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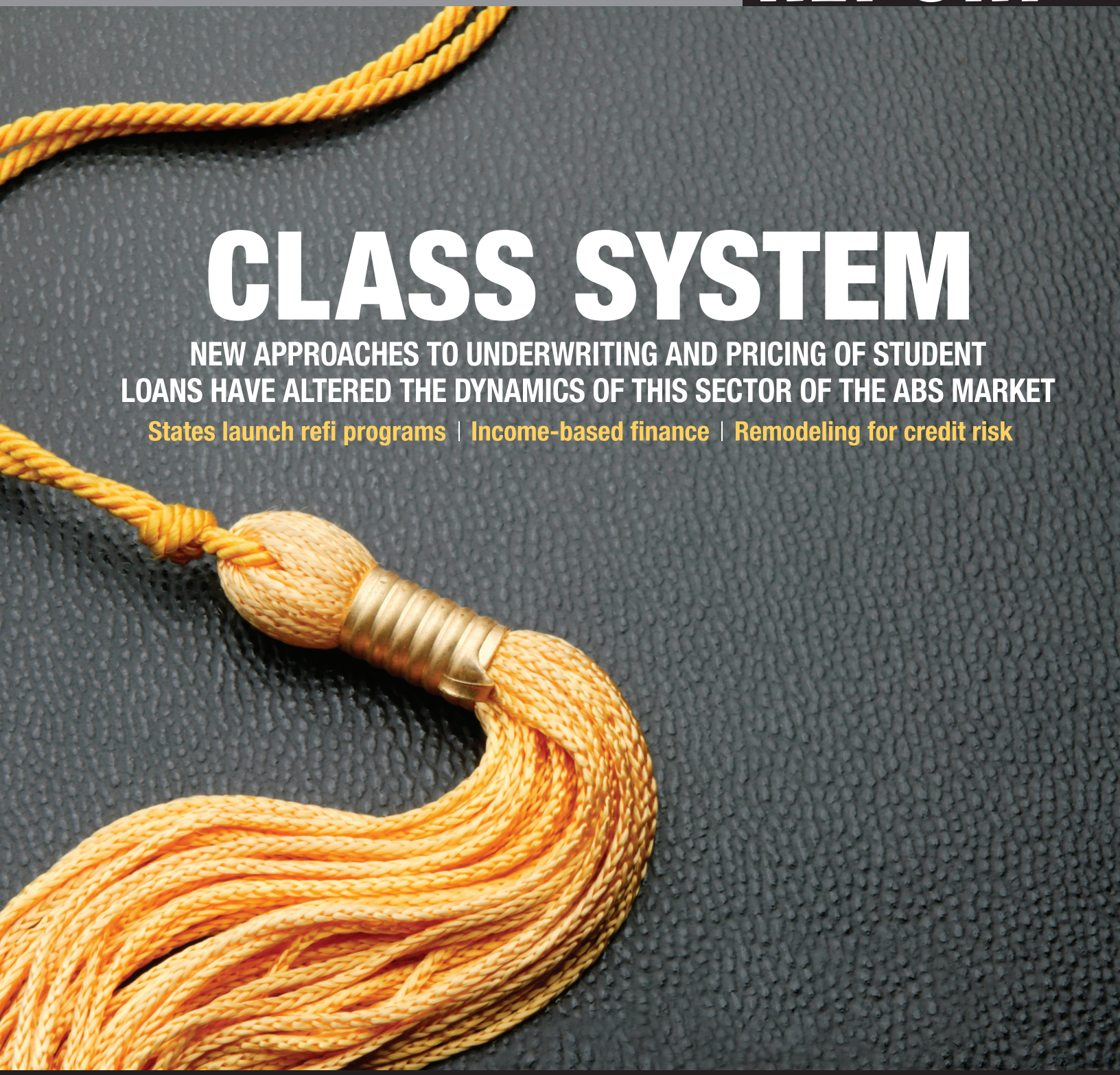
Asset securitization REPORT

The Premier Guide to Asset and Mortgage-Backed Securitization



CLASS SYSTEM

NEW APPROACHES TO UNDERWRITING AND PRICING OF STUDENT LOANS HAVE ALTERED THE DYNAMICS OF THIS SECTOR OF THE ABS MARKET

States launch refi programs | Income-based finance | Remodeling for credit risk

Asset Securitization REPORT

The Premier Guide to Asset and Mortgage-Backed Securitization

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Value Signals

American higher education isn't oriented on employment outcomes, which can make it an uncertain investment opportunity. Even government guaranteed student loans are not without risk, as the past year has shown.

Increasingly, however, borrowers who graduate and can land, and keep, a job are able to reduce the burden of their student debt by refinancing into a loan with a lower interest rate. Marketplace lenders SoFi and CommonBond were among the first to recognize this opportunity. A few banks are also in the business. And now some state student loan authorities are getting in on the game, as I explain in my cover story. Thanks to guidance issued last year by the Internal Revenue Service, they are able to fund this lending by issuing tax-free bonds, which could potentially allow them to undercut other lenders.

The second article in our education package is an interview with Tonio DeSorrento, founder of Vemo Education, which advises colleges and universities on ways to better align the cost of financial aid packages that they offer with the value delivered. The appeal to borrowers is obvious: If they earn less than they expect, they can be sure that their payments won't be overly burdensome. Eventually, this kind of financing can provide information that schools can use to make their programs more competitive.

This is our summer issue, so we naturally devote some attention to the more esoteric asset classes, which tend to come to market at this time of year. Glenn Fest interviews Stacey Lawson, chief executive of Ygrene Energy, an originator of Property Assessed Clean Energy financing, about the firm's plans to tap the securitization market on a regular basis.

Duke Energy Florida has just completed what some are describing as a landmark utility fee securitization; in my article I explain why the deal was marketed as a corporate bond and how well this paid off.

And Keeley Webster at sister publication Bond Buyer spells out the danger to tobacco bonds from California's higher smoking age.

—Allison Bisbey, *Editorial Director*

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CORRECTION

An article in the May/June 2016 edition misidentified the credit rating agency on a railcar lease securitization, NP SPE II; the deal was rated solely by Kroll Bond Rating Agency.

CLASS SYSTEM

STATES ARE JOINING THE RANKS OF STUDENT LOAN CHERRY PICKERS. THEY SENSE OPPORTUNITY HELPING GRADUATES LOWER PAYMENTS

by Allison Bisbey

SoFi and CommonBond found a multi-billion dollar opportunity refinancing student loans to borrowers with advanced degrees and high-paying jobs. A few banks, including Wells Fargo, Darien Rowayton and Citizens Financial, are in the business, too.

Now, a number of states, including Connecticut, Massachusetts, Minnesota, New Jersey, Rhode Island, and Vermont, are getting in on the game.

There are 18 state-based student loan programs. The majority of them fund their lending via the capital markets, by issuing either taxable or tax-free revenue bonds. Until recently, these agencies could only use the proceeds of tax-exempt bonds to lower the interest rate on loans they originated to borrowers still in school. That changed in November 2015, when the Internal Revenue Service gave them the green light to use tax-exempt bonds to refinance student loans for anyone who lives in-state or attended an in-state college, regardless of the original lender.

While SoFi and CommonBond have focused, at least initially, on "High Earners Not Rich Yet," or HENRYs, state agencies are targeting a different, and potentially much bigger, stratum of the population: the middle class.

"We try to set DTI (debt to income) and FICO requirements at a level that will get a vast majority of the loans repaid, but we're not setting the bar so high that nobody would qualify," said Marilyn Kosir, manager of the refinance program at the Minnesota Office of Higher Education.

Like SoFi and CommonBond, the non-profits want to help borrowers, and taxpayers, by lowering monthly payments. They are offering refi loans to qualified borrowers with rates below 5%. For a borrower paying 8% or 9% on some federally guaranteed or private student loans, that's big savings.

An Economic Benefit That Can Keep Talent In-State

"There's an economic benefit for the state," said Chad Pastorius, manager of strategic planning at the Rhode Island Student Loan Authority. "All of our loan program borrowers save money, giving them more disposable income than they would have if they borrowed elsewhere."

