent brings modern technology to the operations of loan administrative agents.

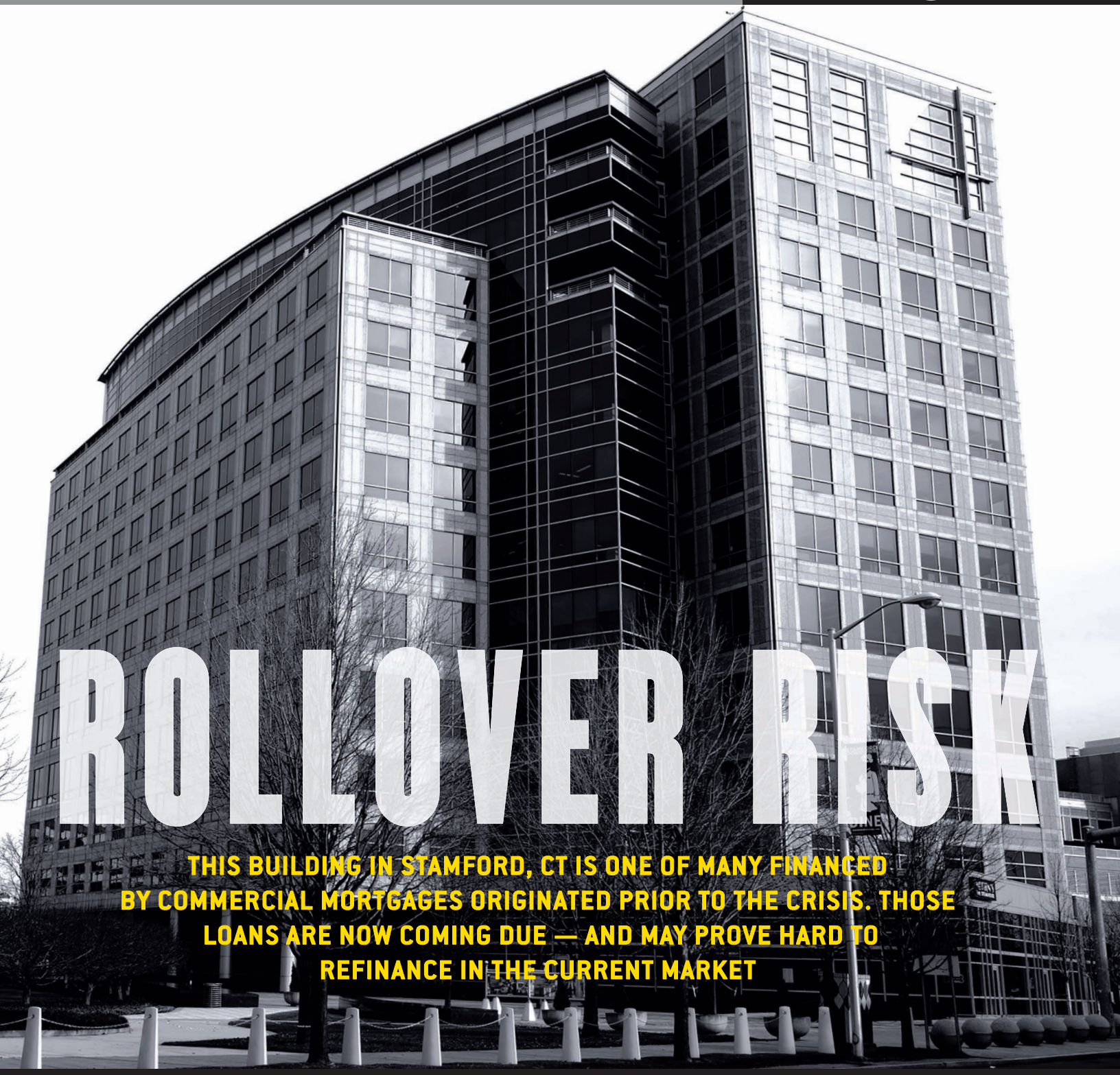
Solvas|Accounting™ is a dynamic and flexible financial accounting and reporting software package designed for investment managers and fund administrators. Solvas|Accounting can generate financial reports for portfolios of financial instruments. The system supports unlimited reporting entity configurations, provides multi-currency support, and allows for various accounting methodologies.

If you would like to test drive one of our products, please visit **www.SolvasSoftware.com** or email **FinancialTechnology@deloitte.com**

October 2016
Volume 16, Number 7

Asset securitization REPORT

The Premier Guide to Asset and Mortgage-Backed Securitization



ROLLOVER RISK

THIS BUILDING IN STAMFORD, CT IS ONE OF MANY FINANCED BY COMMERCIAL MORTGAGES ORIGINATED PRIOR TO THE CRISIS. THOSE LOANS ARE NOW COMING DUE — AND MAY PROVE HARD TO REFINANCE IN THE CURRENT MARKET

CONTENTS

Asset Securitization REPORT

The Premier Guide to Asset and Mortgage-Backed Securitization

One State Street Plaza, 27th Floor, New York, NY 10004

Editorial
Editorial Director: Allison Bisbey
allison.bisbey@sourcemedia.com; 212.803.8271

Senior Editor: Glen Fest
glen.fest@sourcemedia.com; 817.708.2470

Associate Art Director: Neesha Haughton
neesha.haughton@sourcemedia.com; 212.803.8815

Contributors
Andy Peters, Bryan Yurcan

Group Editorial Director, Banking & Capital Markets
Richard Melville
richard.melville@sourcemedia.com; 212.803.8679

VP, Content Operations and Creative Services: Paul Vogel
paul.vogel@sourcemedia.com; 212.803.8832

Director of Creative Operations: Michael Chu
michael.chu@sourcemedia.com; 212.803.8313

Director of Content Operations: Theresa Hambel
theresa.hambel@sourcemedia.com; 212-803-8245

Publishing
VP Capital Markets Division: Harry Nikpour
212.803.8638

Vice President of Sales, Banking & Payments: Dennis Strong
212.803.8372

Associate Publisher: Louis Fugazy
212.803.8773

Marketing
Marketing Director: Jeannie Nguyen
212.803.8324

Marketing Manager: Raquel J. Lucas
212.803.8322

SourceMedia™

Chief Executive Officer: Douglas J. Manoni

Chief Financial Officer: Michael P. Caruso

Chief Revenue Officer: Marianne Collins

EVP and Chief Content Officer: David Longobardi

Chief Marketing and Digital Officer: Minna Rhee

SVP, Conferences: John DelMauro

SVP, Human Resources: Ying Wong

Subscription Information
help@sourcemedia.com
212.803.8500
Bulk subscription US/Canada $2,995
Annual Rate (8 issues) International $2,995

Asset Securitization Report - (ISSN # 1547-3422) Vol. 16, No. 7, is published 8 times a year by SourceMedia, One State Street Plaza, 27th Floor, New York, NY 10004. Postmaster: Send address changes to Asset Securitization Report, SourceMedia, P.O. Box 47069, Minneapolis, MN 55447.

Moving On

Steve Eisman, the money manager who profited from the mortgage meltdown, thinks the financial system is safer under Dodd-Frank and has no sympathy for securitization pros grappling with the financial regulation.

But moving on, as he recommended in his keynote speech at IMN's ABS East conference, is easier said than done. The aftermath of the financial crisis continues to weigh heavily on the industry. The commercial mortgage market is grappling with a large volume of loans taken out at the height of the real estate boom that must now be refinanced. While the worst loans went bad early, other were modified, putting off the day of reckoning. As Glen Fest and I explain in the cover story, this poorly underwritten debt is coming due at an inopportune time. Conduit lenders are still coming to grips with risk retention, and several have exited the market.

CLO managers got a much earlier start tackling risk retention, but this sector is not quite prepared either, judging by comments made at the conference. While they have adopted a number of strategies to fund the economic risk that they must hold in their deals, there are still reporting requirements to contend with. Meanwhile, managers of deals just coming out of their non-callable periods are rushing to reset rates before risk retention rules take effect.

