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Asset securitization REPORT

The Premier Guide to Asset and Mortgage-Backed Securitization

REROUTED

FOR THE FIRST TIME SINCE THE CRISIS, CLO MANAGERS ARE SHORING UP COLLATERAL BY DIVERTING FUNDS THAT HAD BEEN EARMARKED FOR JUNIOR CREDITORS

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Asset Securitization Report

The Premier Guide to Asset and Mortgage-Backed Securitization

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REROUTED

FOR THE FIRST TIME SINCE THE CRISIS, CLO MANAGERS ARE SHORING UP COLLATERAL BY DIVERTING FUNDS THAT HAD BEEN EARMARKED FOR JUNIOR CREDITORS

>> by Allison Bisbey

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Asset-backeds of almost all stripes have recovered much of the ground lost early in the year, but the picture for CLOs is complicated. Even as prices of leveraged loans in their portfolios rise, some managers are tripping up against tests designed to protect the credit quality of their portfolios. So far this is only happening to deals with outsized exposure to oil and gas and metals and mining companies. These credits haven't recovered as much as the rest of the loan market and many have been downgraded heavily or are in default. That affects the way managers can value the loans for the purposes of their coverage tests. The upshot: three deals that fell short in April were obliged to divert cash earmarked for junior investors in order to purchase additional collateral. As I explain in my cover story, that's painful for these investors, at least in the short run. But, in theory at least, it ultimately benefits all investors in a deal.

Valuations of debt issued by CLOs have also started to improve, and that has allowed issuance to pick up after a slow start to the year. However, as Justin Plouffe of The Carlyle Group notes in an interview with Glen Fest, the ranks of buyers are still thin. This gives those still at the table more say in the terms.

Relief came early for Europe's CLO market when the ECB announced it was expanding economic stimulus. This allowed managers to complete some deals that had been in the works for months. But one manager that Glen spoke with, Jeremy Ghose of 3i Debt Management, thinks that volitilty will continue to be a problem for this market. It can result in substantial gaps in price expectations between buyers and sellers.

Another story by Glen looks at first quarter earnings of business development companies that have large holdings of CLO debt and equity; they appear to be in no hurry to unload them, despite the selloff in these securities, which has forced them to write down valuations.

—Allison Bisbey, *Editorial Director*

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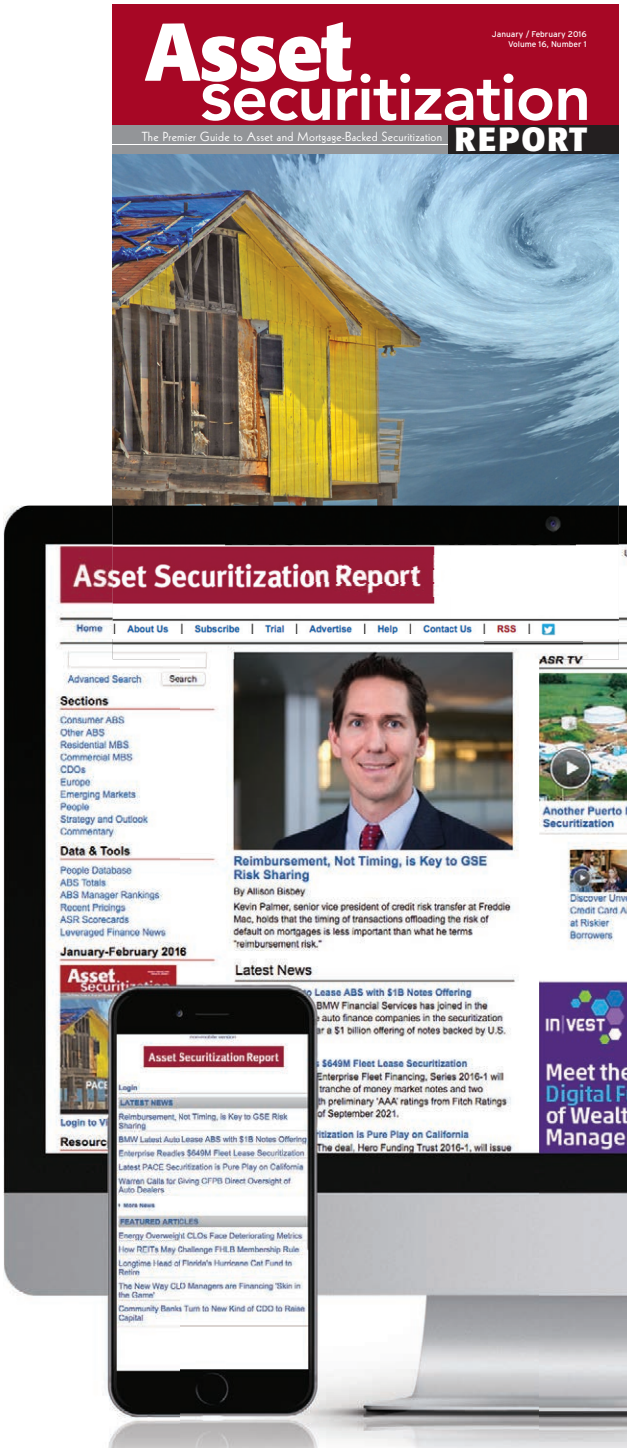

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Where is OCC in Court Battle Over Usury Limits?

BY WILLIAM M. ISAAC AND ALEX J. POLLOCK

A decision of the Second Circuit Court of Appeals in the case of Midland Funding v. Madden threatens the functioning of the national markets in loans and loan-backed securities. The ruling, if it stands, would overturn the more than 150-year-old guiding principle of "valid when made."

The effects of the decision could be wide-ranging, affecting loans beyond the type at issue in the case. It is in the banking industry's interest for the Supreme Court, at the very least, to limit its applicability. And since the Madden case could deal a blow to preemption under the National Bank Act, it is time for the Office of the Comptroller of the Currency to voice an opinion.

Under the valid-when-made principle, if the interest rate on a loan is legal and valid when the loan is originated, it remains so for any party to which the loan is sold or assigned. In other words, the question of who subsequently owns the financial instrument does not change its legal standing. But the appeals court found that a debt buyer does not have the same legal authority as the originating bank to collect the stated interest.

In the words of the amicus brief filed before the U.S. Supreme Court on behalf of several trade associations, "Since the first half of the nineteenth century, this Court has recognized the 'cardinal rule' that a loan that is not usurious in its inception cannot be rendered usurious subsequently. … U.S. credit markets have functioned on the understanding that a loan originated by a national bank under the National Banking Act is subject to the usury law applicable at its origination, regardless of whether and to whom it is subsequently sold or assigned."

This, the argument continues, "is critically important to the functioning of the multitrillion-dollar U.S. credit markets."

And so it is.

Marketplace lenders and investors have already raised intense concerns about the decision, but the impact could go further. The validity of numerous types of loan-backed securities could suddenly be called into question. Packages of whole loans also include the diversified debt of multiple borrowers from different states with different usury limits. But the Madden decision suggests those structures are at risk of violating state usury laws.