The agencies also sense a new business opportunity as the portfolios of federally guaranteed loans that they service run off. Most started out as lenders under the Federal Family Education Loan Program, but since 2010, the U.S. government has lent directly to students, cutting out state student loan authorities and other middle men. That prompted some states to shutter their student loan authorities; other agencies turned to making loans that are subsidized by the ssuance of tax-free bonds, but are not guaranteed by the federal government.

"Every year, hundreds of millions of dollars are borrowed to attend schooI in Rhode Island, and there are Rhode Island residents who go out of state, so it's a large market," Pastorius said.

Critics question how much taxpayers will really benefit, however.

"It will benefit people who would benefit relatively little," said Robert Kelchen, assistant professor of higher education at Seton Hall University. "People who have good, steady jobs typically have the ability to refinance at lower rates" with the likes of SoFi, CommonBond, and Earnest. Some banks such as Darien Rowayton also offer refinance loans.

"I can see why states are very interested," he said. "It's a benefit they can sell to keep talented students in-state. The question is whether the benefit is large enough to actually achieve that purpose … whether saving $500 a year is really going to keep you in state."

There's another drawback to refinance loans offered by both marketplace lenders and state student loan authorities: They cherry pick the most creditworthy borrowers from the U.S. government's student loan portfolio. That's because the borrowers that both kinds of lenders target subsidize the less fortunate, who are more likely to default. This puts federal taxpayers on the hook for more losses.

(Moody's Investors Service has taken this refinance activity into account in its revised methodology for rating bonds backed by Federal Family Education Loans. The new criteria, published in June, assume that 2% of consolidation loans will be prepaid voluntarily each year; private refinance loans offered by online lenders, banks, and now state agencies are part of the reason.)

Kelchen said that, in theory, state programs using tax free bonds could undercut private lenders by offering lower interest rates, though it's unclear how much lending capacity states have. Any tax-free bonds that they issue to make refinance loans would count against federal caps on the volume of such borrowing in each state. That could potentially cannibalize subsidized lending to students still in school.

Limits on Tax-Free Funding

The first state agencies out of the gate with refinance loans did not wait for the IRS to give the green light. Minnesota is funding the initial $100 million of lending on balance sheet; the program was launched in January and origination is over $20 million. Participants must be Minnesota

"Every year, hundreds of millions of dollars are borrowed to attend school in Rhode Island, and there are Rhode Island residents who go out of state, so it's a large market."

residents with a certificate or degree who are employed and have at least $10,000 in eligible loans. To participate, you need a credit score of 720 (or 650 if you use a co-signer) and your total debt can be no more than 45% of your total income.

Interest rates for SELF Refi loans range from 3% to 4.35% on variable-rate loans and 4.5% to 6.95% on fixed-rate loans.

Rhode Island and Massachusetts are funding their refinance programs with taxable bonds.

Rhode Island launched its program in 2014. Participants must have a credit score of 680 and a salary of $40,000 or more to qualify without a co-signer. Rates on five-year loans with a co-signer are 4.49% if borrowers sign up to make automatic payments and 5.74% for loans with no co-signer. Refinance loans with 10-year and 15-year terms are also available.

"We've made about $25 million in loan;, we originate around $1.5 million to $2 million a month," Pastorius said. "We have a large federal loan legacy portfolio; some of those refinancing had higher-interest, PLUS [graduate school] loans and some of our own private borrowers," he said. However, "I'd say more than half of loans are coming from other lenders."

The Massachusetts Education Finance Authority also went the taxable route, issuing $75 million in bonds to fund its refinance loan program, which launched in January. The loans pay fixed rates of interest as low as 4.95% and variable interest rates as low as 3.25% and have terms of 15 years.

Refinance programs in other states, including New Jersey and Connecticut, are in earlier stages.

The Education Finance Council, a trade group for state student loan authorities, runs a monthly refinance working group. "I'd say if not all [members] that currently issue bonds, then a large percentage of those that do are in process or about to launch refinance programs," said Debra Chromy, the organization's president.

Even with the guidance that the IRS issued in November, there are still reasons to issue taxable bonds. That's because the agency specified that states refinancing private student loans with proceeds of tax-free bonds must get schools to certify that these loans did not exceed the cost of attendance, a cumbersome process.

States Can Also Refinance Parent Loans

The IRS guidance issued in November also allows states to use proceeds of tax-free bonds to refinance student loans that parents take out on behalf of their children.

"We heard from a lot of families that mom and dad are really the ones that plan to take on responsibility for the debt on co-signed loans, but all of a sudden the student has got this debt on his/her credit, creating a problem if he/she wants to rent an apartment," Chromy said.

But the bigger opportunity is refinancing.

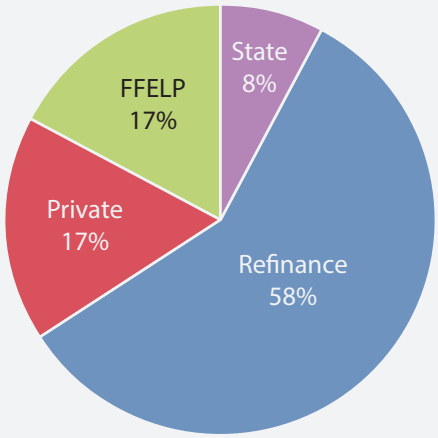
With interest rates at current levels, even taxable funding via the bond market allows states to offer interest rates that are competitive. While SoFi advertises rates as low as 2.15%, most borrowers, even HENRYs, don't qualify. "Maybe you're not getting 3.5% from SoFi, maybe you're getting 5.5%," Kelchen said. "So there may be room for the states to come to market at 4.5%, instead."

Marketplace lenders, as well as banks, are aware of the possibility. SoFi, which originally targeted borrowers with advanced degrees from a few select universities, now offers loans to graduates from any accredited college or university that meets its other underwriting criteria.

"They're going to bump into each other at some point," said Kelchen.

NEW AMBITION

STATE STUDENT LOAN AUTHORITIES HAVE A RELATIVELY SMALL SHARE OF THE STUDENT LOAN MARKET, AS MEASURED BELOW BY ISSUANCES OF ASSET-BACKED SECURITIES THIS YEAR THROUGH APRIL. BUT THEY COULD BECOME BIGGER PLAYERS AS THEY EXPAND TO REFIS FOR GRADUATES



Total Issuances = $4.98B

SOURCE: DBRS

What Income-Based Finance Can Teach Higher Ed

Should engineering students get more, or more attractive, financial aid than poetry students?

Many colleges charge similar tuition for different degrees. And the federal government charges the same rate of interest for a given type of loan regardless of the school the borrower attends, or his or her field of study. Interest rates on private loans may vary according to a borrower's current creditworthiness, not future earnings potential.

But what if financial aid, or even tuition, could be priced based on the outcome – a student's ability to land, and keep, a job?

That is what income-based finance has the potential to do, according to Tonio DeSorrento, founder of Vemo Education, which advises colleges and universities on ways to better align the cost of financial aid packages they offer with the value delivered.

Tonio DeSorrento

The idea is not new; it is used in some Latin American countries and is being piloted in the United States by some nonprofits. But many of these programs market directly to consumers. Vemo is partnering with colleges and universities, which have their own funding and plenty of potential borrowers.

Purdue University announced in November that Vemo was advising it on a plan to create funds that its students can tap to pay for tuition, room and board. In return, students would pay a percentage of their earnings after graduation for a set number of years, replenishing the fund for future investments.

There is an obvious appeal for borrowers: If they earn less than they expect, they can be sure that their payments won't be overly burdensome.

Eventually, DeSorrento said, this kind of financing will provide information that schools can use to market their programs and to make them more competitive.

An edited transcript follows.

Where has income-based finance been tried before?