An Observation by Christopher Whalen, head of research at Kroll Bond Rating Agency, looks at the impact that various kinds of regulation have had on mortgage servicing rights. They are becoming unattractive not just for banks, but for some smaller non-bank servicers, which have little access to funding them. Not everyone is heading for the exits, however. An article by Andy Peters at sister publication American Banker looks at some regional banks that are bucking the trend and stockpiling MSRs. And unlike non-bank servicers, they don't need to access the securitization market.

Regional banks are also eying the private student loan market, which is largely dominated by Sallie Mae, a frequent securitizer, followed by Wells Fargo and Discover, which keep their loans on balance sheet. An article by American Banker's Bryan Yurcan explains how tech is giving these firms a leg up.

—Allison Bisbey, *Editorial Director*

Silent Crisis in Housing Finance

It's shaping up to be solid year in the U.S. housing sector. New mortgage originations are up over last year's total of $1.6 trillion in new credit. Furthermore, default rates are continuing to fall on one- to four-family mortgages, mirroring the generally benign credit environment across the banking industry's $9 trillion in total loans.

But beneath this calm surface, the U.S. mortgage industry is facing a crisis. Kroll Bond Rating Agency outlined some of the issues regarding liquidity and profitability in a recent report. The basic problem, however, comes down to over-regulation.

In the wake of the 2008 financial crisis and the passage of the Dodd-Frank law two years later, the composition of the market for making and servicing residential mortgage loans has changed dramatically: the costs for servicers are rising and smaller nonbanks are replacing a dwindling population of bank lenders.

BY CHRISTOPHER WHALEN

With the creation of the Consumer Financial Protection Bureau, the cost of servicing mortgage loans in the U.S. has dramatically risen. Prior to the crisis, servicing a defaulted mortgage cost less than $500 annually. Today, under the harsh regulatory regime put in place by the CFPB, the cost is closer to $2,500 — and that estimate does not include the extensive delays in foreclosure timelines now built into current state and federal laws. Sure, servicing performing loans is less costly; however, profit margins have also been squeezed so that investors in these businesses are lucky to see single-digit equity returns.

Adding to the mortgage market's predicament is the exit of banks from the single-family mortgage business in favor of multifamily and commercial assets that are not subject to the CFPB mortgage rules. The reasons for the steady exodus of banks from the residential mortgage space are many, but Basel III and U.S. prudential regulations are chief among them. U.S. regulation today is antithetical to mortgage finance generally and imposes restrictions and penalties on this important asset that go against the traditional American view of home ownership as a societal benefit.

As commercial banks migrate away from mortgage lending, the nonbanks that are taking their place have smaller balance sheets and lack an ability to retain the cash balances that once made mortgage servicing an attractive business for bank lenders. Indeed, nonbanks miss roughly half of the potential revenue from a residential mortgage loan because they cannot retain the cash balances. The nonbank must give this cash business to a depository and then borrow the money back with a haircut. This makes it extremely tough to achieve profitability overall.

Many publicly traded mortgage firms are not particularly profitable, and as a result, trade at deep discounts to book value, effectively cutting them off from equity market funding.

Continued writedowns of MSRs, in part due to the application of fair value accounting, have significantly diminished investor confidence in mortgage investments and have limited capital market access for a number of nonbank mortgage companies. The same factors have pushed up the cost of debt financing for short-term needs such as warehouse lines and default advances (provided by banks, of course), and have made it impractical for nonbanks to raise term debt financing even in the high-yield market.

Given the sharp increase in the cost of making and servicing residential mortgage loans, the top four U.S. banks are slowly exiting the government and conforming loan markets.

The U.S. faces the prospect of having the market for government-guaranteed and conforming loans largely in the hands of smaller, less-capitalized nonbanks at a time when depositories are restricting lending to good customers.

In the near term, we face the risk of a substantial number of smaller nonbank mortgage lenders and servicers exiting the housing market, either voluntarily or via bankruptcy. In the event of a default of a nonbank mortgage servicer, it seems pretty clear that it will be very difficult to find buyers for these businesses — much less raise new capital and provide the indemnification required to operate in the agency markets. Secured bank lenders will liquidate the collateral held against credit lines. The unsecured creditors may simply walk away, leaving the CFPB and other regulators to figure out who will service these unprofitable loan portfolios.

In the medium term, it is pretty clear that mortgage servicing fees are going to need to rise by about 100% in order to help mortgage servicers make up some of the profitability lost since 2010.

If we, as Americans, want a healthy mortgage industry that is compliant with the law and able to meet the needs of consumers, then we must adjust the economics of this heavily regulated business to allow investors to meet their cost of capital. Otherwise, nobody will want to be in this business. And as mortgage servicing fees rise — and they will — it will be the consumer who must pay the freight for the various benefits of regulation under Dodd-Frank.

Christopher Whalen is senior managing director and head of research at Kroll Bond Rating Agency.

Big Banks Shouldn't Inherit Our Housing Finance System

Eight years after high-risk, deceptive lending practices precipitated a near-meltdown of the global economy, we learned that at least 5,300 Wells Fargo employees created 2 million sham accounts that its customers apparently did not want, need or understand. Those unwitting Wells customers paid at least $1.5 million in fees.

But if only the bad-news stories about big banks ended there, and if only policymakers weren't threatening to help big banks boost their profits even more. Observers should take note of recent proposals to revamp the housing finance system into a more bank-centric model, which could benefit the largest institutions to the detriment of other mortgage market participants.

The Wells scandal came on the heels of Bank of America's agreement in June to pay $430 million for misusing customers' cash. About a week after the Wells story broke, it was also reported that the Department of Justice was seeking $14 billion from Deutsche Bank to settle claims about the bank's sale of mortgage-backed security. In the meantime, Deutsche Bank is also mired in a scandal involving $10 billion of suspicious trades out of its Russian unit that resemble money-laundering.

How can this still be happening? In the eight years since the financial crisis, there have been dozens of congressional hearings, thousands of news stories, a host of best-selling books and a blue-ribbon commission promised to help us understand what went wrong and how to prevent a recurrence. The Dodd-Frank Act was heralded as a means of "constrain[ing] the growth of the largest financial firms" and ensuring that the "irresponsible lending" that led to the financial crisis "never happens again." But since then, the nation's "too big to fail" banks have only gotten bigger, and, as this newest Wells Fargo episode demonstrates, old habits die hard.

In fact, since President Obama signed the deeply flawed Dodd-Frank in 2010, the banks regarded as too big have grown by 30%. The six largest banks now control assets of approximately $10 trillion, equal to almost 60% of our country's GDP (compared with 17% in 1995).

Now, against this backdrop of stratospheric growth, the big banks could be closer to having more control over America's colossal mortgage markets and their traditional stewards: Fannie Mae and Freddie Mac. Like every major American financial firm, private mortgage companies Fannie and Freddie faced acute financial distress during the crisis of 2007-8. Although the two companies were never deemed insolvent, Congress injected billions into the two private companies and placed them into a conservatorship under the supervision of the Federal Housing Finance Agency.

The Wells scandal should be a wakeup call to policymakers working on housing finance reform.

Already the largest nonagency player in mortgage origination, Wells Fargo spent more than $20 million lobbying Congress on housing finance issues since 2013. Wells Fargo was a proponent of failed legislation written by Sens. Tim Johnson and Mike Crapo, who followed a model favored by Sens. Bob Corker and Mark Warner, which would have replaced mortgage giants Fannie and Freddie with a more bank-centric model. And more recently, Wells has been advocating for the FHFA's implementation of the Common Securitization Platform, which would allow big banks to sell "agency" mortgage-backed securities.

Some applaud such a move because they view Fannie and Freddie as emblematic of big government cronyism. Others say the two mortgage giants have been historically successful in assisting millions of people in securing homes over three generations, and they should be reformed and recapitalized rather than eliminated. Regardless, no one has come up with an acceptable alternative to Fannie and Freddie for keeping the nation's mortgage market liquid and stable enough so that qualified buyers can obtain loans to buy homes.

To date, Fannie and Freddie have repaid the full $187 billion advanced to them by the Treasury Department plus

BY LOGAN BEIRNE

another $60 billion in dividend payments. Compare that with the over $200 billion the big banks have paid to the Treasury as penalties and fines for their misconduct. Despite these facts, Wells Fargo and peer banks are pushing for the government to line their pockets with the mortgage companies' revenue streams — rather than permit Fannie and Freddie to retain earnings and rebuild their capital base in order protect taxpayers against future bailouts.