A possible interpretation to narrow the impact of the case would be for future court decisions to find that the Madden outcome only applies to the specific situation of this case, namely to defaulted and charged-off loans sold by a national bank to an entity that is not a national bank. Thus, only the buyers of such defaulted debt would be bound by state usury limits in their collection efforts, and the impact will largely be limited to diminishing the value of such loans in the event of default.

The Second Circuit decision might not, based on this hypothesis, apply to performing loans or to the loan markets in general. However, as pointed out in a commentary by Mayer Brown, "it will take years for the Second Circuit to distinguish Madden in enough decisions that the financial industry can get comfortable that Madden is an anomaly." The law firm's commentary presented many potential outcomes, including that the Madden case could be "technically overturned" but without the high court providing explicit support for the "valid-when-made" principle. That "would be a specter haunting the financial industry," according to the firm's analysis.

It would be much better for the Supreme Court to reaffirm the valid-when-made principle as a "cardinal rule" governing markets in loans.

But at this point, one would also expect the OCC, the traditional defender of the powers of national banks and the preemption of state constraints on national bank lending, to be weighing in strongly. The comptroller of the currency should protect the ability of national banks to originate and sell loans guided by the valid-when-made principle.

Everyone agrees that national banks can make loans under federal preemption of state statutes, subject to national bank rules and regulations. Everyone agrees, as far as we know, that the valid-when-made principle is required for loans to move efficiently among lenders and investors in interstate and national markets, whether as whole loans or securities.

In our view, the OCC ought to be taking a clear and forceful public position to support the ability of national banks to originate loans which will be sold into national markets.

William M. Isaac, a former chairman of the FDIC, is senior managing director and global head of financial institutions at FTI Consulting. Alex J. Pollock, a former president and CEO of the Federal Home Loan Bank of Chicago, is distinguished senior fellow at the R Street Institute.

How Far Will RICO Probes of Online Lenders Go?

BY MICHAEL J. BRESNICK AND EVAN MINSBERG

The U.S. Department of Justice is now applying a statute more commonly known in organized crime cases - the Racketeer Influenced Corrupt Organization Act - to the conduct of online payday lenders.

RICO prohibits the "collection of unlawful debt," but its use in dealing with the online lending industry charts new ground. Prosecutors have cited the statute in three recent criminal cases, against Adrian Rubin, Scott Tucker and Charles Hallinan. They must prove the defendants were in the business of lending money "at a [usurious] rate" that was at least twice the enforceable rate. The indictments allege the defendants' business models fit this description perfectly, and that they were able to operate mainly through "sham" arrangements with Indian tribes to claim sovereign immunity from state usury laws.

Whereas Rubin pleaded guilty to the charges against him and is awaiting sentencing, Tucker and Hallinan so far are contesting the allegations made in their indictments, which will present an early opportunity to see the theory tested in the courts.

The government's extension of criminal RICO into online payday lending naturally leads to several related questions:

First, it is logical to wonder if the government might seek to extend the criminal statute into other online lending models. For example, could nonbank purchasers or assignees of consumer loans made over the Internet and funded by banks find themselves the subjects of a criminal RICO investigation if the loans exceeded the limits in state usury laws? The simple answer is possibly, as long as federal preemption laws and the "Valid-When-Made Doctrine" do not apply - issues that are currently before the United States Supreme Court. Indeed, civil RICO has already been extended to marketplace lending, where the statute has been cited in a class action suit against Lending Club that alleges usury violations.

Moreover, although less likely, it is conceivable that the investors, too, could be wrapped up in a RICO investigation if they are aware that the loans to be collected violate state usury laws, since RICO covers anyone who "directly or indirectly" participates in the conduct of the enterprise's affairs.

Second, the same questions apply equally to debt buyers who purchase delinquent loans originated by banks. Might they also be subject to a RICO investigation? Given the government's current approach, it certainly seems possible, depending on the outcome in the Supreme Court, if they seek to collect loans that violate various states' usury laws.

Third, the acquiring banks that have online payday and other lenders as customers, and others involved in the onboarding and monitoring of these merchants, should reconsider the adequacy of their BSA/AML controls and other methods to mitigate fraud and consumer protection risks.

To be sure, prior guidance issued by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp., along with the Federal Financial Institutions Examination Council's BSA/AML exam manual, discuss the need for financial institutions to understand the principal business activities, geographic location, and sales techniques of their merchant customers. This includes whether the merchants are operating legitimate businesses. Unfortunately, these requirements are written only in general terms and institutions looking for more specific advice may be frustrated.

For example, institutions may wonder to what extent they must investigate in which states their lender customers make loans, study the various APRs of such loans, and be certain that the recipients of each of the loans live in states that do not have bans or other rate caps. With respect to online payday lenders, they also may ask if they need to be certain that the stated relationships between payday lending businesses and tribes are more than sham arrangements.

Lenders, financial institutions and others in the chain should pay close attention as RICO cases applying to online lenders progress through the courts.

The government's decision to extend RICO's "collection of an unlawful debt" language to online payday lenders is a significant moment in federal law enforcement. If this new theory of law enforcement survives legal challenges, look for the government to continue using it in the online payday lending industry and potentially beyond.

Michael J. Bresnick is chair of the financial services investigations and enforcement practice at Venable LLP in Washington, D.C. Evan Minsberg is an associate at Venable specializing in financial services regulation.

REROUTED

FOR THE FIRST SINCE THE CRISIS, CLO MANAGERS ARE SHORING UP COLLATERAL BY DIVERTING FUNDS EARMARKED FOR JUNIOR CREDITORS

by Allison Bisbey

Sometimes, you have to rob Peter to pay Paul.

For the first time since the financial crisis, some collateralized loan obligations are being forced to divert funds normally used to pay junior noteholders to be used for the benefit of more senior noteholders.

CLOs, collectively the biggest investors in below-investment grade corporate loans, have a number of tests that they must meet each month that are designed to protect the quality of their portfolios. Some of the most common tests measure the amount of collateral supporting each class of notes issued by a CLO (interest diversion), the amount of assets supporting all of the notes, collectively, (overcollateralization) and the amount of interest available to pay notes (interest coverage).

If a CLO fails any of these tests, cash flows earmarked for holders of the most subordinated securities may be used instead to purchase additional collateral. In some cases, the funds may be used

to repay the principal of senior notes
Two CLOs, Mountain Hawk II CLO and ECP CLO 2014-6, failed their interest diversion test for the April payment date, according to research published that month by Deutsche Bank. As a result the managers, Western Asset Management Co. and Silvermine Capital Management, respectively, diverted some cash flow from the most subordinated tranches of these deals, known as the equity, to be reinvested in new collateral.

Another deal managed by Silvermine, Silver Spring CLO, failed two tests, interest diversion and overcollateralization, causing payments to both the single-B rated tranche and the unrated equity tranche to be diverted to pay down principal on the most senior, triple-A rated tranche.