TONIO DESORRENTO: In Latin America, by Lumni, and in the U.S. by a couple of funded companies that tried in the peer-to-peer space. I'd argue they are different concepts from what we are doing today. We're not recycling people, products or platforms. It's all from scratch, all applied differently, at scale, in the school channel. There's one other funded originator [in the U.S.], Cumulus Funding in Chicago. They are doing great. They have a different product, a substitute for short-term/high-interest loans.

Why work with colleges, as opposed to going directly to consumers?

Education is about developing human capital, and income-based finance is an investment in human capital. The use of proceeds is well-aligned with interests of investors; both hope to raise an obligor's income. American higher education isn't oriented on employment outcomes, which makes it a less certain investment opportunity in some cases. But college itself is a huge driver of the economy; it delivers a lot of value. Good things happen for graduates, regardless of course of study.

The most valuable way to use income-based finance is to help other good things to happen in higher education. If we can help a college with recruitment or retention, then this pays for itself, the scale is there, the sky's the limit. We're not competing with private student loans. We might help people do that [compete with private loans], but the best use [of income-based finance] is solving problems aside from dropping a student's [effective] interest rate. At root, the value in Vemo for a school is to cause an alignment in cost of education and value delivered.

Will income-based finance replace or supplement student loans?

When we go to a campus, we're not going to displace a single dollar of federal student loans. Most campuses, at the undergraduate level, have tuition far in excess of federal loan limits; students need either private loans, or sometimes emergency loans from their schools. We help find capital and connect the sources of capital that they [schools] already have with students.

Marketplace lenders are struggling to find borrowers, as are many banks. It's very competitive. At Vemo, we didn't want to spend time or resources chasing borrowers. So we go places that already have potential obligors and capital resources (colleges and universities), and create those relationships for them.

Won't income-based finance tend to encourage higher tuition, just as federally subsidized lending does, by making it easier for students to pay more?

Forgive the lazy hypothetical, but if I'm an investor and you tell me you got into two schools, Party School and Engineering School, and you wanted me to back you for one of them, I'd pick Engineering School. In fact, if Engineering School costs $50,000 a year and Party School costs $40,000, it might be worth it for me to give you $10,000 more each year to go to Engineering School. If Party School costs the same – and it were up to me – I would never let you go there.

The goal for an investor in this case is not to take more money from one graduate [than another], it's just to get back the same dollar-on-dollar return for the same risk and duration of investment. The lower the likely income stream from an education investment, the lower the amount you would want to invest. But every [course of study] is fundable. To cite an oft-underestimated course of study, poetry graduates don't starve. They aren't all professional poets, but they do something [else] that they like and that pays. But an investor might ask a school to deliver that degree less expensively.

In a market dominated by income-based finance, without federal subsidies, schools that delivered less value would have to charge less. But that's not a system we're ever going to have. So this is all incremental to the federal student loan system for now.

In general, if a program is viable is today it will probably still be viable, [but] performance on income-based finance products will send signals about employment value.

Will schools offer income-based finance products to all students?

They might, but it doesn't have to be across the board.

One example is that it could replace an emergency aid program. Most schools have them. Say a parent is laid off; they can't let you come for free, but they'll often give you loan, charging you interest, but since you're in hardship situation, they don't want to. [Instead] they can use an income-based finance product as a hardship accommodation, and if it works out you'll pay them back and they'll help more people, but if it doesn't, they haven't layered more debt on you and helped wreck your life. Schools can also use us to target specific programs where loans are a bad fit, or invest with their endowments to bolster value-based recruiting messages.

There are millions of dollars of need for this targeted stuff on almost every campus. Elite schools, mid-tier schools, both privates and publics. That's where our value is. We're trying to change people's behavior in ways that are good for them. The financial product is a byproduct.

What kind of value can income-based finance provide for a particular degree or program?

One is granular data on outcomes. That kind of data can let [schools] make a different argument about the value of their school versus a competitor. Another is alignment. Schools can work with Vemo to structure and finance programs where the school earns more when graduates earn more.

Don't they need a few years' worth of data to do this?

Not necessarily. … If the school is getting institutional value – recruitment, retention or otherwise – from an income-based finance program, then pricing on the financial products (and thus performance history) is less important. [A school] doesn't have to take a wild risk on a person. There's pretty good info about what happens at different schools over time; you can measure carefully, and decide if want to invest in change. [Say] you've got the fourth-best employment outcome, and want the first-best, we can help you manage to that.

And once schools have more data?

We can say, "People in this program underperformed the earnings of people at your peer school's program; consider doing XYZ." Schools using income-based financing have an incentive to respond, and not just for the good of the graduates. There are big opportunities [for Vemo and others] here because most colleges don't have the budgets to gather actionable data, much less invest in solutions, and we help provide that.

If there's a flat tuition, is poetry subsidizing engineering?

For any risk and duration combination, you're looking for similar dollar-on-dollar return. We work [on programs] that are priced across many courses of study at some schools. The goal up front is for every student to receive similar terms, dollar-on-dollar, but there's always a range of outcomes. Some people will overachieve, others underachieve, and they will cross-subsidize that way.

What other potential uses are there?

People might say, "If you agree to teach low-income students or perform a public service, there's forgiveness." Or a state university might say, "You [only] have to make payments if you move out of state. Every month you are in-state you get a deal, and every month you are not, you pay [a percentage of your income]" – which would approximate the forgone state income tax from a state with brain drain. We're not there yet, but this will be used one day as a kind of precision social impact bond.

Does income-based finance lend itself to securitization?

Yes, though there isn't an immediate securitization story. One day our work with colleges and universities will help the market better understand this asset class, and an enterprising banker will find us. — *AB*

Moody's New FFELP Criteria May Bring More Downgrades

Last Spring, Moody's Investors Service raised the alarm about generous repayment plans for federally guaranteed student loans, putting nearly $40 billion of bonds backed by these loans under review for possible downgrades.

The reviews were shelved when Moody's subsequently decided to conduct a wholesale review of its criteria for rating Federal Family Education Loan Program (FFELP) securitization on July 9, 2015, leaving 58 deals in ratings purgatory.

The purgatory continues, but now it has been extended to an even wider universe of deals.

On June 14, the rating agency published its update methodology to takes into account heavy borrower usage of Income Based Repayment (IBR), which slows down the rate of repayment, sometimes to as long as 25 years from the standard 10. This means that bonds backed by these loans may not pay off at their final maturity. The uncertainty is a problem for investors who had planned to put their money to work elsewhere. Failure to pay off at maturity is also an event of default.

But, after extensive feedback from market participants, Moody's has also revised its methodology in ways that benefit the bonds. It assumes that more borrowers will voluntarily prepay the loans. It also added new prepayment assumptions that account for government reimbursements of principal and accrued interest on a loan if the borrower dies or becomes disabled.

The new prepayment assumptions also account for potential loan forgiveness for borrowers who enroll in IBR, although this is likely to have very little impact on the speed at which bonds are repaid. That's because borrowers in IBR must make 300 qualifying payments before the forgiveness kicks in. So the earliest that loans can be forgiven in this program is 2034.

Debash Chatterjee, managing director of Moody's structured finance group, said that the revised methodology is "less punitive" than originally proposed.

Nevertheless it has resulted in a much broader universe of bonds being put under ratings review.

Moody's took rating actions on 403 tranches of bonds backed by FFELP loans as well as bonds backed by a mix of FFELP and private student loans that do not benefit from a government guarantee.

It placed 266 tranches in 141 transactions ($44.9 billion) on review for downgrade, 89 tranches in 59 transactions ($3.1 billion) on review for upgrade and 45 tranches in 34 transactions ($2.8 billion) on review with direction uncertain. Moody's also confirmed the ratings on three tranches ($1.5 billion).

In addition, 101 tranches ($30.7 billion) previously placed on review for downgrade remain on review for downgrade and four tranches ($1.4 billion) previously placed on review for upgrade will remain on review for upgrade.

The rating agency will start releasing its rating actions shortly on a rolling basis and expects to complete the actions within six months. In some cases the ratings migrations on these bonds, which are normally rated 'Aaa,' could be large.