Wells Fargo and other big banks are now lobbying Washington to hand over Fannie and Freddie's business to them. If recent history is any indication, that would be a disastrous mistake.

Logan Beirne is an Information Society Project fellow and lecturer at Yale Law School. He is also the chief executive of Matterhorn Transactions Inc., a legal information services company.

ROLLOVER RISK

THIS BUILDING IN STAMFORD, CT IS ONE OF MANY FINANCED BY COMMERCIAL MORTGAGES ORIGINATED PRIOR TO THE CRISIS. THOSE LOANS ARE NOW COMING DUE — AND MAY PROVE HARD TO REFINANCE IN THE CURRENT MARKET

by Glen Fest and Allison Bisbey

When the commercial real estate market crashed late in 2007, the worst loans went bad early.

Since then, property values have largely recovered and underwriting has loosened, putting many borrowers in a better position to refinance when their loans came due.

Other borrowers are treading water; they continue making payments, but their property values haven't fully recovered, and they have not paid down much principal or boosted cash flows.

Their day of reckoning is fast approaching.

The sheer volume of loans maturing this year and next - $232.4 billion, according to analytics provider Trepp – leaves some borrowers scrambling for funds to refinance their loans, which repay most of their principal in a final "balloon" payment.

By comparison, $70 billion of CMBS loans matured in 2015 and just $37 billion in 2014.

This debit is also coming due at a particularly bad time, as lenders who underwrite loans to be

securitization conduits are grappling with new regulatory requirements to hold on to the economic risk in their deals. Several conduit lenders have exited the market this year. Underwriting is also tightening again, as lenders rein in the most questionable practices (such as underwriting to projected, as opposed to current, income).

Analysts at JP Morgan estimate that net issuance of commercial mortgage bonds was negative $57 billion in the first nine months of the year. Some of the underlying loans that came due were refinanced by other kinds of lenders, such as commercial banks or insurance companies.

Others are in default, or headed there. In September, 4.78% of commercial mortgages in CMBS were behind on payments, an increase of 10 basis points from August, according to Trepp.

The September jump represents the sixth time in the last seven months that the rate has increased, after hitting a post-crisis low in February of 4.15%.

The majority of troubled loans were taken out in 2006 and 2007, just before the real estate bubble burst, when property values and investor confidence were both high. "The underwriting was a little shoddy, to say the least," said Steve Kuritz, a managing director at Kroll Bond Rating Agency.

Many are suburban office buildings, which are losing big tenants as large corporations relocate to central business districts.

In April, a $165.5 million loan backing the former headquarters of CA Technologies in Islandia, N.Y., was shifted to a special servicer that handles troubled commercial mortgages on behalf of bondholders. Though CA Technologies continued making contractual lease payments after vacating the building in 2014, it appeared unlikely that the owner would be able to refinance and make the final balloon payment in August. So the loan, part of the collateral for the $4.24 billion Goldman Sachs Mortgage Securities 2006-GG8, is designated an "imminent monetary default" by Trepp. (In late August, CA agreed to a sale-leaseback agreement to new private-equity investors headed by CRIC Capital and Prudential Real Estate Investors).

Also of concern is a $265 million loan secured by an office tower in Stamford, Conn., that formerly housed part of UBS' wealth management business. The property, 400 Atlantic Street, is 73% occupied and the loan is still current, but it seems like an unlikely candidate for refinancing when it matures in 2017 because it is so far underwater. The property has a loan-to-value ratio of 198.19%. The loan makes up 5.39% of another Goldman deal, the $7.56 billion GS Mortgage Securities Trust 2007-GG10.

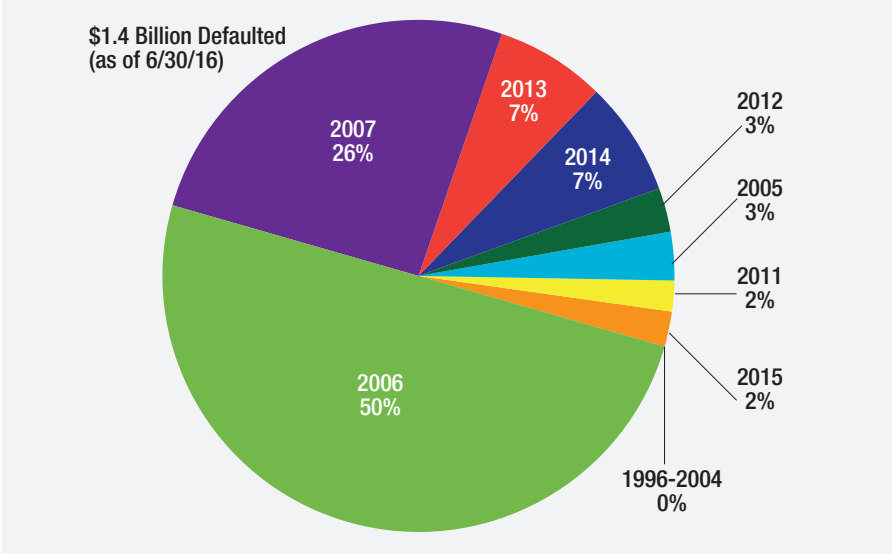
UBS's departure from another Stamford building, 677 Washington Street, is responsible for putting a $165 million loan in special servicing in January. The borrower, CWCapital Management, is reportedly seeking a workout for the 700,000 square-foot building. The building's loan-to-value ratio is more than five times, and the debt-service-coverage ratio is covered by UBS lease payments that are to continue through the end of 2017.

The loan was securitized by the former Lehman Brothers and UBS in a deal dubbed LBUBS 2004-C1.

All told, 37% of CMBS loans backed by office properties that mature over the next two years are poor candidates for refinancing, according to KBRA, because they have LTVs of 85 or greater, as

BAD APPLES

LOANS TAKEN OUT BEFORE THE FINANCIAL CRISIS ACCOUNT FOR THE MAJORITY OF DEFAULTS ON COLLATERAL FOR MORTGAGE BONDS THIS YEAR



SOURCE: FITCH RATINGS

calculated by the rating agency.

Regional malls are also vulnerable to tenant turnover; many have lost anchor tenants as retailers succumb to competition from e-commerce. KBRA has weak refinancing outlooks on 27% of loans backed by retail properties. Kuritz said that regional malls, in particular, "scare" CMBS investors.

Even a strong, iconic mall backed by a national owner can run into trouble, however.

Philadelphia Mills (formerly Franklin Mills), a mall owned by Simon Property Group with in excess of 1.18 million square feet, has been in special servicing since 2012. The loan was modified, splitting it into two separate notes. The senior, $112.9 million A note is listed by Trepp as an imminent maturity default though it is current, 91% occupied and has a debt-service-coverage ratio of 168%. It has an LTV of over 144%.

Struggling malls pose outsize risks to mortgage bond investors because the loss severities can so high. The liquidated loans on 30 malls that have gone under since 2008 lost 75% of their principal on average, according to Moody's Investors Service.

That's almost twice as severe as the 45% average for all CMBS loans liquidated over the same period.

"Very few of the top tenants in malls 20 years ago are still strong performers – or even still in business – today," the rating agency stated in an August report.

To be sure, the majority of CMBS loans coming due this year are well positioned to be refinanced. More than 80% have a debt-service coverage ratio above 140%. And at today's rates, interest payments would be much lower than at the 6% coupons prevalent in 2006 and 2007.

But there's no mistaking that both the outstanding 2006 and 2007 vintage loans are of lesser credit quality than CMBS loans made today, according to Mark Gallagher, a senior strategist with CBRE. "A lot of these were full-term, interest-only loans" that did not amortize, he said. Many were underwritten with "fairly aggressive pro forma assumptions" about future rents that did not materialize.

Gallagher said that CBRE has grown "quite a bit more pessimistic" in the ability to refinance 2007 CMBS vintage loans, in particular. "In our study, we came up with a figure of 29% of [deals maturing in 2017] that could face some sort of challenge to refinancing."

Loans that ran into trouble immediately after the credit crisis were often modified because, at the time, there was little appetite among real estate investors for distressed properties. Typically, a loan was split into two notes, an A note that the borrower could repay under existing cash flows, and a subordinate B note with a deferred payment. (These B notes were often called "hope notes;" investors hoped that they could avoid a loss on the notes if the property's value or tenant revenue eventually increased.)