No surprise, all three deals have unusually heavy exposure to the oil and gas and metal and mining industries, where downgrades and defaults of loans have been most heavily concentrated.

Silver Spring CLO, issued in July 2014, had 15% of its portfolio invested in loans to energy companies and 4% in loans to metals and mining companies as of late February, according to Moody's Investors Service.

And ECP CLO 2014-6 had 11% of its portfolio invested in loans to oil and gas companies and 4% in loans to metals and mining companies as of late February.

In comparison, most outstanding CLOs issued since the financial crisis have limited exposures averaging about 6% to energy and commodity-related industries.

While the broader leveraged loan market recovered some lost ground in March and April after selling off steeply in the first two months of the year, a number of companies in these sectors have either been downgraded or have defaulted.

In April alone, three loans totaling $1.7 billion defaulted: Peabody Energy filed for bankruptcy, Vertellus Specialty missed an interest payment, and Stallion Oilfield conducted a distressed debt exchange. That pushed the trailing 12-month institutional leveraged loan default rate to 1.8% in April, up from 1.6% at the end of March, according to Fitch Ratings.

When loans are downgraded too steeply or are in default, they can cause CLOs to trip coverage tests because, at that point, managers can no longer value the loans at par, or face value.

Although managers can avoid realizing a par loss by selling low-priced assets and replacing them with another similarly discounted asset, this kind of substitution is subject to many criteria that depend on the particular deal.

Ideally, diverting cash flows from junior noteholders to purchase additional collateral ultimately benefits all noteholders. That's because CLOs generally fail these tests at times when loan prices are falling, allowing them to acquire new collateral at a discount. And unless these loans are considered to be deeply distressed (generally meaning they are trading below 80 cents on the dollar) the CLOs can value these new loans at face value, for the purposes of their tests. The end result is that all notes held by CLO investors are supported by more assets, and at a lower average cost.

But there just aren't as many bargains as there were at the beginning of the year. Outside of energy, metals and mining, spreads (or risk premiums) on leveraged loans have narrowed considerably over the past three months. As of late April, spreads on double-B rated loans were at 383 basis points over one-month Libor, on average, 25 basis points less than they were one month prior and 75 basis points less than they were three months prior, according to Deutsche Bank.

In other words, the only really cheap loans are the ones that CLO managers probably don't want to buy.

And loans in general are scarce. In the first four months of the year, just $160 billion of leveraged loans were issued, down 25% from the same period a year ago, according to Thomson Reuters LPC. And just $100 million of those loans were syndicated primarily among banks, a decline of 29% on the year. Just $60 billion were syndicated among CLOs and other institutional investors, a de-

While the average CLO has low exposure to the energy and commodity sectors, and to deeply downgraded loans in general, there are likely to be additional deals that divert funds.

cline of 17% on the year.

While the average CLO has low exposure to the energy and commodity sectors, and to deeply downgraded loans in general, there are likely to be some additional deals where managers are compelled to divert funds from junior noteholders to shore up collateral. Deutsche Bank identified five other CLOs that were failing interest diversion tests in April, but had yet to take remedial action: Silvermore CLO, EPC CLO 2013-5, KVK CLO 2014-1, West CLO 2013-1, and Oaktree CLO 2014-1.

The deals were all completed in 2013 and 2014. In the report, the analyst noted that deals printed in 2012 have had more time to build up larger margins of overcollateralization, though downgrades and defaults of loans were chipping away at cushions on these deals as well. On the other hand, deals completed in 2015, after problems at oil and gas companies became apparent, generally do not have any exposure to the energy sector.

Moody's has identified a somewhat larger pool of deals at risk. Although most CLOs that it rates have significant buffers to protect against overcollateralization test failures, 26, or roughly 5%, are at greater risk of because they exceeding their limit on assets rated 'Caa' or lower and have large exposures to the riskiest assets, the rating agency stated in an April 25 report.

Moody's considers interest deferrals to be a negative for mezzanine and junior notes – it has downgraded these portions of both Silver Spring CLO and ECP CLO 2014-6 – at least until the tests are "cured." But it is positive for senior notes, and "could build credit enhancement for even mezzanine and junior notes in the long term," the report states.

The rating agency only rates the senior notes of Mountain Hawk II CLO, the other deal that is already diverting cash flow earmarked for equity holders; as a result it has not downgraded any securities issued by the deal.

The report notes that, during the peak of the 2008-09 credit crisis, nearly 40% of CLOs failed their junior overcollateralization tests, and 10% failed their senior overcollateralization tests. However, cash flow diversion and mandatory deleveraging helped nearly 70% of them cure these test failures within one year.

CLO managers are in a much better position than they were headed into the financial crisis, when they found their hands tied by provisions that made it difficult to add collateral that would have improved the portfolio's credit quality.

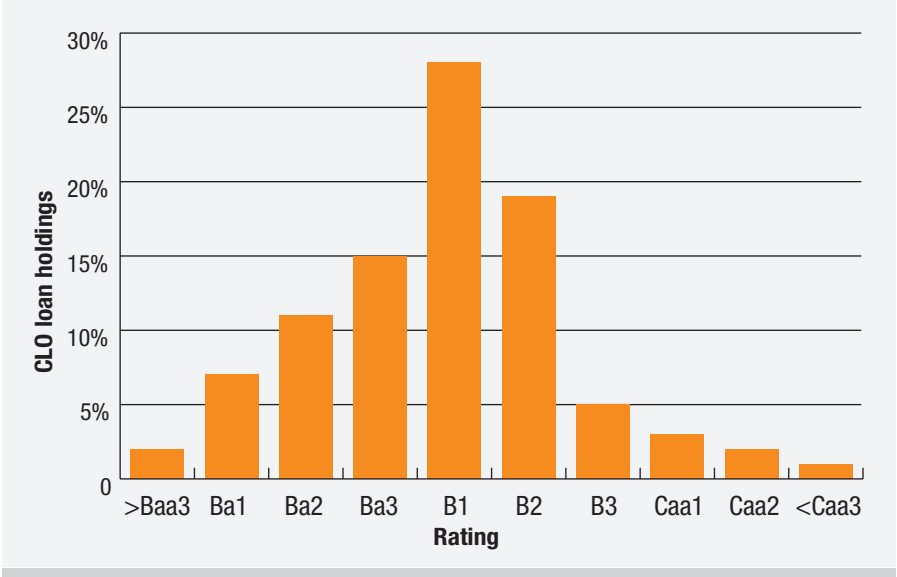
At the time, many deals contained language compelling managers to value collateral acquired at a deep discount at the purchase price. So acquiring such loans would not help them boost their cushions of collateral, at least as measured by their test. This might have made sense in normal market conditions, when only distressed loans traded at deep discounts. But at the time, even the highest quality loans were trading at historic lows, and so had to be classified as deep discount.