When concerns about slower repayments emerged last year, it roiled the normally staid market for FFELP bonds last year. The ratings reviews (Fitch Ratings is also taking actions) and subsequent selloff of FFELP bonds spurred servicers into action.

Navient, the largest sponsor of FFELP SLABS, has been able to extend the legal final maturity dates for $6.8 billion of bonds that it sponsors since December 2015. This is considered to be the cleanest solution to extension risk; the challenge is that it requires rating agency and bondholder approval.

It now has $84.3 million under review. In some cases the migrations on these securities, which are normally rated 'Aaa,' could be large.

Other servicers have called bonds and provided other kinds of support for tranches at risk of failing to pay off at their final maturities. Moody's has said that, while such support can be helpful, it is optional and the willingness of a sponsor to provide such support may change and is not a given.

Reaction to the new methodology has been muted. Analysts at Deutsche Bank wrote in a June report that it was "encouraging" to see that Moody's took market feedback into account.

But the analysts are concerned that the new approach, which uses 28 different scenarios, will be difficult and time consuming to model. — *AB*

"Money Market Reform"

The Move to Floating NAV Institutional Funds Looms Large

Our panel of asset managers sheds light on what the new SEC regulations mean for products, fund operations and clients.

MODERATOR

Elliot Kass
Editor-at-Large,
Asset Securitization Report, SourceMedia

Ever since the financial crisis of 2007 and 2008, financial regulators have sought a way to guard against another institutional money market meltdown. The Securities and Exchange Commission's (SEC) most recent money market reform rules are a continuation of this effort and an aggressive attempt to ensure fund stability even during times of severe financial duress.

Issued in 2014 and slated to take effect this October, the latest SEC regulations distinguish between institutional and retail funds, and require prime, municipal and tax-exempt money market funds to move from a fixed $1.00 share price to a floating NAV. The new rules also allow all money market funds to temporarily bar investors from making withdrawals—or to impose fees on investors who redeem shares—during times of extreme market volatility.

Recently, in New York City, the Asset Securitization Report hosted an executive roundtable to address the impact of money market reform on financial institutions, asset managers and their clients. Moderated by ASR Editor-at-Large, Elliot Kass, six industry executives participated in the forum. They included: Tom Callahan, who leads BlackRock's Global Cash Management business; Jeff Carson, a vice president at Wilmington Trust; Debbie Cunningham, chief investment officer for global money markets at Federated Investors; Christina Kopec, who heads product strategy for fixed income and global liquidity at Goldman Sachs; Jeff Silverstein, a partner in Seward and Kissell's Real Estate and Global Bank and Institutional Finance and Restructuring groups, and Patrick Tadie, a group vice president at Wilmington Trust.

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Elliot Kass: This is really the second wave of money market reform that we're seeing now. Is it something that you were all expecting? Do you think the reform is needed, or do you think the regulators are engaged in some overkill?

Debbie Cunningham: The SEC's efforts to change the regulations around money market funds were precipitated by the financial crisis of 2007 and 2008, and the impact on the Primary Reserve Fund, where it "broke the buck" with defaulted paper. At that point customers didn't know what their portfolios owned anymore and just wanted to get out. So the prime money fund industry fell by about 25% from September 15 to September 19, 2008.

With 2002's amendment, the SEC changed some risk-mitigating devices—things like shorter weighted-average maturities and more liquidity. The 2014 amendment that will take effect this October introduces floating-net asset value, gates and fees. These are packaging changes that affect how a fund is sold and what the end result is for the customer. But the actual changes to the fund portfolios and how they are managed occurred after the 2010 amendment. I do think that 2010 was enough and that the 2014 changes are overkill.

Jeff Carson: Although the 2010 reforms were an important step in making money market funds safer, analysis by the SEC suggested additional reforms were needed. I think there

were some opportunities regarding the operational and regulatory costs necessary to implement these changes and the unintended consequences of the reform, but this is the environment we're in and we've got to work within it.

Christine Kopec: The question is whether or not these new features fundamentally change the utility or the appeal of funds. The new reforms were intended to make them safer and avoid runs. But if certain features render funds out of guideline, or just untenable for an investor, then the intent becomes irrelevant. We're trying to figure out what these changes ultimately mean for clients.

Tom Callahan: There was a lack of confidence after the crisis and something needed to be done. The very lengthy rule making process, which I think was described by one of the SEC commissioners as one of the most difficult in the history of the agency, went on for almost five years. During that period various people in the industry were either for or against gates or fees or floating NAV, but none of us asked for all of the above, which is what we got. Now we're left in the uncomfortable position of having to go to our clients and explain how these three new substantial features are going to make prime funds a viable option for them going forward.

Patrick Tadie: It'll be interesting also to see what happens if those come into play. A lot of people don't expect it to happen very often, hopefully never. But if it does happen, it will be interesting to see what the clients' reactions are and

"It seems clear that there will be a shift of assets to government funds."

Jeff Silverstein
A partner in Seward and Kissell's Real Estate and Global Bank and Institutional Finance and Restructuring groups

whether they go back to their advisors and say, "Hey, wait a minute, I didn't really understand that."

Jeff Silverstein: It's going to be a difficult situation, because on the one hand all these changes are probably beneficial in the long run and will make money market funds a safer product. But, particularly in a structured finance transaction, or a corporate debt transaction where the cash needs to be there on the payment date or else there's a default, it's difficult to look at the possibility of a gate without changes in the transaction documents to accommodate that.

Cunningham: The likelihood of a gate being imposed under the new rules, in contrast to the likelihood of a gate being imposed now without the new rules, is identical. There were just clarifications on trigger points and when the board needs to meet to review issues. A gate is never going to be imposed on a willy-nilly basis. This is something that would be highly unlikely.

Callahan: If one of our funds, or any prime fund, were to break liquidity and have to apply gates or fees, that's the end of that fund. That would result in a permanent loss of confidence by investors. So the thought that somehow we're going to be willy-nilly putting in gates and fees is just wrong. We're all going to run a lot of excess liquidity to make sure that we never come near [the 30% reserve liquidity threshold stipulated by the new rules – editor], because breaking liquidity is the equivalent of breaking the buck. It would be a fatal blow to a money market fund.

Kopec: That will be another dynamic to watch. The rule doesn't say that you have to impose a fee or a gate. It says that the board has to at least contemplate imposing one or take some other action. The question is: Will clients recognize that this is meant to protect investors? The threshold for boards is very high, and this isn't something they will do the minute something falls below 30%.

Another question is: Will people come to expect higher liquidity as the norm? One of the things we think a lot about is yield. There's a one-for-one trade off—the more liquidity you build up in a fund, the lesser the yield potential. If the main thing investors want out of the fund is the yield. You have to play with those tradeoffs and see whether people will take different types of risks in prime funds.

Kass: What do you think the impact of all of this will be on interest rates?

Silverstein: It seems clear that there will be some shift of assets to government funds. That's a huge market, and whether that shift will be enough to have a material effect on rates remains to be seen. The greater concern is the commercial paper market. If large amounts of institutional money are shifting to government, what's going to be left for commercial paper? There I would expect a greater likelihood of seeing some effect on rates and commercial paper becoming more expensive.

Cunningham: Government yields will definitely go lower and prime yields higher.

Tadie: There are going to be some investors who say, 'I really don't like what I'm seeing in the government space. I don't like the rates; I need to find something else that's going to yield more.' And maybe that has an unintended effect and people start

"It's a massive implementation of something that's never been done before, and it has to be carried out simultaneously among lots of different asset managers."

Christina Kopec
Head of product strategy for fixed income and global liquidity at Goldman Sachs

looking at something that might be viewed as more risky.

Kass: What are you doing to prep your clients for all of this? What kind of conversations are you having and what kind of concerns are coming up?

Carson: It's a process. First of all, you've got to educate your client-facing teams about what's going on, so when a client calls they can answer their questions [and suggest] other options. And if you give something to the client to review, maybe that starts another conversation around features that they haven't really thought of in the past such as; 'What are your goals? Is it liquidity? Safety? Yield? What's your time horizon?' Money market funds were something clients never really thought about in the past. Now they have to become more involved in the process.