More recently, rising property values have made it easier to liquidate troubled loans. This allows mortgage bondholders to recover at least some of the principal right away.

A property that goes through what is known as a "discounted payoff," or principal reduction, may be difficult to refinance in the conduit market. "It's tainted," said Ilan Bensoussan, sector specialist and trader at Semper Capital Management.

A property that goes through what's known as a discounted payoff is "tainted" and may be difficult to refinance in the conduit market. The borrower may need a bridge loan.

Instead, the borrower needs to get a bridge loan, which typically has one- to three-year tenor and can be securitized in commercial real estate collateralized loan obligation (CRE-CLO).

"Some [bridge lenders] will finance at 50, 60 or 70 LTV … the borrower makes payments for 6-12 months, and then refinances the loan into a conduit," Bensoussan said.

He thinks that the CRE-CLO market poised to grow in the next year, in part because of the number of 2007 vintage loans coming due and in part because this market is well prepared to comply with risk retention. CRE CLO issuers retain as much as 30-35% of the risk in a deal, so the impending requirement to hold 5% isn't a problem.

"Shut Up and Move On," Eisman Tells Securitization Pros

What does Steve Eisman have to say to the industry whose blunders made him rich?

"You f------ blew up planet earth. Shut up and move on."

Eisman, the money manager who foresaw, and profited from, the collapse of the subprime mortgage market, hadn't attended a securitization conference since 2007, as portrayed in the movie, The Big Short. But Information Management Network, the organizer of an annual confab in Miami, clearly recognizes a good draw. It invited him to give the keynote speech.

"It feels like Daniel in the lion's den," he quipped.

Then he apologized in advance for offending his audience, and launched into an explanation of the mortgage crisis and an assessment of the current state of the economy and financial system, or "why things still suck."

Bloomberg News

Steve Eisman

Bottom line, we don't have the three prerequisites for a full-blown crisis: too much leverage, a big asset class that blows up, and a lot of banks holding this asset class.

By that measure, neither subprime auto loans nor student loans are going to be the next mortgage crisis.

Eisman seems more concerned about Europe, where banks are still much more highly leveraged than in the U.S., and where regulators in peripheral countries like Italy, Spain and Portugal have been slow to force them to recognize losses.

He's actually pretty pleased with U.S. financial regulations enacted since the financial crisis, particularly given how critical he was of regulators' performance in the past.

"Prior to Dodd-Frank, the bank regulators had two tasks: Protecting the safety and soundness of the banking system, and protecting consumers from bad actors in the financial services industry," he noted. "They did as bad a job as anybody could do anything in the history of planet earth."

Dodd-Frank split these two roles, creating the Consumer Finance Protection Bureau and giving the Federal Reserve primary responsibility for the banking system.

"The CFPB has done a great job, in my opinion," Eisman said. "Wall Street doesn't like it … but I really couldn't care less."

The money manager said he did not expect the Fed to be very effective "but I'm happy to say they've proven me wrong." He noted that Citibank's leverage ratio has declined to 10 to 1 from 35 to 1 before the financial crisis "which is like the distance between Mercury and Pluto."

Eisman's most cutting remarks, and his biggest laughs, came at the expense of audience members who asked if regulation gone too far. One person complained that regulation was being applied not just to mortgages but to securitization of all kinds of assets that performed well during the financial crisis. That's when he told the audience to shut up and move on, adding, "Who gives a s--- if it's fair."

Eisman is no fan of the quantitative easing, which he described as "monetary policy for rich people." The money man said that central banks "use QE to go out the risk curve, so people invest in the stock market, but it does not impact the economy. Most people do not invest in the stock market, they invest in banks [they are saving more] and banks don't pay interest on their money."

From a corporate perspective, GDP is lower than pre-crisis, if you buy back stock you get a return on your investment that's fairly certain, or build a new factory, where the return is uncertain. In a zero interest rate environment, you'll choose the more certain reward. Very low interest rates have a negative signaling effect. A lot of people think something has to be wrong.

Eisman is not a big believer in marketplace lending, either. "Silicon Valley is clueless," he said. "If you buy a book on Amazon, that's the end of the relationship." Whereas, if you make a mortgage, "that's the beginning of the transaction." And there are only two business models. "The first is to originate the loan and hold it, which means you're a bank. That's a low margin business. The second is to originate a loan and sell it, and who are they going to sell it to? You [Wall Street]. And you are fickle."

So what did it feel like to prove everybody wrong?

"In 2007, I'm so happy I can't stand it. But in 2008, it was planet earth [in trouble]. I told someone I felt like Noah … do you think Noah was happy?"

Asked to name the next big short, Eisman initially declined. "I'm not in such a rush to do it again," he said. "It took years off my life."

Then he relented, saying, "The only big short out there is when the world loses confidence in QE." But he did not offer any ideas on how to profit. — *AB*

Another Court Case Clouds Marketplace Lending

Madden v. Midland Funding isn't the only recent legal case that raises questions about the "rent a bank" business model employed by many marketplace lenders.

On Aug. 31, the U.S. District Court for the Central District of California ruled that CashCall was the true lender onb loans issued by Western Sky Financial, a type of tribal lender. The court sided with the Consumer Financial Protection Bureau, which charged that Western Sky Financial's loans violated usury laws in 16 states – and that its partnership with a tribal banking institution in South Dakota did not provide CashCall with federal pre-emption over state statutes.

This does not bode well for online lenders such as Lending Club that rely on third parties to underwrite loans that they then purchase, rather than take out banking licenses in a patchwork of individual states. Without federal pre-emption, they too could be subject to a patchwork of individual state laws – and their loans uncollectable, according to participants at IMN's ABS East conference.

Richard Nieman, head of regulatory affairs at Lending Club, thinks that such comparisons are a stretch, however. At a panel on marketplace lending, he dismissed comparisons to CashCall's business model as not one of apples to oranges, but "oranges to orangutans."

While CashCall charging predatory APRs of 300% for loans through a questionable arrangement with a tribal lender, Lending Club and its partner bank cap APRs at 36% for borrowers who are primarily using the funds to finance out of high cost credit card debt.

"This is an example where courts are going to use whatever the facts are to get at those irresponsible lenders," Nieman said.

The Madden V Midland case, which was similarly unsettling to marketplace lenders, nearly made it the Supreme Court, but justices declined to hear the case this summer, While many participants felt this left the industry in the lurch, the outcome could have been even worse, "it avoided an even worse outcome," according to Alan Birnbaum, an analyst with Moody's Investors Service. — *GF*

Investor Base for Credit Risk Transfer Keeps Growing

Of all the new asset classes offering exposure to the U.S. housing market, credit risk transfer notes may have developed the biggest following.

In fact, the expanding investor base for Connecticut Avenue Securities and Structured Agency Credit Risk notes creates a kind of virtuous circle: As trading volume increases, banks are dedicating traders to the asset class.

And this, in turn, helps attract additional investors.

Credit risk transfer notes are the primary way that Fannie Mae (CAS) and Freddie Mac (STACR) get taxpayers off the hook for residential mortgages that they insure. The notes are general obligations, but their performance is linked to the timely payments of a pool of securitized loans.

Over 150 institutional investors have participated in the two programs to date; throw in some smaller reinsurance products offered by the two companies and there are 200 unique investors. "We've doubled the number of investors over the last 24 months, and we'll probably double it again over the next 28 months," said Kevin Palmer, senior vice president for credit risk transfer at Freddie Mac.

"There's a lot more capacity to take on credit risk transfer, even ouside of the capital markets," at insurance companies," he said.

There is now some $30 billion of CAS and STACR outstanding and monthly trading volume has quadrupled to $2.8 billion from $700 million, according to Andy Davidson, president of Andrew Davidson & Co.

While there's talk of liquidity struggles, "It's important to remember, we're not talking about triple-A pass throughs or something wrapped," said Casey Neilson, a director at Wells Fargo Securities. "It's leveraged mortgage credit risk."