As a result, collateral managers would often refrain from substituting a loan of rapidly deteriorating credit quality that did not constitute a deep discount loan at the time of purchase (and therefore was valued at par for purposes of the OC tests) for a higher-quality deep discount loan due to the negative impact the trade would have on OC test compliance.

Since then, many deals issued pre crisis have amended their terms, allowing them to substitute high quality but deeply discounted loans without negatively impacting their overcollateralization tests.

SWEET SPOT

LOANS WITH SINGLE-B RATINGS STILL ACCOUNT FOR THE BULK OF HOLDINGS IN U.S. CLOS; THOSE RATED CAA1 AND BELOW ACCOUNT FOR JUST 5.5%.



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Why Broadly Syndicated CLOs Are Getting Clubbier

The CLO market got off to a rocky start this year, as defaults on leveraged loans started to multiply, sending prices of these assets down sharply and putting many deals at risk of tripping coverage tests.

The resulting selloff in collateralized loan obligations themselves, combined with a dearth of new loans, has made it difficult to bring new deals to market.

But one of the biggest challenges in putting new deals together, according to Justin Plouffe, managing director of U.S. and European CLOs at The Carlyle Group, has the thinning ranks of buyers of CLO debt.

Plouffe says that this has resulted in "clubbier" transactions; that's a term more commonly associated with leveraged buyouts, where a few large investors team up to by a company.

But CLOs are now distributed among a much smaller group of investors than has been the case in recent years. And these investors individually have more power to negotiate deal terms than they would have otherwise.

Just $15.1 billion of CLOs (in 37 deals) were completed in the U.S. through May 2, down 66% from the same period of 2015. The Carlyle Group completed two of them totaling $901 million in April, following what Plouffe described as a deliberative and measured ramp-up of senior-loan assets over first three months of the year

Plouffe is an attorney and former partner at Ropes & Gray who joined Carlyle in 2007. He spoke with *Asset Securitization Report* following the launch of the deal about the loss of liquidity in CLO trading, opportunities for bargain hunting in the secondary loan market, and the firm's efforts to navigate impending rules requiring managers to retain a share of the risk in their deals. An edited transcript follows.

Carlyle GMS CLO 2016-1, issued on April 22, was Carlyle's first CLO for 2016. Can you walk us through the market's trends and challenges, such as volatility in loan spreads, that Carlyle faced in putting together this deal?

Justin Plouffe

JUSTIN PLOUFFE: In the first quarter of the year there have been fewer participants in the debt tranches of CLOs. That means that it takes longer to put a transaction together.

Transactions tend to be less broadly distributed and more bilaterally negotiated. We've seen this in the market before. The market comes and goes in terms of the number of participants. That's probably that largest challenge, that there have been fewer participants in the market.

How do you view the market conditions right now for new deals? Can the new primary issuance market recover enough to still reach the forecasted 2016 volume levels of $75 billion to $90 billion?

I think issuance will pick up for the remainder of the year, but I doubt it will be at the level that gets us above $75 billion.

Is the secondary market becoming a growing resource for CLO issuance out of necessity to fill the pipeline, or because of sell-off pricing opportunities?

Both.

One of the challenges on the asset side is lack of consistent new issuance in the loan market. That means collateral managers have no choice except to turn to the secondary market. But I think volatility in the secondary market also offers some attractive opportunities. Many managers like the value they can purchase in the secondary market so turn to the secondary as a means of ramping up a portfolio.

How has the lack of liquidity been impacting the trading of CLO paper this year?

Liquidity has been inconsistent. Earlier in the quarter, when we saw significant widening of spreads in the junior part of the capital structure, that widening did not seem to be based on a significant amount of volume, and when trades picked up we saw spreads contract.

As growing defaults and downgrades of leveraged loans increase pressure performance of assets in CLOs, do managers have to adapt to new ways of monitoring the portfolio loans for sell/hold decisions?

This is what we have seen in past credit cycles. CLO managers have to pay very close attention to the triple-C

assets, to their WARF [weighted average rating factor] scores, to defaulted assets and assets likely to default because all of those things can make it very difficult to trade within the CLO and they can result in cutting off equity cash flows. The last three or four years have been a very benign default and downgrade environment, but we're seeing that change. But it's not a surprise. This is what happened in the last two credit cycles, and experienced CLO managers should be ready for it.

Will energy exposure continue to stress CLO overcollateralization cushions and the (typically 7.5%) threshold on Caa-rated asset limits? Or do you think CLO managers have that issue contained?

I think that's highly dependent on the CLO manager and specific portfolios. We see certain transactions that are in very good shape in terms of their energy exposure. We see other transactions that we think will continue to have problems throughout the rest of the year. I think that is a question that has to be decided deal by deal.

Has Carlyle made any changes related to its own energy exposure in its CLOs?

We were relatively underweight in energy starting in 2014, so we felt we were well positioned. We have not made any significant changes recently to our energy exposure because we had already underweighted the industry.

Are there particular sectors or certain pockets of the leveraged loan market that may provide good pricing opportunities for CLO managers this year?

There are definitely credits we see that we think are underpriced and areas to add value. I would not say there is one particular sector. It's more of a credit-by-credit analysis.

We are looking to find value in companies that we think have traded off unfairly maybe due to the overall market sentiment and not anything that is fundamentally wrong with their credit profile.

How has Carlyle prepared for the upcoming U.S. risk retention standards? In particular, how do you plan to warehouse or finance the retention stake?

We are prepared to comply with risk retention rules in the U.S. We're starting to see the market require that even though the rules don't technically come into effect until December.

We currently comply with risk retention rules for European CLOs as well. We've been preparing for this for some time. It's an expected market development, and we expect to continue to be in the CLO market in size despite the new regulations.

We take a very straight forward approach: the collateral manager purchases the retention notes. We are interested to see how the market views new types of structures, and we are aware they are out there.

Is Carlyle focused on ways to get future deals into compliance with risk retention rules in both the U.S. and Europe?

Right now, we are not seeking dual compliance for transactions. We have not seen the market demand for that.

There are some complexities to achieving dual compliance. So I think it will be interesting to see over the course of the next 12-24 months whether or not the market moves to require dual compliance.

One of the panels at the upcoming IMN CLO conference will feature discussions about the "real cost" of implementation for risk retention. What do you think have been the real costs that were perhaps unanticipated by regulators and examiners?

Risk retention certainly makes management of CLOs a more capital-intensive business. It is likely to be dominated by managers that have access to more capital, whereas prior to risk retention, managers could be relatively asset lite and balance-sheet lite and still carry on a business. It will change the capitalization of managers in favor of the more heavily capitalized.

"The last three or four years have been a very benign default and downgrade environment, but we're seeing that change. But it's not a surprise. Experienced CLO managers should be ready for it."

I think the other cost is the cost of financing of companies that come to the loan market to be funded. There is a theory that risk retention will reduce the number of CLOs issued – CLOs are a large portion of the loan market – and that could result in increased cost of financing for companies coming to the loan market.