Tadie: Another thing we've looked at is what do the transaction documents look like—can you make retroactive changes or not? Do we have to change the definition of what's an acceptable investment?

Silverstein: Particularly on the corporate trust side, we've been urging all our clients to be very proactive in getting all necessary information from the various money market fund providers, to their corporate trust clients as early as possible, so that these ultimate decision makers can be in position to make the

necessary elections in a timely manner. And those decisions will need to be made well before October.

Carson: Everyone's been targeting October 14, but decisions have to be made much sooner than that. A lot our clients are institutional investors and can't be in a retail fund; by the end of August, they have to choose another option. So that starts that conversation early. Intermediaries are going to have to move their Institutional clients off the sweep platform. If they're in a prime fund, that's going to happen in late August, early September, so even before we get to October 14, there's going to be a lot of mandatory movement into other products, and decisions have to be made months in advance.

Kopec: Over the past two years we've been communicating with clients in phases. First, was assessment—what do the rules actually say? How is this going to work? Then it was planning—what are your options? What are you thinking about? Now we're in the implementation phase. And what we've tried to do is, first of all, be completely clear about the future of our product line, because that is probably the biggest question that most clients have. And then, second, try to narrow for each different type of client what has to be done at this point versus those things they can continue thinking about.

Callahan: I don't think we should underestimate the burden this has put on our clients, because even once you take them through the assessment phase—and it was quite difficult getting them comfortable around fees, gates, floating NAV—then there are still all the internal processes that they have to go through with their boards and to get their investment guidelines changed. Even if they get to that point, then they [still need to consider] things like how many NAVs per day? And, if you're going to have more than one, what time are they going to be? So even if you have board approval, trying to understand which service providers are going to be able to offer which products, and which of those products are going to work within your

infrastructure, is an enormously complex task.

Kass: Several of you alluded to new products that could potentially emerge out of this process. What are you seeing on this front?

Cunningham: We definitely are getting a lot of inquiries about separate accounts, but these have to have a fairly large balance and are suitable for large institutional clients; they're not comingled. For smaller clients, we're going to launch a private prime liquidity product this summer. It will be a billion dollar fund for co-mingled clients. And it will be the exact same product in terms of portfolio management as a prime 2a-7 fund that consists of diversified, high quality, short maturity holdings with triple A ratings. But rather than offer it through a 2a-7 format, it will be offered only to qualified institutional buyers and investors as a private placement through the 3c-7 format. So the institutional community that wants the old product can have it in this private prime liquidity fund.

The other fund that I can tell you about is a maturity restricted 2a-7 fund. We're doing a 60-day one on our prime side and a 7-day one on our municipal side. These will be institutional floating net-asset value products with four zeroes rather than two on the pricing side. But because they're using amortized costs, the likelihood of them fluctuating is extremely minimal. The yield will be better than a government fund, but less than a traditional prime fund, so there's a little bit of a give up to have a very stable asset value product.

Kopec: What will happen on the product side depends entirely on what people value. Do they say, "I have the same need, but now this is the priority," even though in the past it was something else. Or do they have the same priority, and we say, 'We can't give you the same thing because it doesn't exist anymore. We can give you different things with different tradeoffs.' But you have to identify what those tradeoffs are and there's nothing that perfectly replaces what existed. There's also nothing to say that the funds in the future won't meet your need. It's just whether or not you can get comfortable with how they've changed versus what an alternative offering gives you, knowing that neither of them is identical to what you've had in the past.

"At some point industry groups will go back to the regulators and say, 'Here's what's working; here's some confusion. We need to clarify some things.' "

Patrick Tadie
A Group vice president at Wilmington Trust

Kass: So are clients going to opt for the security of a traditional vehicle, or are they going to go for the greater return that they might get from the new product?

Kopec: Exactly. And are they comfortable with an unregulated product, which is what a private fund is, versus a regulated product, which is comparable to what they have today in terms of transparency and compliance.

Callahan: In 2014, when the new rules were announced, there was some hope that the industry was going to re-engineer a whole suite of brand new products that was somehow going to miraculously replicate the institutional prime fund, which was a great one-size-fits-all product that clients all knew and loved. We've tried all sorts of innovation: We have a seven day product that we have live in the market right now that may work for some subset of clients; maybe some clients get comfortable around unregulated funds; I think all of our separately managed account businesses are growing quickly. But the conversation has shifted from 'what's the magic bullet new product?' to 'how are we going to take the products that we already have and make them work within the client's infrastructure?' That's when the conversation gets tricky, because

this one wants an 8 AM NAV and that one wants 9. These shades of grey may not sound so important to people on the outside, but for clients who need those specific features to make these funds work in their infrastructure, they become critical. So it's much more about how can we be as operationally flexible as possible, as opposed to some skunkworks new product that's going to take the market by storm.

Kass: What about this whole process keeps you up at night?

Silverstein: My concern is having the thousands of clients that need to make their investment decisions determine what the appropriate product is for their needs. Also, communicating those decisions to their trustees is going to be a difficult process. I know our clients are working very hard to be ready, but it's going to be a lot of work over the next several months.

Cunningham: I think communication is the key to that. We know what the packaging differences for the funds will look like. We know what the structural effects on the portfolio will be. But we have yet to deal with the clients' decision making and reaction to these changes. So we need to communicate with them continuously to get us through the October timeframe.

Tadie: We'll see what happens after October, because there's going to be a lot of feedback back to the market, and my guess is there'll be some changes based on that. At some point industry groups will go back to the regulators and say, "Here's what's working; here's some confusion. We need to clarify some things." It'll be an iterative process.

Kopec: We need to make sure that implementation goes smoothly from an operations, pricing and trade flow standpoint. All that just has to work, and that's [a tall order] because it's a massive implementation of something that's never been done before, and it has to be carried out simultaneously among lots of different asset managers.

"If one of our funds, or any prime fund, were to break liquidity and have to apply gates or fees, that's the end of that fund."

Tom Callahan
BlackRock's Global Cash Management business

Callahan: One of our big fears is the unintended consequence that all this is going to have on government funds and their ability to stay open past 3 o'clock. There's consensus in the industry that prime funds are going to strike their final NAV at 3 PM. Traditionally, the way asset managers have been able to keep their government repo funds open late in the day is by having a joint trading account between a prime fund and a government fund. But now that prime funds are closing at 3 PM, the ability of government funds to stay open past 3 PM is going to be sorely challenged and a huge part of our industry needs liquidity after 3 PM. For example, the DTCC doesn't even do settlement until 3 PM. If the industry is not able to offer a deep liquid post-3 PM solution, I think that's going to be very damaging to a meaningful number of our clients.

Carson: My fear is for the client that waits too long to make a decision. It's not like—'okay, I'm moving you out of sweep into this product.' Even with the best processes in place, there are a number of steps that need to happen, and that takes time.

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Ygrene Stepping Up the PACE

Demand for loans that allow homeowners to finance energy-efficiency upgrades by increasing their property taxes is booming and Ygrene Energy Fund is planning regular trips to the securitization market to finance its programs.

The California-based originator of Property Assessed Clean Energy (PACE) financing is preparing its first public PACE bond securitization as early as this summer, in a $150 million transaction that will be rated by Kroll Bond Rating Agency. Another $200 million transaction is planned for the fall. And by 2017, it expects to come to market quarterly.


Stacey Lawson

To date, Ygrene has completed one securitization, a private placement, in 2015, in a deal privately rated by KBRA.

The Company Plans Two Rated Deals This Year

To fund all of these energy efficiency projects for homes and businesses, it has obtained a new $250 million warehouse credit facility from three undisclosed banks, boosting total committed capital to over $785 million. Ygrene is riding a surge of interest in the PACE arena, which in 2016 expects to see $2 billion of loans originated – equaling the volume that dozens of PACE programs nationwide have issued for approximately the past eight years.