Neison said typical trading lots are $3 million to $5 million for last cash flow tranches of deals. "But when you see the opportunity to trade $10million to $30 million, it's going to trade better." — *AB*

Stay Tuned for More Handset Securitization

For investors who were intrigued by Verizon's first-ever handset securitization offering in July, one of the deal's underwriters has a message: Stay tuned.

"We are bullish," said Eric Shea, an executive director with Mitsubishi UFJ Securities said on a handset panel at IMN's ABS East conference. "We do expect to see more issuance in the sector and expect to see it across more than one carrier."

Joseph Lau, managing director at RBC, echoed that sentiment. "While we haven't seen a lot [of issuance] to date, certainly we do anticipate there's going to be a lot of continued buzz," he said.

Shea estimates that Verizon, AT&T, T-Mobile and Sprint could collectively issue $15 billion to $20 billion of securities a year backed by financing for mobile phones and tablets.

By comparison, credit card companies tap the securitization market for some $30 billion a year, while issuance of bonds backed by auto loans and leases totals some $50 billion a year.

So far, though, Sprint is the only other carrier to announce plans to tap the securitization market.

Panelists also discussed the challenges in structuring and rating the new asset class. For instance, Raffi Dawson, a managing director at Mizuho Americas, said the bank had to cobble together cell-phone service receivables data dating back to 2007 to measure indicators of strong customer account performance that would likely translate to the new business model. The bank found a strong performance correlation between satisfactory accounts and the length of time a customer has been with a carrier.

Panelists said the receivables backing Verizon's deal had similar structures to auto and credit card deals, which consumers typically prioritize because of the potential for repossession or suspension of charging privileges. For phones, the carrot (or stick) is the loss of service for a delinquent bill – and the fact the device loan is due and payable should a customer fail to fulfill a leasing period agreement.

That assured Deutsche Bank as the trustee for the deal, said Eileen Hughes, a director at Deutsche. This allowed the bank to accept the deal without a backup servicer, normally a must-have in a consumer credit securitization – a decision also aided by Verizon's investment-grade rating.

Verizon had to provide a high level of credit enhancement (36%), a reflection both of the lack of performance history for the asset class and the fact that the pool of receivables is revolving, giving Verizon the ability to add new leases. — *GF*

Investors "Picking Over Rocks" for Risk Adjusted Returns

Some big investors are keeping their powder dry; in the event that an exogenous event roils the financial markets, they want to be able to take advantage of any bargains in asset-backeds.

In the meantime, it's tough to find assets that produce decent returns that don't have excessive risk.

Despite a narrowing lead for Democratic candidate Hillary Clinton in the November presidential election, 69% of audience members polled at an investor panel cited the health of the U.S. economy as the biggest risk to the structured finance market. New regulations came in second, with 18% of the vote; just 13% cited the outcome of the presidential election as the top concern.

Aegon USA Investment Management,concerned about the election. With the outcome "a coin flip," the insurer is positioned fairly conservatively, according to James Baskin, head of U.S. Structured Finance. "We have room to add in an adverse outcome," he said, without specifying what that outcome would be. "We've made room via paydowns, inflows," he said. "It's difficult, given our fundamental view of structured products - they're still cheap - to proactively sell.

TIAA-CREF also struggles to put new money to work profitably in high-quality asset-backeds. "Despite the spread compression we have seen over the last month or two, we continue to see inflows in the funds we manage," said ABS portfolio

manager Aashh Parekh. He said the firm does look at riskier asset-backeds, "but with exogenous events looming, it becomes a challenge" to move further down in credit.

So what assets do the panelists like?

TIAA-CREF and Loomis Sayles are enthusiastic about cell phone securitization, though they wish Verizon's inaugural deal paid a higher risk premium. "It seems like good collateral, and there are some pretty good mitigants to the risk of credit performance," Parekh said.

Alessandro Pagani, Loomis Sayles' head of securitized assets, takes some comfort from data showing that consumers see paying their cell phone as a high priority, even if the debt is unsecured. "Ask your kids, would you eat" [or use your cell phone]?

Pagani also plans to take another look at bonds backed by federally guaranteed student loans now that rating agencies are concluding their reviews of a broad swathe of these securities.

New York Life Investment Management is keen on aircraft finance "because we like the big ticket size, and there's still some spread," said managing director Scott Seewald. Aside from that the insurer is not fixated on any particular asset class. "It's lot of picking over the rocks, picking over the seashells," Sewell said. — *AB*

Plenty of Liquidity in Single Family Rentals

Early fears that Wall Street landlords might have trouble refinancing their holdings of large portfolios of single family rental homes have proven unfounded.

The loans backing the first few rental property securitizations to mature were extended, prompting concerns that the bulk of deals in the sector might ultimately come due at the same time, crowding each other out. But over the past few months, one sponsor, Progress Residential, refinanced a deal, and another, Colony American Finance, paid one down, opting to keep the underlying mortgages on balance sheet.

Jonathan Ezrow, chief financial officer of Pretium Partners, says that growing interest in this asset class guarantees that there will be multiple exit strategies for investors, including accessing the public markets through an initial public offering or merger.

"I always say we can sell our portfolio the way we bought it, one house at time," said Jonathan Ezrow, chief financial officer of Pretium Partners, which manages Progress. "It's not plan A, but we can do it."

Ezrow, who was speaking on a panel at IMN's ABS East conference in Miami, expects the single family rental sector to attract more and more institutional investors over the next five to 10 years.

The number of single family rental houses, relative to size of the overall U.S. housing market. is very small. "We're going to see more private institutional investors in this asset class over the next five to 10 years.

Progress was founded in 2013 by former Goldman Sachs partner Donald Mullen Jr and Curt Schade, a veteran of Bear Stearns. Other big investors in the asset class include Cerberus Capital Management, Blackstone Group, and Colony Capital. Ezrow thinks that the potential investor base is much larger.

"How many real estate investors have exposure to offices?," he asked rhetorically. "How many have exposure to multifamily? And how many exposure to single family rental? Very few."

"It's a $20 trillion, income-producing asset class. Why wouldn't most real estate investors want an allocation? If an asset is operating well, and generating economic value, there are usually a lot of ways to exit."

Liquidity has also increased for smaller players. Colony American Finance lends to landlords with a portfolios as small as one or two rental properties. Initially, all of the loans it made were used to refinanced existing loans or take equity out of existing holdings. But Beth O'Brien, president and CEO, said that Colony is now seeing a "health amount" of acquisition activity, as well. Perhaps 25% of the firm's stabilized portfolio of loans were used to acquire new properties.

"It's people who are already in the market who see they can expand their portfolios because financing is available," she said.

Neither panelists sees slowing home price appreciation as an impediment.

"We don'tneed home price appreciation to be profitable," Ezrow said, noting that Prospect can operate its business more efficiently than it could a few years ago, driving down costs.

"Our borrowers have never been focused on home price appreication," O'Brien said. "They've always been in the business for yield. I don't know what else there is at this attractive a yield for somone that size." — *AB*

Fannie, Freddie Helping Older Apartment Buildings Go Green

Fannie Mae and Freddie Mac want to make it easier for owners of older apartment buildings to make energy efficient upgrades.

Both government sponsored enterprises discount the interest rates on loans for buildings with one of several "green" certifications, such as LEED.

They are also offering to underwrite some of the projected savings from upgrades on buildings of a certain age, allowing owners to take out bigger loans.

The new products have the potential to unleash large amounts of capital, reducing the carbon footprint of some of the biggest users of energy, residential buildings. A significant portion of the nation's multifamily housing stock dates back to a construction boom in the 1960s and 1970s, and has yet to benefit from efficiency gains over the past few decades.

Landlords, lenders, and even mortgage bond investors stand to benefit as well, since lower utility bills and more comfortable apartment units tend to reduce tenant turnover.

"This is a no brainer," said Buzz Roberts, president and chief executive of the National Association of Affordable Housing Lenders.

"It's a good thing for borrowers, it's good for Fannie and Freddie and lenders, because it makes them more competitive," he said. "And energy improvements make for a safer asset, insulating a property against increases in energy costs."

It also discourages borrowers from turning to other lenders, creating a separate lien on the property. "We want to make our financing a one-stop shop, so borrowers aren't going to a third party," said Chrissa Pagitsas, director of Fannie Mae's multifamily green initiative.