I'm not sure that we've had enough time to see if in fact that has happened, or if the demand for loans will be filled by other sources, but it's definitely something to keep an eye on in the coming years. — GF

Volatility Still a Problem for European CLO Managers

The European Central Bank's announcement of expanded economic stimulus has provided some welcome relief for the region's CLO managers, allowing several to complete deals that had been in the works for months. 3i Debt Management was one of those managers; it priced the €413 Harvest CLO XV in March, some two months after the deal was launched. Jeremy Ghose, the firm's managing partner and CEO, still has a cautious outlook for the remainder of the year, however. In a telephone interview with Asset Securitization Report, he warned that the current rally in European credit markets is likely to run out of gas, and the ensuing volatility will continue to make it difficult to securitize below-investment grade corporate loans and bonds.

And if 3i, one of the biggest European CLO managers, struggled to price a deal in these conditions, where does that leave other smaller, less experienced players?

Ghose, an industry veteran, founded the London-based leveraged finance business of The Mizuho Corporate Bank in 1988. He became one the first non-Japanese board members for Mizuho, joining 3i in 2010 when private equity firm 3i Group acquired Mizuho's investment management business.

How do you see the European CLO market shaping up this year?

JEREMY GHOSE: My view is that it's going to be an up and down year for all in the CLO market, not least in Europe but also the U.S. As you know, in 2015 the total issuance globally was around $100 million to $110 billion. My sense is that it's going to be approximately half of that this year. Our expectation is for approximately $50 billion to $60 billion globally. My sense is that in Europe we're going to see circa $15 billion in total issuance, which will make Europe a much bigger percentage of the global pot.

Why is that the case?

One, Europe is a significantly smaller market than the U.S. The risk retention rules mean that the number of players with the capability of issuing CLOs is about 20, so by default the larger players face an implied ceiling on the number of CLOs they can issue because the investor base is not endless.

Jeremy Ghose

The investor base is in fact very concentrated. Investors want to diversify and they don't typically want to double up or triple up on the same managers or on the same collateral. If you take all of that into account, it means we will continue to see a somewhat constrained CLO market in Europe. However, more positively, a couple of newcomers have printed CLOs and there may be one or two more.

Another factor is deal flow. The private equity houses have a lot of dry powder. So that's good news. But what we typically still see is that in volatile times, there is often a substantial gap in price expectation between what a seller wants for his assets and what a buyer is prepared to pay.

What's the impact of the European Central Bank's expanded stimulus?

Clearly, Mr. [Mario] Draghi's quantitative easing program is overall good news for the credit markets. I think with the ECB increasing it from 60 billion to 80 billion [euros] per month, and extending it to corporate investment grade bond purchasing, this gives the overall markets a big boost. What that also does is delay the credit cycle, which is good news for the CLO market because if defaults are rising on the portfolio side and CLO equity is trading at a very low price in the secondary market, often investors are better off buying that discounted secondary paper as opposed to buying primary new CLO equity.

Does 3i plans additional issuance?

We just priced Harvest XV, which we were hoping to do in January. We were ready to go then, however it took us until the end of March to price the deal, so that shows how tough the current market is. We will continue with our issuance levels, with the next one projected around June/July and, all things being equal, we usually print one in the autumn. That becomes our three CLOs in a calendar year on this side of the ocean, and we also have plans to do the same in the U.S. It remains difficult to issue more than three CLOs in Europe in a calendar year.

This is caveated by what we see on the deal flows side. If there are no deals and the M&A market and PE firms are not active, then there are no loans to invest in. Investors don't want to see us always investing in the same loans. They want to see new primary deals.— GF

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- Bruce Barton

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New Employee Perk Could Be a Boon for Student Lenders

As more U.S. companies help their employees pay off student loans, some lenders are sensing an opportunity to reel in new, potentially high-net-worth customers.

Student loan assistance is emerging as today's hot new employee benefit, in the same way the 401(k) did a few decades ago. These payments, of up to $2,000 annually, are increasingly seen as a way for firms to attract and retain employees who are straining under the weight of education debt.

Some lenders that specialize in refinancing student loans are hoping to profit from this corporate perk. The basic premise is that borrowers who are excited to get a helping hand from their employers will also be amenable to refinancing at a lower interest rate.

In the coming weeks, Citizens Financial Group in Providence, R.I., plans to announce a new partnership with Gradifi, a Boston-based startup that administers student loan assistance benefits on behalf of employers.

Under the deal, the $143 billion-asset Citizens will have the exclusive right to make loan refinancing offers to borrowers who use its partner's platform. Citizens has been looking to grow its student-lending business; its balances increased by 93% last year.

Meanwhile, Social Finance Inc., a rapidly growing online lender that got its start in student loans, recently built its own benefits platform for employers.

SoFi is using its platform to administer employers' student loan contributions, even in cases where the loans are backed by the federal government or another private lender. The company is betting that once borrowers open SoFi accounts, they will be more apt to refinance into a SoFi loan.

There could be cross-selling opportunities as well. Down the road, it's not hard to imagine borrowers — many with advanced degrees and good-paying jobs — turning to lenders that refinanced their student debt for mortgages, car loans or other financial products. SoFi is already offering mortgage loans to many of its student-loan customers.

> *"I know I should be saving for my retirement, but that benefit is pretty attenuated for me. I don't expect to see that money for 40 years."*

Citizens and San Francisco-based SoFi are both responding to a surge in interest in student loan assistance at large U.S corporations.

PwC, the accounting and consulting firm with more than 200,000 employees globally, announced in September that it will contribute $1,200 annually toward reducing an employee's student debt.

Fidelity Investments, which has 45,000 employees, said last month that it will offer them $2,000 per year to help pay back their student loans. Fidelity launched the new benefit following a broad effort to gauge the mood of its workforce.

"What we heard was that student loan debt was a significant challenge," said Jennifer Hanson, head of benefits at Fidelity, referring to feedback provided by the firm's employees. "They were putting off things like buying a home, getting married, having children, until they paid off this debt."

Across the country, total student debt increased from $481 billion in the first quarter of 2006 to $1.32 trillion in the fourth quarter of last year, according to data from the Federal Reserve Board.

Young adults carry the biggest debt burdens, which means loan assistance can be a particularly attractive perk for recent graduates. Nearly 70% of members of the class of 2014 had student debt, and those who did owed an average of $28,950, according to a report last year by the Institute for College Access & Success.

"This is a custom benefit made for the millennials," said Bruce Elliott, manager of compensation and benefits at the Society for Human Resource Management in Alexandria, Va.

His organization found last year in a survey that 3% of participating companies were providing student loan repayment assistance to their employees. Elliott expects that number to rise over time, in part because it has become much easier for employers to offer the benefit.