"What we're seeing in the marketplace is a massive [increase] in volume," said Stacey Lawson, Ygrene's chief executive,.

That is still just a sliver of the overall $200 billion energy-upgrade market, according to Lawson. But she said there is plenty of demand for "green" investments such as bonds backed by pools of residential energy efficiency and renewable energy improvement loans.

PACE loans provide an alternative financing vehicle for homeowners and companies by offering loans that are repaid through local or state tax assessments. While PACE loans are relatively small-dollar in relation to the house value, they hold a first-lien position on improved properties (a potential conflict with federally guaranteed loans backed by the Federal Housing Finance Agency).

They provide institutional investors that have long-term liabilities – such as life insurance companies or pension funds – with matching long-life, lower-risk assets providing yield on extended terms of up to 20 years.

Ygrene's initial securitization was placed with a single investor, a U.S. insurer. Renovate America, another PACE originator, has completed seven rated deals since 2013. In June, it placed $305.3 million of 'AA'-rated bonds.

A standard PACE loan usually prescribes that cost savings from energy upgrades exceed the annual levies from the special assessment assigned by the PACE lien. (In Renovate's latest deal, the 13,432 assessments had an average balance of $23,433 with average annual payments of $3,149).

Energy upgrades are more than solar panels; many of Ygrene's loans fund HVAC installations, energy-efficient window upgrades, and LED lighting. PACE programs are also being expanded for use in home improvements to mitigate climate concerns. PACE loans have been used to build sea walls and raise foundations to better protect Florida residences from hurricanes or to back water conservation or irrigation improvements in drought-stricken California.

The expansion of PACE utilization is matching the geographic expanse of PACE programs to more than 30 states, and an institutional investor base than has exceeded 60 firms, Lawson said. What is attracting many to the sector is PACE's hybrid structure as a tax-lien securitization within a traditional residential mortgage-based securities model: The pool of assets in a PACE securitization involves thousands of homes with attached PACE assessments, typically with balances in the $20,000 region. But instead of proceeds from P&I receivables, the investor returns come from tax collections – a far more reliable cash flow resource for investors.

Thee limited historical data on credit performance has kept rating agencies from assigning ratings higher than double-A. But Lawson believes that they will soon feel comfortable assigning triple-A ratings as origination volume increases and robust secondary market develops.

Another concerns is that Federal Housing Finance Agency, which oversees Fannie Mae and Freddie Mac, objects to PACE liens that are senior to those of the two housing agencies.

But ratings agencies have downplayed the risk of a regulatory challeng. And Lawson said that the GSEs are providing guarantees on homes with PACE liens; only a small number of Fannie/Freddie-backed loans have been contingent on a PACE lien payoff.

"You might see prepay speeds go up a little bit [6-8%], and that is already factored into many of the models of the ABS securitizations we've seen," she said. — *GF*

Duke's Utility Fee Deal Sets Important Precedent

Duke Energy Florida marketed its $1.3 billion securitization of utility fees as a corporate bond, and the strategy appears to have paid off. The deal was priced last week at interest rates in line with those of some the highest rated U.S. companies and government agencies.

DEF's bonds are tied to a special charge on the utility's electric delivery and transmission services that are associated with the retirement of the Crystal River Unit 3 nuclear power plant. The bonds are also backed by a guarantee of the state's utility regulator to adjust the charge every six months to whatever level is necessary to pay the bonds on time.

Barclays Classify Bonds as Corporates for Bond Indexes

The securities have unusually long durations for this sector; over $500 million had maturities from 15 to almost 19 years. By comparison, most other deals in the utility sector have original terms under 10 years.

The tranche with the longest duration pays a spread over Treasuries similar to those of triple-A rated bonds issued by Johnson & Johnson and the Tennessee Valley Authority.

The all-in duration adjust cost of the $1.297 billion offering was 2.72%, an all-time low for a bond offering with such long maturities, according to Andrew Maurey, director of the division of accounting and finance at the Florida Public Service Commission.

Even so, DEF may have left some money on the table. That's because it wasn't until Friday, after the deal priced, that Barclays announced it would classify the bonds as corporates for the purposes of its bond indexes — which could attract a broader investment base.

Had this determination been made before the bonds were priced, DEF might have lowered its funding costs even further.

The 15.2-year and 18.7-year tranche were the most successful, pricing 103 basis points and 116 basis points over the G-curve, or interpolated Treasuries curve, respectively. In the case of the 18.7-year bond, that was just 3.0 basis points more than a comparable bond issued by Johnson & Johnson.

RBC Capital Markets and Guggenheim Securities served as joint bookrunning managers.

Still, inclusion in Barclays' corporate index could set a precedent for future utility deals structured in a similar manner.

The bonds will be issued by DEF's wholly owned, but bankruptcy remote, subsidiary, Duke Energy Florida Project Finance. The offering prospectus was filed with the Securities and Exchange Commission on a form SF-1, which is designated for asset-backeds. Yet this filing describes the bonds as "a type of ratepayer obligation charge bond." It goes on to state that the bonds are "corporate securities," and "are not asset-backed securities as defined by the SEC governing regulations."

Notably, there is no tranching for credit risk; all five tranches of securities issued by DEF Project Finance are rated triple-A by three credit rating agencies: Moody's Investors Service, Standard & Poor's, and Fitch Ratings. That means neither investors nor rating agencies need to analyze how cash flows might be diverted to different classes of bonds under different scenarios. The only difference between the classes is the maturity dates.

Crystal River Nuclear Plant

The bonds will be included on DEF's consolidated balance sheet and treated as debt of DEF for U.S. corporate income tax purposes.

DEF may have left some money on the table in another respect: It did not market the bonds to European investors, traditionally important buyers of utility fee securitizations.

Deal Was Not Marketed to European Investors

Maurey said that the Commission did consider the European market, but concluded that the bonds could be priced and sold cost effectively in the US without having to cross the pond.

"Given how the markets reacted to Brexit news at the time of pricing, perhaps a European effort would have produced even better results," he said. "We had a great outcome with this issuance. But if the need to issue these type of bonds arises in the future, expanding the marketing beyond the U.S. should receive stronger consideration." — *AB*

Latest Blow to Tobacco Bonds? Higher California Smoking Age

California's new, higher legal smoking age heralds more trouble for securitization of tobacco settlement payments.

On June 9, the legal age for purchasing tobacco products in the state went up three years, to 21. The move is expected to lower the state's tax income by about $68 million a year, according to legislative analyses.

It could also have broad implications for other states that depend on a tobacco sales tax for revenue as well as for investors in bonds backed by revenue that U.S. tobacco companies agreed to pay under a 1998 master settlement agreement with 46 states, Washington D.C., and Puerto Rico.

Richard Larkin

"As an analyst covering tobacco bonds, I am concerned about anything that will reduce future receipts needed to repay debt," said Richard Larkin, director of municipal credit analysis at Stoever Glass & Co.

Legal Age for Purchases Rises Three Years, to 21

States have received more than $50 billion so far under the MSA, according to the National Association of State Attorneys General, which manages the agreement. The bonds are secured by the states' share of revenue from the master settlement.

A lot has changed in the 18 years since the MSA. Sales of cigarettes and other tobacco products have declined steadily, with tobacco excise tax revenue falling from its peak in the late 1990s.

In California, Larkin said, both of these dynamics will be factors if voters approve a new tobacco tax measure that is expected on the November ballot; combined they could potentially reduce cigarette consumption and sales by up to 19% in the state, Larkin said.

"For a state as large as California, which is estimated to contain about 11% of national smokers, the reduced demand will be significant," Larkin said.

It is currently estimated that declines in national consumption must be less than 3.5% annually for most tobacco bonds to pay in full.

Between the already implemented change in legal smoking age, and the expected tobacco tax ballot measure, California could single-handedly take care of a 2.1% annual decline, Larkin said.

"I have seen studies that estimate in 2015 that smokers from 18 to 24 in California represent 15% of all smokers," Larkin said.