Another potential benefit: Fannie and Freddie may attract new investors to their commercial mortgage bonds, which can be marketed as green, or at least greener.

Fannie Mae recently increased the discount on interest rates for loans on green-certified buildings, to up to 39 basis points from 10 basis points originally.

For owners of older vintage buildings, there are two products: Green Rewards for conventional and affordable rental housing, and Green Preservation Plus, which is only available for affordable rental housing. To qualify, borrowers need to demonstrate a capital plan to reduce energy usage or water usage by at least 20%. Fannie Mae now reimburses the cost of the audit. If approved, borrowers also receive a pricing discount. For Green Rewards loans, the loan can be upsized by underwriting up to 75% of the owner's projected energy and water cost savings and 25% of the tenant's projected energy and water cost savings.

"We want to help owners fix the leaks, get a better dishwasher, put in a more energy-efficient heating and cooling system," Pagitsas said. "A better quality unit means lower turnover. And turnover is a huge expense, and not just because the unit sits vacant; the landlord has to paint and clean the carpets."

Fannie Mae puts the additional loan proceeds in escrow until the property owner has made the improvement. Then, for the life of the loan, the owner needs to report its ENERGY STAR FormScore. This will allow Fannie Mae to compare financial metrics with energy metrics.

The program was launched in January; through July, over $1.2 billion was financed.

Freddie Mac also gives discounted loan pricing for properties with at least one


Adobe Stock

affordable rental unit that have a green certification. Borrowers can also get discounted loan pricing and additional funding by improving the water and energy efficiency of their buildings.

Owners of properties at least 20 years old who commit to reduce energy and water consumption by at least 15% can choose from two products, Green Up and Green Up Plus. To qualify, they must complete a property assessment to identify energy and water savings opportunities.

The borrower receives a menu of potential improvements and can pick any combination that will achieve the targeted reduction, so long as they spend at least $250 per unit. Freddie Mac reimburses some or all of the cost of the assessment when the loan closes. Like Fannie, it monitors the energy use of the building for the life of the loan.

Peter Giles, vice president of multifamily production and sales, said the loans can be underwritten as quickly and efficiently as a conventional multifamily loan, which is key to getting borrower acceptance.

"Tenants are happy with lower utility bills," he said. "We've heard owners say that they actively market the fact that their building is green."

Freddie Mac originally targeted $3.5 billion a year, but based on commitments to date, Giles thinks it could reach $5 billion a year. — *AB*

Asset Securitization REPORT

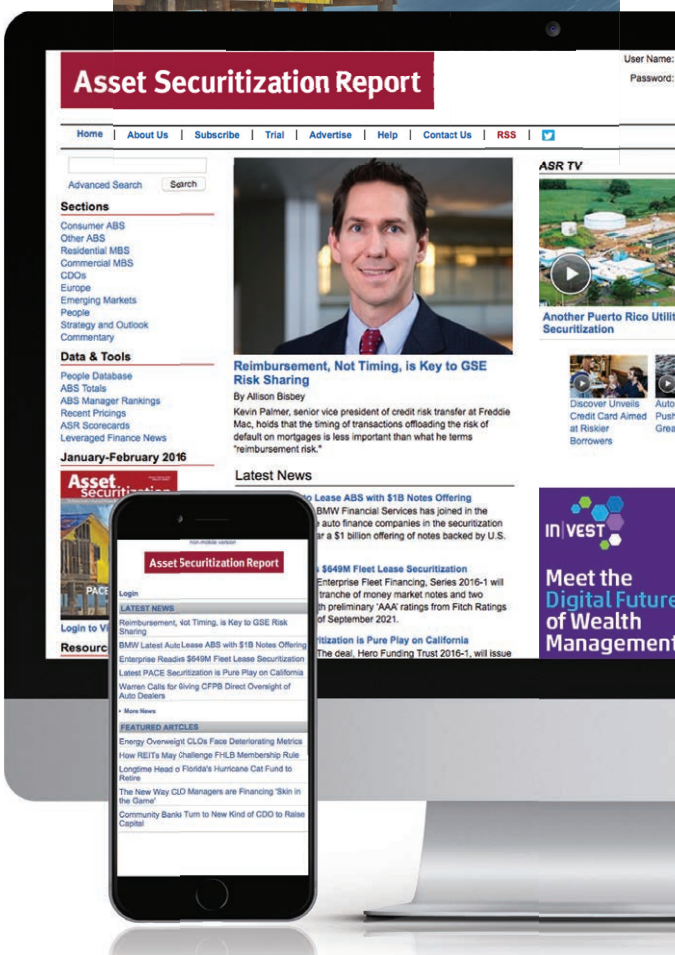
REGISTER TODAY

www.structuredfinancenews.com

Asset Securitization Report provides a full range of news, people coverage, analysis and expert commentary, as well as a weekly aggregation of Wall Street's securitization research.

REGISTER TODAY TO ENJOY THESE BENEFITS:

- Unlimited premium content online
- Searchable access to articles in our comprehensive archives
- Our proprietary people database on the top players in the structured finance world



For more information please contact Customer Service at 800-221-1809 or custserv@sourcemedia.com

Bucking Trend, These Banks Stockpile MSRs

When it comes to servicing mortgages, SunTrust Banks and Flagstar Bancorp are zigging while much of the banking industry is zagging.

Over the last several years, many banks have either exited the business of servicing residential mortgages or severely curtailed their exposure. They have done so as new rules have required them to hold more capital against mortgage servicing assets and an unprecedented wave of refinancing, spurred by rock-bottom interest rates, have cut into servicing fees.

Banks held just $35.9 billion of mortgage servicing rights at March 31, down from nearly $70 billion in the first quarter of 2011, according to Kroll Bond Rating Agency. While the drop can be attributed in part to declining values of mortgage servicing rights, it is also largely a result of banks' moving the assets off their books.

Most of the assets have been gobbled up by nonbank financial firms, but a handful of banks, including the $195 billion-asset SunTrust, in Atlanta, and the $14 billion-asset Flagstar, in Troy, Mich., are also eager to acquire or retain servicing assets. SunTrust, for example, bought $8 billion worth of servicing rights in the first quarter.

Aleem Gillani, SunTrust's chief financial officer, said at a recent investor conference that the mortgage servicing rights the bank has acquired have helped to boost its fee income and return on equity. The deals have also brought in scores of new clients who, down the road, may need other banking services, Gillani said.

Flagstar has built enough scale in the mortgage business, and has developed the technology infrastructure, to operate in the space efficiently, said KBRA senior managing director Christopher Whalen.

Both companies continue to collect millions of dollars in servicing fees. In the second quarter, SunTrust's servicing fees rose 73% to $52 million from a year earlier. Flagstar's rose 24% to $21 million. Neither SunTrust nor Flagstar has provided estimates on future servicing revenue.

"Having our customers have to make their mortgage payments across the teller line, we think, gives us a competitive advantage."

Not all banks are in position to do so because their operations are too small to be cost-effective or they don't have enough capital flexibility, said Terry McEvoy, an analyst at Stephens. The Basel III capital rules limit banks to holding MSR assets of no more than 10% of total capital and raised the risk weighting on MSRs to 250% from 100%. Both were intended to force banks that hold large mortgage portfolios to maintain a larger cushion if loans went bad.

Flagstar, meanwhile, "is focused on subservicing, where you don't hold the mortgage servicing right as an asset, but you're still servicing the loan for others," McEvoy said in an interview. "That's an attractive option for other banks looking to outsource their servicing."

Flagstar, which had roughly $300 million of mortgage servicing assets on its books at June 30, signaled its commitment to expanding its servicing business in September when it announced that it had hired Don Klein, a former Ocwen Financial executive, as senior vice president of business development for subservicing.

First South Bancorp in Washington, N.C., is also looking to add servicing assets. In July the $961 million-asset bank South acquired an MSR portfolio with a total unpaid principal balance of $84.6 million. President and Chief Executive Bruce Elder said he believes mortgage servicing gives First South a competitive advantage in rural markets it serves, like Kinston and Rocky Mount, N.C., where competing banks don't do servicing.

"Having our customers have to make their mortgage payment across the teller line, we think helps give us a competitive advantage," Elder said in an interview. "That's a great cross-selling opportunity."