Within the past 18 months, Gradifi, SoFi and Santa Monica, Calif.-based Tuition.io have all launched programs to administer student loan repayment assistance on behalf of employers. This is a complicated business — in large part be-

See Perk on Page 26 >>

Thaw in Student Loan Market Could Revive Portfolio Sales

Over the past year, threats of steep downgrades have chilled demand for securitizations of federally guaranteed student loans, but two recent transactions suggest that the market is beginning to thaw.

This development could help open the door for banks to resume unloading portfolios of Federal Family Education Loan Program (FFELP) loans. Such loans have become unattractive to hold, because of increased regulatory scrutiny of student lending and loan servicing and because banks see other, more profitable ways to put their money to work.

In February, Navient Corp., the largest servicer in this asset class, sold $1.1 billion of bonds backed by FFELP loans in what chief financial officer Somsak Chivavibul said was the largest such deal in over two years. And in April the company completed a $497 million securitization that, while smaller, was distributed more broadly and commanded far better pricing.

The triple-A rated notes, which have a weighted average life of 5.2 years, were priced to yield 138 basis points over the one-month LIBOR; that's far more than FFELP bonds yielded before Moody's and Fitch put the credit ratings of some $40 billion of these securities on watch last year. But it's also much less than yields at which comparable securities trade in the secondary market, according to research published by Deutsche Bank in April.

The latest deal "opens the door to future transactions," Chivavibul said on a April 20 conference call discussing first -quarter financial results. He noted that Navient acquired the collateral only recently. "There wasn't that avenue over the past year, to acquire a portfolio, unless you had access to term funding."

In November of 2014, Navient disclosed it was buying $8.5 billion of FFELP loans from Wells Fargo; three months later, Bank of America moved $2.7 billion of student loans from its investment portfolio to its available-for-sale portfolio. But bulk portfolio sales ground to a halt last year as a result of the rating reviews.

Moody's and Fitch have yet to conclude their reviews; both are in the process of revising their criteria for rating FFELP bonds to account for the slower rate at which borrowers are repaying loans. Thanks to the growing popularity of some generous government programs, many FFELP bonds are at risk of not paying off at maturity, even though Uncle Sam guarantees they'll be repaid eventually.

"We believe the final criteria will be more favorable than the initial draft proposals, but we decided not to wait to restart our asset-backed program," Jack Remondi, Navient's chief executive, said on the conference call.

The two securitizations that Navient completed this year have a feature, unavailable on most outstanding bonds, that reduces the chance of unpleasant surprises. Both have an extremely long final legal maturity – 49 years. By comparison, most FFELP loans have original terms of 10 years and FFELP bonds typically have 20-year terms.

Navient has also extended the maturity on $4.8 billion of outstanding FFELP bonds to date. On the conference call, Remondi said the longer terms are "well in excess of what's needed" to avoid a maturity default. "This is providing protection to investors … that the ratings will exist through the life of the bonds," he said.

Maturity extensions are one of several options that Navient and other student loan servicers are exploring to avoid downgrades on FFELP bonds. It is looked upon favorably by Fitch and Moody's but can be difficult to execute because in some cases it requires the approval of 100% of the investors.

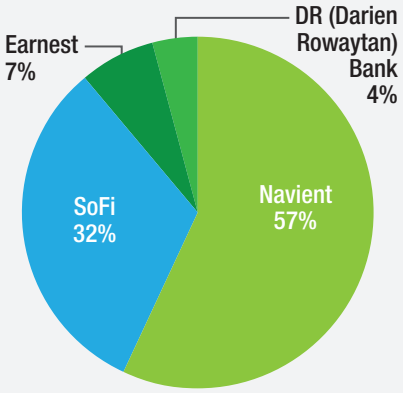
But other options, including repackaging FFELP bonds into new securities with extended maturities and pledges to call bonds at risk of maturity default, are viewed less favorably by the agencies.

The strong reception for Navient's latest securitization could make holders of older bonds reconsider the benefits of extending maturities, however.

"Given the strong execution on this deal, we think that bondholders of watch-listed FFELP who have thus far ignored calls to amend and extend might take another look at whether having very long maturity dates could improve the value of their securities," Deutsche Bank stated in the April report. — *AB*

Big Man on Campus

Navient is the most active securitizer of student loans this year, and the only one reselling federally guaranteed loans. All the rest have securitized only private student loans.



Total issuance as of April 13: $1.7 billion

Sources: Deutsche Bank, Thomson Reuters

Did This Lease Securitization Miss the Train?

Leasing rates for tankers have fallen sharply as oil prices decline and participants wait for new U.S. safety standards to take shape. So it would seem like an inopportune time to tap the securitization market to fund railcar leases, particularly for a first-time issuer.

But that is exactly what Napier Park Global Capital, the hedge fund spun out of Citigroup, did in April, when it issued $260 million of bonds backed by railcar lease payments.

The deal, dubbed NP SPE II, consists of two classes of senior notes, both provisionally rated single-A by both Kroll Bond Rating Agency and Fitch Ratings. The $103.3 million tranche of class A-1 notes will amortize over a 10-year period, while the $156.545 million tranche of class A-2 "soft bullet" notes are expected to be paid off in a single payment in April 2026.

Credit Suisse Securities is the lead.

The notes are backed by a pool of 2,905 railcars with a fair market value of approximately $342 million acquired by the trust from Trinity Industries Leasing.

The securitization trust will also enter into a rental sharing agreement with RIV II, a joint venture between Napier and Trinity that owns 476 railcars. Under the agreement, NP SPE bondholders and RIV will pool their lease revenues and Trinity will distribute them according to their pro rata percentages of the total fair market value of the combined portfolio.

Trinity will service both portfolios and manage the rental sharing agreement. At closing, bondholder's railcars will account for approximately 90% of the total fair market value of the total portfolio.

This agreement diversifies the sources of bondholder cash flows, according to KBRA. That's because RIV's portfolio has a smaller proportion of tank cars; as a result, the share of tank cars in the combined portfolio is 48.4%, down from 52.1% of the securitization trust's portfolio. KBRA views this diversification as a credit positive. In addition, the securitization trust bears the costs associated with only its own assets, so this diversity comes at no extra cost.

NP SPE II will enter into railcar rental sharing agreement with Trinity Industries.

The majority (89.2%) of bondholder's fleet at closing are under a full service lease, in which the lessor is responsible for maintaining and servicing the railcars, administering and paying applicable taxes and providing ancillary services to the lessee. The remainder (10.8%) of the fleet at closing is under a net lease, in which the lessee is responsible for all maintenance, applicable taxes and expenses.

The lease rate for full service leases is typically higher than net leases.

The railcar industry is capital intensive; operators are required to purchase expensive equipment as well as make modifications to older products in order to remain compliant in an increasingly regulated environment. A federal law passed in May 2015 established new safety requirements for tank cars, including enhanced braking mechanisms and restrictions on continuous blocks of cars carrying flammable liquids such as crude oil. Another law passed in December 2015 introduced further safety standards that apply to any individual cars carrying flammable liquids.