He said the current price of a pack of cigarettes in California is $5.89. Studies show that a 10% increase reduces demand by 3.5%. In California's case, the proposed $2-per-pack tax would be a 34% increase. Using the multiplier, the tax increase alone could cause demand to drop another 12%, he said.

Tobacco bonds are supposed to be structured to deal with almost any future developments and still have money to pay bondholders in full. When they were first sold in 1999, Larkin said, there were believed to be only two variables that would affect tobacco cash flow: inflation, which has a built-in 3% inflation adjustment, and consumption trends.

At the time, rating analysts and investors believed that consumption declines would be less than 2% annually, he said.

"I started covering tobaccos in 2003, and found that consumption declines were averaging about 4%, twice as bad as assumed," Larkin said. "Since 1998, the average declines have been a little more than 4%."

Cash Flows Are Increasingly Unpredictable

In 2005, a new dynamic reared its head: The tobacco companies began withholding between 10% and 15% of their annual payments under a permitted clause in the settlement, he said.

"At first, no one took these disputes seriously except me," he said. "By 2010, the rating agencies finally began to recognize that these disputes were not going away, and started downgrading them until most tobaccos were rated below investment grade."

In 2013, about 26 states decided to settle their disputes from 2003 for partial payments; about 16 states were exempted from litigation on 2003's dispute. Six states lost their cases in arbitration. Those disputes continue, even for this year based on 2015 consumption and sales.

A handful of states are seeking to privately and individually settle their portions of the dispute with Philip Morris.

"With the confusion and unpredictability of all of these settlements, arbitration rulings, continued disputes, and now privately negotiated side-settlements, any notion that these bonds were predictable securitized bonds with predictable cash flows is out the window," Larkin said.—*Keeley Webster*

Why More CLO Managers Are Putting Deals on Autopilot

The economics of actively managing a pool of leveraged loans for the benefit of several different classes of investors are not good. So some CLO managers are putting their deals on autopilot.

Managers of collateralized loan obligations profit from the "arbitrage," or difference between the interest they pay on the bonds and the interest they receive on the loans. The narrower the spread between these two yields, the skimpier the profit.

Even before Britain voted to leave the European Union, sending investors into "risk-off" mode, this spread was narrow, by recent standards. That was partly because issuance of leveraged loans has been relatively scarce this year, and partly because CLO investors soured on the deteriorating credit quality of energy and other commodity loans backing CLOs.

Narrow profit margins are less of a problem for CLOs with static portfolios than for those that are actively managed. The low overhead allows managers to charge lower fees. These deals also amortize much more quickly than CLOs with actively managed portfolio, which appeals to certain investors.

In the first six months of the year, four managers - Palmer Square Capital Management, American Capital CLO Management, Zais Group and Telos Asset Management - issued static CLOs totaling $1.1 billion, according to Wells Fargo Securities. Three of them are small shops with $5 billion or less in CLO assets under management.

While that's a small portion of overall CLO issuance, it's at a pace without precedent since the financial crisis.

"There were ad hoc issuances of static or semi-static CLOs, but what we've seen this year, especially at beginning of the year, is very different from what we've seen the last four years," said Leon Mogunov, a structured finance analyst at Moody's Investors Service. "There was a good reason for that. It's all about arbitrage; it's about opportunistic time during the specific market conditions."

Palmer Square of Mission Woods, Kansas, has completed two static CLOs this year, and it plans to come to market regularly. The firm has built a dedicated platform to separate static CLOs from its five previous transactions, which are actively managed. It plans to come to market regularly with static deals.

President Chris Long says that these deals attract a wider base of investors who aren't comfortable with or knowledgeable enough about how CLOs are actively managed.

Management fees are typically 25% to 50% lower than fees for actively managed CLOs, Long said. And that's not because managers step away after the ramp-up and marketing of a portfolio – they still must conduct credit analysis on asset and industry performance. But managers do not have to manage cash balances from repayments to schedule for reinvestments, for instance; they also are excused from having to rebalance the portfolio for overcollateralization and other tests due to the immediate amortizing nature of the vehicle.

Static CLOs also benefit from lower legal and ratings agency fees as well as document expenses, said Long.

"You can see and touch the portfolio right off the bat and make an investment decision based on your comfort level," he said. Ultimately, "we believe the return is also more predictable, in that the expected returns fall into a relatively tight band given the shorter duration of the product."

There's a downside to putting an investment portfolio on autopilot, however: Ivestors risk being stuck with loans to companies that are in financial distress or default, since managers are unable to sell assets and replace them with better ones. This puts the onus on manager to make good decisions right out of the gate.

Long says Palmer Square selects higher-rated loans for its CLOs. —GF

Supreme Court Leaves Lenders in Lurch by Passing on Case

The Supreme Court's June 27 decision not to hear a closely watched lending case leaves unresolved some key questions for the U.S. financial industry.

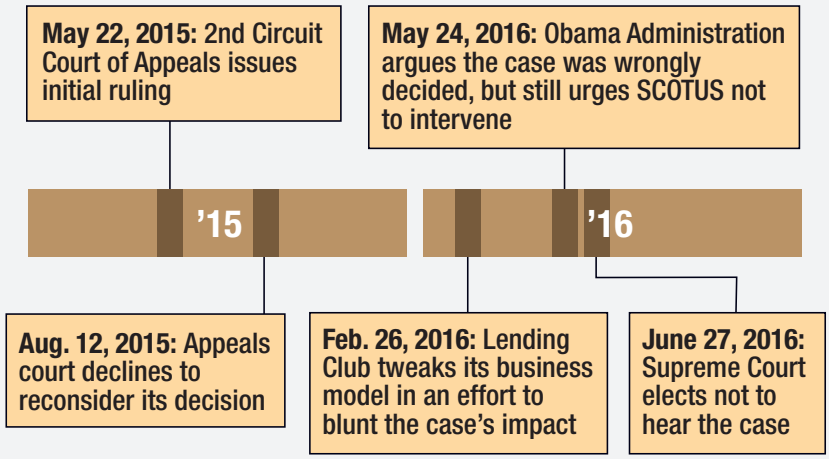
Among them: Can marketplace lenders convince investors that loans in excess of state rate caps are safe to buy? Will continued uncertainty impact the market for certain bonds that are backed by consumer loans? And should banks be worried about a potential erosion of their longstanding pre-emption authority?

"We're sort of at halftime of the game here. And we still need to see how the second half plays out," said Brian Korn, a partner at Manatt, Phelps & Phillips.

The case, Madden v. Midland Funding now heads back to U.S. District Court for further proceedings.

Uncertainty Reigns

Consumer lenders have been waiting more than a year for clarity on the enforceability of state interest rate caps



Source: Staff reports

The lawsuit arose from the sale of charged-off credit card debt from a Bank of America subsidiary to Midland Funding. A New York resident named Saliha Madden sued, arguing that once the debt was sold to a nonbank, the Empire State's usury cap applied. Therefore, to the extent that Madden originally owed interest at rates in excess of New York's cap, it could not be collected.

The 2nd Circuit Court of Appeals sided with Madden in a May 2015 ruling, and one result was that lenders curtailed lending to riskier borrowers in New York, Connecticut and Vermont.

Although Midland lost its appeal, the firm still has legal arguments to make, and could still prevail in district court. But even if that happens, the appeal court's ruling would remain in effect in New York, Connecticut and Vermont, said Kevin Petrasic, a partner at White & Case.

Marketplace lenders are still plagued by uncertainty. For more than a year, consumer lenders that partner with banks in an effort to get around state usury laws have been seeking to reassure skittish investors that their loans are not overly risky. The Supreme Court's decision to stay out of the fray could make their job more difficult.

"With further court decisions needed to provide more clarity around the likelihood of losses resulting from the use of the partner bank origination model, whether the current arrangement remains viable remains to be seen," Alan Birnbaum, a senior analyst at Moody's Investors Service, said in a press release.

Under the business model at issue, lenders originate the loans but typically hold on to them for only a few days before they are sold to investors.

Earlier this year, Lending Club, which has originated more loans than any other marketplace lender, made changes to its relationship with Utah-based WebBank in an effort to blunt the impact of the Madden case.