SunTrust, Flagstar and First South want to continue expanding their servicing portfolios, but they're still struggling with a declining value of the MSR assets they hold on their books. That's partly because MSRs lose value when interest rates are low and consumers refinance their mortgages or make prepayments, which can reduce the overall fee income that the servicer receives.

The fact that megabanks are exiting the business creates the perfect opening for a bank like First South, Elder said.

"When everyone is racing to the exit door, that opens doors for you to stay in the business," Elder said. - *Andy Peters*

Small Banks Count on Tech as Equalizer in Student Lending

The private student loan market is dominated by big financial institutions and established lenders, but could technology help smaller banks gain a foothold?

That's the hope of community banks such as First Dakota National Bank in Yankton, S.D. The $1.1 billion-asset institution — which was the first in the Dakotas to receive a bank charter, in 1872 — has partnered with ReliaMax, a company that insures, originates and services loans on behalf of lenders, with the goal of considerably expanding its student lending portfolio.

"We look at this as a big opportunity for us and hope to make the most of it," said Rob Stephenson, First Dakota's president and chief operating officer.

The bank has begun using ReliaMax's Connext product, which was launched in August, and is designed to allow smaller banks to offer student loans even if they lack the internal resources to underwrite and service these loans. ReliaMax insures, underwrites and services the loans on behalf of the bank, which funds them. The product can be integrated into banks' online platforms and uses proprietary analytics to enable banks to target the most coveted borrowers, said the company's chief executive, Michael VanErdewyk.

First Dakota's Stephenson said the bank did not have a formal student-loan strategy before this. It had accumulated only about $2 million-$3 million of student loans on its books over a 20-year period, mostly through "accommodation lending; schools that we had relationships with in South Dakota, families that we knew through regular connections, things like that."

After meeting with ReliaMax about Connext, bank officials grew more bullish. Stephenson estimates First Dakota can grow to about $25 million in student loans in the first 3-6 months of using the product.

"And we're not planning to stop there," Stephenson said. "We sure hope it can grow even bigger. And with the online component, we see this as a nationwide opportunity."

Indeed, the private student loan market is a growth area some banks could consider getting into, said Marc Weston, vice president, senior credit officer with Moody's.

"The private student lending market has been growing; federal loans don't come close to covering the cost of education," Weston said. "So there's definitely a vibrant market for private student loans."

Still, there are challenges for new entrants, he said, including it being "a sector dominated by a [few] large players: SLM Corp., Wells Fargo, Discover."

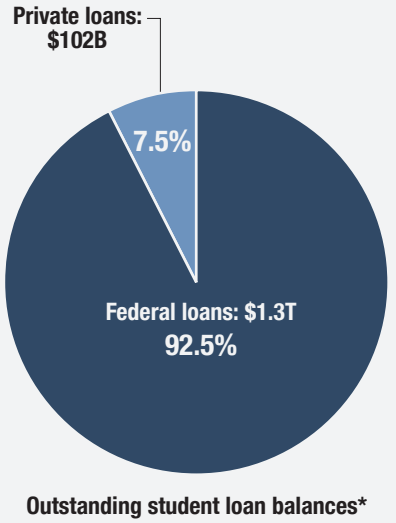
Those three lenders and three others — Citizens Bank, PNC Bank and Navient — account for more than 65% of the $102 billion private student lending market in the United States, according to a report in July by the student-loan-data-analysis firm MeasureOne. Federal loans make up the rest of the $1.36 trillion market.

Another major challenge for smaller lenders is that student loans are "servicing intensive," requiring the necessary technology and internal resources to provide them, Weston said.

That is why First Dakota was intrigued by the partnership with ReliaMax, which services the loans on its behalf, Stephenson said. "We weren't originally looking to enter this market otherwise," he said. "But after hearing about [Connext] we felt we could really scale" in this area.

Still a Rich Slice

The dollar value of private-sector student loans remains considerable even though the government dominates the market. That is why some community banks are seeking help in their effort to break into the business



* From a July 8 report

Source: MeasureOne

And ReliaMax's VanErdewyk said for that very reason the company is targeting banks in the $500 million-$5 billion asset range as its "sweet spot" since they may not have the infrastructure to offer such loans. "We're not looking at the large money center banks," he added.

VanErdewyk also said offering student loans also presents banks with the opportunity to build credibility and a relationship with sought-after millennial consumers.

"Oftentimes the student loan is the first contact with a bank, and it lets them start a relationship with the millennial customer, who is the next generation of bank customer," he said. — *Briyan Yurcan*

Rush to Extend Maturity of CLOs Ahead of Risk Retention

Borrowers typically refinance in order to lower their debt servicing costs by taking advantage of an improvement in either market conditions or their own creditworthiness.

But both Carlyle Investment Management and Voya Investment Management in August worked out arrangements to pay higher interest to investors in the senior notes of a pair of collateralized loan obligations. The CLO managers issued replacement notes for existing tranches, in the process obtaining consent to extend the maturities of the two deals as both approached the end of their reinvestment periods in what are known as reset deals.

While this cost them in terms of the interest rate spread on the notes, they gained a reprieve from pending rules requiring managers to keep "skin in the game," of their deals. After Dec. 24, managers will be required to keep 5% of the economic risk in CLOs (and other kinds of asset-backeds).

Existing CLOs will be grandfathered from the requirement, but it's not clear whether refinancing the notes after Dec. 24 would subject them to the retention requirement. Had Carlyle and Voya waited until 2017 to refinance, they might have had to set aside some of their own capital; in the case of Carlyle Global Market Strategies CLO 2012-3, $27.93 million.

Some $50 billion of U.S. CLOs exit their non-callable periods in the fourth quarter, according to Wells Fargo. In total $250 billion will be eligible to be refinanced, an amount equal to 72% of the outstanding market. Analysts at the bank, as well as at Deutsche Bank, expect that many managers will follow the example set by Carlyle and Voya.

Six Resets, and Counting?

As of Oct. 1, six deals have been resets. In addition to Carlyle and Voya, Apollo Global Management (with two deals reset), American Money Management Corp. and BlackRock Financial Management have sought to largely extend existing terms.

"The main advantage of the reset is that the coupons of the tranches don't necessarily have to be lowered that much for [it] to make sense."

In the month of October along, roughly $40 billion CLOs will become callable, giving managers with a required payment date only a month in which to refinance before the risk retention requirement kicks in.

While managers could simply call a deal and issue a new one, this would be challenging in the current market environment, collateral for new deals is scarce – and expensive. Issuance of below-investment grade corporate loans is down 19% so far this year from 2015's pace, according to Thomson Reuters.

Calling deals and issuing new ones is also more time consuming.

Resets offer a much simpler means to extend a deal's reinvestment period as well as the weight average life test (indicating the expected time period for bondholders to receive principal returns). Managers do not have to obtain new assets, redeem old notes and invest in the ramp-up costs of a new issuance.

"This way the CLO can be restructured to have most of the attributes of a new issue CLO, while keeping the assets in place and not having to go through liquidation of the old CLO and then ramping up a new one," Deutsche Bank analysts wrote in an Aug. 19 report.

"The main advantage of the reset is that the coupons of the tranches don't necessarily have to be lowered that much for the reset to make sense."

Resets "allow managers to manage through a credit cycle downturn, rather than deals going static as defaults rise," the Wells Fargo report stated.

Investor, Equity Advantages

Maintaining, or even increasing, existing spreads on CLOs is certainly an attraction to investors. So is avoiding the deployment of new capital to obtain new CLO investments as they sell out of old positions that – in a traditional refi – are offering tighter spreads and returns. There's no waiting for deals to ramp up, either.

For CLO equity investors, resets can be a way of maintaining distribution levels and income streams that otherwise would take a downturn as deals amortize. Resets could not be happening at a better time for business development companies, some of the biggest buyers of CLO equity.

Many have suffered from declining

net asset-values this year, making it difficult to sell off CLO assets without taking losses.

According to Wells Fargo, the idea of resets was established just last year by Apollo and its ALM CLO VI portfolio. ALM extended its reinvestment period three years, reduced the weighted average coupon by 15 basis points and also used the opportunity to raise its cap on covenant-lite loan assets.

(Three other deals were reset last year, according to Deutsche).