Napier is an employee-owned investment management firm that invests in a broad range of products, including CLOs, diversified credit funds, and cash-generating real assets. The firm got into the railcar business two years ago, when it formed a partnership with Trinity to acquire about $1 billion of railcars. — *AB*

Despite Pain, BDCs in No Hurry to Unload CLO Equity

The pain is spreading among business development companies that put money to work in an unloved corner of the capital markets: CLO equity.

Business development companies, closed-end funds that trade on an exchange, like stocks, are themselves out of favor. They are trading at steep discounts to their net asset values as many of their investments sour, causing them to trim payouts to shareholders. That's particularly true of BDCs that invest in the equity, or most subordinate tranches of notes issued by collateralized loan obligations.

This, in turn, is putting pressure on BDCs to sell assets to repair their balance sheets.

BDCs and CLOs are similar animals; both pool money from investors to lend to below investment grade companies. But CLOs are private funds and generally invest in loans to large companies; these loans are broadly syndicated and relatively easy to buy and sell. Publicly traded BDCs, on the other hand, typically invest in loans to smaller companies as well as in other, less liquid assets – such as debt and equity issued by CLOs.

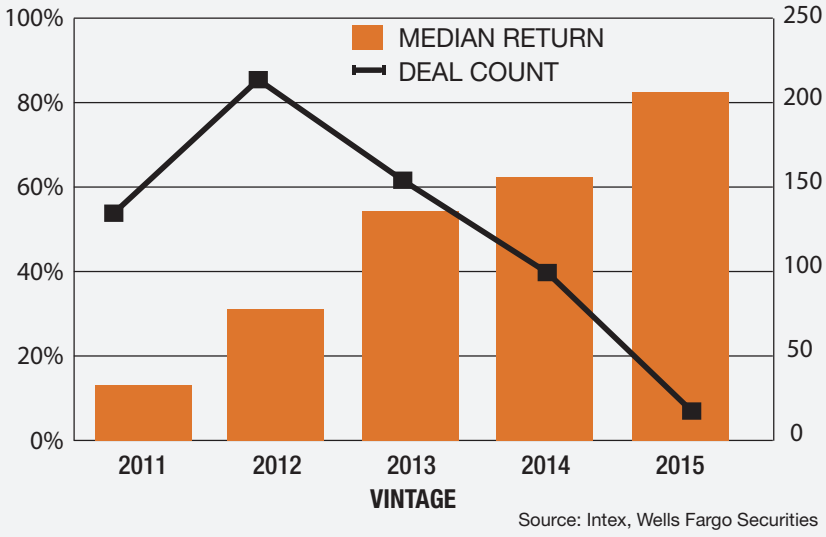
CLO securities sold off sharply early in the year, and, sure enough, several BDCs that reported first quarter earnings in early May, including TICC Capital, KCAP Financial and Ares Capital, have significant realized and unrealized declining valuations of their CLO holdings, including third-party and internal equity.

This comes on top of the drops that were realized in the fourth-quarter by two other BDCs that are major buyers, American Capital Corp. and Prospect Capital.

Prospect, which at nearly $1 billion has the most CLO equity holdings among BDCs, was scheduled to release its first quarter earnings after markets close on May 10.

High Risk, High Return

Median total cash return on the equity, or most subordinated securities issued by broadly syndicated collateralized loan obligations.



Source: Intex, Wells Fargo Securities

TICC's Cohen Calling the Market's Bottom

But despite the deterioration in their CLO holdings, these BDCs appear to be maintaining their dividends, and in TICC's case, at least, to be in no particular hurry to unload holdings.

To the contrary, TICC added $400,000 in CLO equity to its portfolio during the first quarter, as well as $2.7 million in CLO debt, according to filings and statements from chief executive officer Jonathan Cohen in the company's quarterly earnings call on May 3. This despite a market slide that wiped $9.5 million off the value of its existing CLO holdings (including equity) in the first three months of the year.

Apparently the bargains were just too good to pass up...and the price points to low to unload existing holdings.

"What we had seen...during the March quarter was really the low point in asset valuations," said Cohen, according to a transcript. "And so, we certainly didn't want to sell either corporate loan assets or CLO equity assets that we expected would experience some price rebound over the course of the coming months, which is so far what's been happening."

On May 4, Ares Capital reported it wrote down $1.6 million in depreciation in CLO debt and equity (none of it third-party), which are held and managed at its asset management subsidiary, Ivy Hill. Ares has an approximate $20 billion

See BDC on Page 22 >>

BDC
Continued from page 21

CLO portfolio that is the largest of any BDC in the market.

KCAP followed on May 5, reporting net $11.6 million in realized and unrealized depreciation in assets "primarily attributable to our investments in CLO fund securities and our asset manager affiliates."

In a report published late last year, Keefe Bruyette & Woods (the boutique investment bank acquired by retail brokerage Stifel Financial in 2013) had estimated that KCAP had approximately 13% of its portfolio in CLO equity. The CLO portfolio is managed by KCAP's Trimaran Advisors asset management firm.

(According to KBW, KCAP is one of a few BDCs allowed to own a registered investment advisor because it is grandfathered from a Dodd-Frank requirement prohibiting such holdings by a registered investment company).

Most BDCs Are Sustaining Their Dividends

Nevertheless, KCAP is maintaining its dividend at $0.15 a share. The company reported a first-quarter net income of $4.8 million, compared to $6.8 million in the first quarter of 2015, on its direct lending business and its overall investment portfolio fell to $378 million from $488 million a year ago March 31.

Ares is also sustaining a $0.38 a share dividend that it has paid for the last five quarters, and TICC's dividend remains at $0.29 a share.

As regulated investment companies, BDCs have a pass-through tax structure; they must distribute at least 90% of taxable income as dividends to investors to avoid paying corporate income tax.

The devaluations will continue to prompt the market to question whether it is appropriate for BDCs to invest in CLOs, and in particular in third-party CLO equity, given the need for cash flow to meet distribution requirements.

The problem isn't just that a selloff in CLO equity is depressing the value of these securities; in some cases, investors in CLO equity are not receiving any interest. That's because, as conditions in the leveraged loan market deteriorate, some CLO managers are being forced to divert funds normally reserved for equity holders to benefit more senior investors.

"We just don't organize the business inside the BDC," said Ares chief executive Kipp deVeer in a May 5 earning conference call, "because we don't see it as the right place to own CLO investments."

TICC and THL Credit both announced last year plans to unload their CLO equity due to shareholder pressure.

THL Credit, which still has 2% of its portfolio in CLO equity, did not provide a breakdown of quarterly depreciation in its first-quarter earnings tally, but reported it has lost $3 million in the fair market value of the three remaining CLO positions since those assets' purchase dates (2013-2014). The Thomas H. Lee Partners affiliate, however, earned a 14.9% yield in its CLO positions, on top of the 14.8% yield in the fourth quarter.

Chief operating officer Terry Olson said during a May 6 conference call that the company has not changed its plans to sell off the CLOs based on the NAV impact, but has widened its sell offer on the positions based on the overall loan market recovery.