Lending Club also faces a proposed class-action lawsuit that raises similar legal issues. In a June 27 statement, the firm said, "While we are confident that the facts of the case do not directly apply to our business, we look forward to a decision by the lower courts which will reduce unnecessary uncertainty for investors on our platform."

Two other large marketplace lenders, Prosper Marketplace and Avant, no longer make loans to residents of New York, Connecticut and Vermont at rates that exceed the state usury caps.

Prosper declined to comment on the Supreme Court's decision. Avant said in an email, "The ruling was largely expected and does not change the current operations of the Avant platform." — *Kevin Wack*

Who's Afraid of TRID Risk? It's Not Who You Might Think

You'd think a meteor called TRID had hit the secondary mortgage market. Liquidity has dried up since the Consumer Financial Protection Bureau's disclosure rule took effect in October. Private-label securitization has slowed to a trickle.

The conventional explanation is that the rule has vastly expanded the range of potentially erroneous information that the purchaser of a whole loan or loan securitization could be liable for. No one wants to buy trouble. But this may not be the whole story.

There's a general agreement among mortgage market participants that the liability created by TRID (also known as the "Know Before You Owe" rule) is limited and quantifiable. Statutory damages are not available to borrowers for all violations, and are capped at $4,000, plus attorney's fees. Several credit rating agencies have stated that they are comfortable rating bonds backed by loans with violations.

Given those assurances, why aren't deals getting done? According to Laurence Platt, a partner at Mayer Brown, part of the blame lies with third-party firms hired to review the credit quality of loans backing mortgage bonds. He thinks they are labeling too many violations as "material," leaving too few loans available for securitization.

"It's up to investors to determine what they want to buy and what to pay for it," Platt said. "It's fine for a third-party reviewer to identify errors, but my position is that it's not the job of third-party reviewer to determine materiality."

Platt isn't pulling any punches. He says he made this point at a Mortgage Bankers Association conference in June — on a panel that included John Levonick, the head of compliance at Clayton, a leading third party loan reviewer.

"There's a debate as to whether TRID is being treated in an unduly important way," Platt said in an interview. "The answer I heard at the seminar is that, because we can measure for it, it matters. There might be other types of deficiencies or violations, but they [due diligence providers] don't measure for it. You can't always find [defects or violations] on the face of a loan file."

Even when statutory damages are available to the borrower and the assignee is liable, a borrower will only assert a claim on a property that has been foreclosed on, Platt said. In general, this will only happen in the 22 states where the foreclosure process goes through the courts.

> *"It's up to investors to determine what they want to buy and what to pay for it. ... It's not the job of a third-party reviewer to determine materiality."*

In theory, a borrower could hire a lawyer to seek actual damages, which are calculated according to the degree of harm to the plaintiff rather than stipulated in a statute. "But it is virtually impossible to prove actual damages based on a nondisclosure violation," Platt said.

Levonick, also reached by phone, defended Clayton's practice of labeling a wide range of violations as material.

Even before TRID, "there was a clear delineation of assignee liability: Investors wouldn't buy loans with assignee liability because of the significant loss severity, for example HOEPA violations," he said, referring to the Home Ownership and Equity Protection Act of 1994. "Now, with TRID, there exists a world of assignee liability as it applies to statutory damages where the loss can be quantified due to the cap on damages per occurrence."

The likelihood of a consumer making a successful claim for actual damages, when they must prove detrimental reliance and can only recoup $4,000 due to an applicable TRID error, is so low it could be considered nonmaterial, Lenovick acknowledged. "But a consumer does not have to prove they were harmed to collect statutory damages, because of the strict liability aspects of certain TRID requirements."

While it might be hard for a single borrower to retain counsel to recover $4,000, there is fertile ground for a class action. "I can only imagine that the plaintiff's bar is ready, willing, and able to start testing the law through litigation," Levonick said. "We can absolutely expect TRID-related litigation in the future."

Depending on an investor's exit strategy, the mere possibility of a lawsuit could make purchasing such a loan with a nonmaterial TRID error unattractive. "A securitization trust is not structured to handle litigation," Levonick said.

Platt dismissed the threat of class action lawsuits as "not realistic," citing a cap under the Truth in Lending Act on statutory damages for class actions to $1 million or the holder's net worth, whichever is less.—*AB*

Too Many Insurers, Not Enough Mortgages, Says MGIC

This mortgage insurance market ain't big enough for all seven of us. So says Patrick Sinks, CEO of MGIC Investment Corp., which has seen its market share chipped away by smaller, newer underwriters created after the housing crisis.

MGIC was the market leader in the heady days before the mortgage crisis, when origination volume was high enough to sustain as many as eight private mortgage insurance underwriters. Now there are seven competing for a share of a much smaller originations market.

Assuming volume of $1.5 trillion per year, the share that would use PMI is approximately $200 billion in originations, Sinks said.

Mergers Are Possible, But Not Imminent

At that level, "I don't know that there is enough business to go around for seven MI companies," he said at a June 1 investor conference, adding that the need to develop new revenue sources is why the MIs are looking at front-end risk sharing arrangements with the government-sponsored enterprises.

The possibility for merger-and-acquisition activity exists, but nothing is imminent, he said, explaining that any consolidation will likely be prompted by shareholder angst over low revenue in an oversaturated market.

Of the seven companies, PMI is the primary business for four publicly traded companies: MGIC, Radian Group, Essent Group and NMI Holdings. The other three are subsidiaries of publicly traded insurers that write multiple lines of business.

There has been some speculation about possible mergers in the MI space. This includes a published report that said Radian's board could elect to sell the company in the wake of the planned retirement of CEO S.A. Ibrahim and that Essent was the most likely suitor.

Meanwhile, American International Group plans to sell a 19.9% stake in United Guaranty Corp. in an initial public offering. But dissident AIG shareholders had been pushing for a total divestiture or sale of UG.

Radian Chief FinanialOficer Frank Hall when asked about consolidation during that company's presentation said, "The industry has operated with more competitors and fewer competitors, and what the right number is, I don't know."

And National MI's chairman and CEO Bradley Shuster noted there is "a lot of talk about consolidation, but very little real consolidation."

But even if there is merger activity, investors should not count on the surviving entity retaining the combined market share, MGIC's Sinks said.

"If you have a lender who does business with four MIs and two of them consolidate, that doesn't mean you're going to hold that position. You're going to lose that. So the seller obviously wants to maximize their value for their shareholders, while the buyer has to factor in a potential loss of market share," he explained.

What would make a merger successful is taking enough expenses out of the combination to justify the transaction, he continued.

All of the MIs have gone to more granular pricing and that has compression in the market share spread between the largest and smallest MIs, Sinks said. The smallest two companies, Arch and National MI, each had a 4% share in that quarter, while UG had a 24% share.

Industry Moving to More Granular Pricing

For the most recent quarter, Arch had a 7% share, while UG's share fell to almost 20%. MGIC's share declined to 18% from 21% during that same time frame.

Discounted pricing on borrower-paid MI for the most part has gone away, with the exception being for loans originated by credit unions, Sinks said. Aggressive pricing also remains for lender-paid MI, he added.

The hubbub over policy pricing methodology, black box versus rate card, came up in all three sessions. Each company said it had the ability to replicate the black box method used by UG and Arch MI, but their customers didn't want it.

Shuster questioned the relevance of using a black box algorithm to generate the price. "In today's post-TRID world, rate cards [with a matrix based on credit scores and loan-to-value ratios] are more appealing than a black box," he said.

Most of MGIC's customers "prefer not to have a black box. They would rather have the rate cards because there is a transparent price. They know what they're going to get each and every day," Sinks said.

And as companies have increased the granularity of their rate cards, there is less of a difference between them and black box pricing than has historically been the case, said Derek Brummer, Radian's chief risk officer. "Historically, the black box pricing had an advantage on the kind of the higher credit quality [loan]. That is less the case today," he noted. — *Brad Finkelstein, Jacob Passy*

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