For Carlyle, its 2012-3 deal was set to exit its reinvestment period in October. So in mid-August, Carlyle proposed replacement notes through a supplemental indenture that would extend the reinvestment period, the legal final maturity and the WAL test dates by four years.

Those notes carried a slight spread bump to triple-A paper investors, widening the rate to 145 basis points from the original rate of Libor plus 1.41% for the $391.5 million tranche. While wider, the 145 basis points spread was still tighter, however, than the 151 point spread Carlyle received on the 'Aaa'-rated notes on its third CLO for 2016 that priced on Aug. 9.

Some investors in the tranches took tighter spreads, however. According to Standard & Poor's, bondholders of the Class A-2 notes (rated 'Aa') had their rate narrowed to 185 basis points from 225, and B noteholders were squeezed to 250 basis points from 350 basis points (those coupons are in line with the spreads for the contemporary Carlyle CLO).

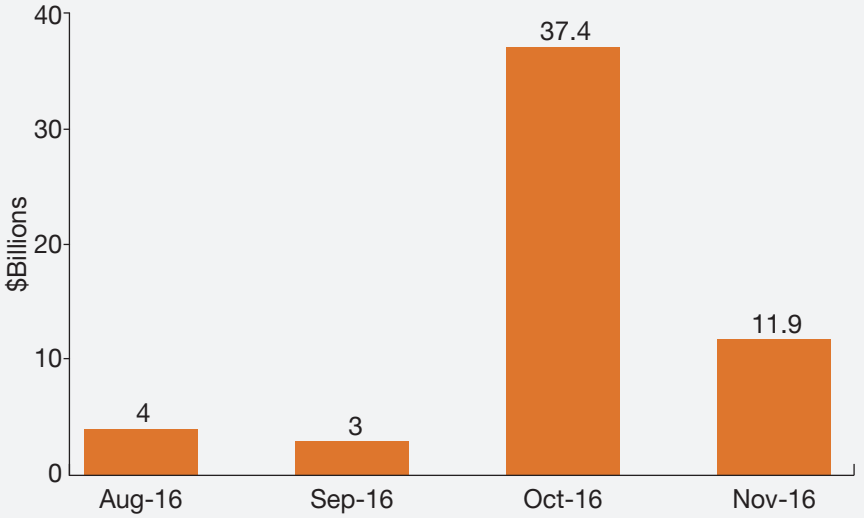
Voya's triple-A investors also benefited from widened spreads, moving to Libor plus 145 basis points from 139 basis points.

Voya obtained extensions to the non-call end date, reinvestment end date, weighted average test as well as the final maturity date.

Voya also obtained looser restrictions on industry concentration limits, according to S&P.

Reset Mania

The volume of collateralized loan obligations exiting their non-callable periods is set to spike in October.



Source: Intex, Wells Fargo Securities

Apollo's Second Run

Voya and Carlyle are among six resets and 22 refinancings that have taken place thus far in 2016, according to Thomson Reuters.

In March another CLO, American Money's AMMC CLO IX, reset terms in March on its $430 million portfolio. That deal's modifications only extended the reinvestment period for two years, but granted a WAL life test extension three more years until December 2021. American also received investor approval permitting an expansion of covenant lite allowances to 50% of the portfolio.

Apollo's second reset was issued in September and scheduled to close in October to issue six classes of replacement notes for its $728.92 million ALM VII transaction which dates to November 2012 (and among Apollo's 11 CLOs under management).

The new terms extended the reinvestment period to 2021, the non-call period to 2018, and the WAL by 8.5 years.

In the replacement AAA-rated, Class A-1 notes sized at $436 million, Apollo agreed to a slightly higher coupon (1.48% over Libor) vs. the original (1.42% over Libor).

But lower rates were granted to the Class A-2 replacement notes, shifting the prior note rate from 230 basis points over Libor of 185 basis points.

The Class B and C notes also presented lower coupons to Libor plus 250 basis points (from 315 basis points) and Libor plus 385 basis points (from 450 basis points), according to Standard & Poor's.

BlackRock on September also presented new terms on a proposed reset of seven class of notes in its $612 million Magnetite VII deal from December 2012.

The largest replacement notes segment of the CLO, the $372 million Class A-1-R notes, has a rate of 135 basis points over Libor.

That is in line with the existing notes' coupon of 137 basis points over Libor, but BlackRock was able to extend it reinvestment period to January 2019, it's non-call period to 2018, and extend its WAL life test to October 2022. — *GF*

Investor-Led Refi? NY Counties Issue More Tobacco Bonds

Seven New York counties issued another $292 million of bonds backed by tobacco settlement payments in September.

Proceeds are being used, in part, to retire outstanding tobacco bonds paying higher interest rates, allowing the issuers to lower their debt servicing costs. Some of the bonds will be repaid and others will be retired through an exchange of old debt for new debt.

Investors may also stand to benefit, however, since some of the old bonds are being retired at a price above their accreted value.

The new notes were issued by the New York Counties Tobacco Trust VI, a public corporation created by Broome, Dutchess, Onondaga, Oswego, Rensselaer, Sullivan and Ulster Counties in order to consolidate their issuance.

Jefferies is the underwriter.

Tobacco bonds are backed by money that U.S. tobacco companies pay under a 1998 master settlement agreement to compensate 46 states, Washington D.C., and Puerto Rico for the cost of caring for sick smokers.

A number of states have securitized these payments, exchanging future receipts for a lump sum payment from bondholders. Investors in these bonds assume the risk that settlement payments will decline in line with consumption of cigarettes. But in a number of cases, they have managed to avoid this risk by influencing the terms of a refinancing.

A 2014 tobacco bond refinancing by another New York county, Niagara, put more money in the hands of investors than in the county, as ProPublica has reported.

The new deal, NYCTT VI, issued five tranches of notes: $132 million of series 2016A-1 turbo, non-callable exchange bonds; $119 million of series 2016A-2 turbo, callable bonds; $21 million of series A-2A federally taxable; $21 million series B hard-amortization senior bonds; and $20 million in series C subordinated turbo bonds, according to a presale report published by Standard & Poor's and the deal prospectus.

S&P assigned ratings ranging from 'A' to 'BBB-' to the new bonds, depending on their payment priority and tenor.

Here's where it gets complicated.

A portion of proceeds from A2 bonds issued on behalf of Broome, Dutchess, Onandaga and Rensselaer will be used to redeem class S1 subordinated bonds issued on behalf of these counties in prior deals. The S1 bondholders will receive 101 of accreted value (or principal plus unpaid accrued interest.)

Another portion of the proceeds of class A2 issuance will be used to repurchase a portion of class S2 and S4 subordinate bonds issued in prior deals.

These classes of securities are held by a group of related investors, which will pay an exchange premium, not specified in the prospectus. This premium will fund a distribution to the counties, as holders of the most subordinate class of securities in the new deal, known as "residual certificates."

The counties are not retiring all of the subordinate bonds that they issued in the prior deals, however. A portion of the bonds, which do not pay interest until they mature in 30 or 40 years, will remain outstanding. While payments on the old bonds will not commence until all of the series 2016 bonds have


Fotolia

been repaid, the old bonds will pile up huge sums of unpaid interest in the meantime.

The $41 million in proceeds of the series B and C bonds, along with other funds, will be used to refund all of the counties' outstanding senior bonds, which pay interest rates ranging from 5.625% to 6.75%, according to the offering prospectus.

However, these new Series B and C bonds also pay no interest until maturity, piling up sums of unpaid interest in the meantime.

Bond Buyer reports that demand for the new bonds was strong. The A2s with a projected average life of 14.14 years were priced to yield 3.47% in 2045 (an approximate yield to maturity of 4.242%) and the A2s with an average life of 17.49 years were priced to yield 3.73% in 2051 (an approximate yield to maturity of 4.420%).

The A2 turbo term bonds were priced at par to yield 2% in 2024 with a projected average life of 1.39 years.

The Series B bonds maturing in 2031 were priced to yield from 0.97% with a 3% coupon in 2018 to 2.72% with a 5%; a 2036 maturity was priced as 5s to yield 3% (an approximate yield to maturity of 3.788%) and a 2041 maturity was priced as 5s to yield 3.13% (an approximate yield to maturity of 4.004%). — *AB*