There's a potential upside to interest rate diversions. In a March report, KBW analyst Ryan Lynch noted that purchasing additional leveraged loans ultimately benefits all investors in a deal, since it can boost the overall quality of the portfolio - including that of equity holders.

The report noted that, while CLO equity investments can be volatile, they "historically have produced attractive returns."

But if those returns disappear, shareholders at some point may revolt. At least one BDC, TICC, is embroiled in a proxy battle with one of its largest shareholders, the specialty lending arm of private equity firm TPG, because of impairments in its CLO holdings.

On May 2, TPG send a letter to TICC asking its board of directors to address its concerns about the "rapid deterioration of the value of CLO equity investments held by TICC."

"These consistent poor returns and ongoing deterioration of NAV per share are in part a result of a failed investment strategy into CLO equity," the letter read. "This not only distorts management fees but also contributes to the unsustainable nature of TICC's dividend."

TPG points to a 26.6% slide in TICC's NAV per share from $9.78 in March 2014 to $6.40 as of Dec. 31 of last year.

The fight with TPG has erupted well after TICC's announced plans to divest of CLO equity assets. But that progress has been slowed by the fourth-quarter disruption of the corporate credit market as well as falling CLO equity valuations. (TICC's Cohen did not address the TPG complaint during the May 3 analyst call).

"CLO equity pricing probably hit its low point mid-to-late February, March was an up month," TICC's Cohen said, according to the 1Q transcript. "The end of March was particularly strong for the CLO market, CLO equity market broadly defined and the month of April has been particularly strong in terms of CLO equity prices in the secondary market.

"We're actually beginning to see some primary market activity. We continue to see significant strength across the CLO equity market concurrent with and partially as a function of, the strength in the syndicated corporate loan market," he added.

Cohen had said in a previous earnings call that TICC remained "committed" to rotating out of CLO equity "over time." — *GF*

Risk-Transfer Bonds Exposed to TRID Violations, Moody's Says

New lender disclosure requirements aren't just disrupting the market for private-label mortgage bonds; they could also impact the market for bonds that transfer credit risk of mortgages insured by Fannie Mae and Freddie Mac to the private sector.

The Consumer Financial Protection Bureau's TILA-RESPA Integrated Disclosure Rule, known as TRID, which took effect in October, was intended to help homeowners understand the total costs of a home loan. But because of the number of variable to account for on the forms, compliance has proven extremely difficult. This has caused private investors to reject loans at an unprecedented rate, out of concern that they could be held responsible for noncompliance.

The Federal Housing Finance Agency, Fannie and Freddie's regulator, has directed the government-sponsored enterprises NOT to conduct loan-level reviews for technical compliance, at least during a transitional period. Moody's Investors Service believes that this creates a risk for investors in bonds linked to the performance of loans insured by Fannie and Freddie, known as credit risk transfer transactions.

Connecticut Avenue Securities (CAS) and Structured Agency Credit Risk (STACR) are general obligations of Fannie and Freddie, respectively, yet investors can lose interest or principal in the event that enough loans insured by the GSEs default.

While the CFPB has said it would be lenient on lenders that make good faith efforts to comply, the rule opens the door to private action by borrowers.

The most likely way that a TRID violation could cause a loss to a loan, according to Yehudah Forster, a senior vice president and lead author of the report, is if the borrower successfully used it in a defense to a foreclosure; in that case, the holder of the loan [an MBS trust] could be responsible for up to $4,000 in damages plus attorney's fees.

If, for example, that came to $20,000, this would reduce proceeds from a foreclosure, potentially leading to increase in loss severity on that loan.

Fannie or Freddie, as guarantor to the loan, would be responsible for making good on the losses to holders of the mortgage bonds backed by the loan. And the GSEs might withhold funds from investors in risk transfer bonds, which act as a form of reinsurance.

The risk is to future Connecticut Avenue Securities and Structured Agency Credit Risk; none of the deals done so far have loans subject to TRID.

The risk is only to future CAS and STACR. "None of the deals done so far have had loans subject to TRID," Forster said. "It remains to be seen when these loans will show up in a reference pool."

Moody's thinks that risk of TRID violations will be "slightly credit negative" for those future deals.

Fannie and Freddie both released statements saying that the Moody's report overstates the possibility that TRID-related losses could impact investors in CAS and STACR.

"We require our sellers to be TRID compliant," Freddie said in its statement, which was emailed to ASR. "If we become aware of a loan with a material TRID violation, we have the ability to remove it from the STACR reference pool in order to eliminate potential losses from being passed on to investors."

Likewise, Fannie's statement said that it expects lenders to make good faith efforts to comply with TRID and remains committed to working with these partners during this time of transition. "If a TRID violation were to occur that results in assignee liability, this would result in a repurchase under our rep & warrant framework and therefore would not result in a loss to the CAS investor," the company said.

Moody's itself expects that overall losses on CAS and STACR owing to TRID violations to be "fairly small," despite its expectations that the frequency of TRID violations on loans purchased by Fannie and Freddie will initially be high. And these losses are likely to be mitigated because lenders will be compelled to repurchase some of the loans with TRID violations from the GSEs.

By contrast, future private-label residential mortgage-backed securities will be less exposed to these risks, because private-label issuers are conducting thorough third-party due diligence for the loans that they purchase. — *AB*

Ginnie Mae to Test Pools of Modified Loans

Ginnie Mae is mulling whether to guarantee a new type of securitized-loan pool.

It plans to conduct a test run made up entirely of modified and reperforming loans that at the outset would come from its balance sheet.

"We're doing this as an experiment. We have quite a few of these loans that we've bought out from pools over the years, mainly from the Taylor Bean default," Ginnie President Ted Tozer said, referring to Taylor, Bean & Whitaker.

Ginnie would sell the new pool type outside of the main "to be announced" market as a specified pool. Reperforming and modified loans otherwise will continue to be pooled along with recent production in multi-issuer Ginnie II securities.

The government agency plans to issue pools made up of Ginnie-owned loans using the new pool type by this summer, John Getchis, senior vice president of capital markets at Ginnie, wrote in an email.

"We will share our price discovery with the industry," he said.

Specified pools are more common at the agencies than at Ginnie, according to a 2015 JPMorgan Chase report. For example, Freddie Mac has three pool types for modified or reperforming loans, Freddie spokeswoman Lisa Gagnon wrote in an email. All contain loans that were performing for 12 months at securitization.

Ginnie is testing a specified pool of this type that has a large number of mods to pool because its previous subservicer of the Taylor Bean portfolio was unable to pool those loans as they became current, Tozer said in an email.

Tozer did not immediately reply to questions seeking the names of the subservicing companies that formerly handled or currently run the Taylor Bean portfolio, or why the reperforming loans had not previously been pooled.

The volume of newer FHA reperforming and modified loans that issuers could contribute to the potential new pool type has dwindled in line with 90-day delinquencies since the downturn when Taylor Bean defaulted.

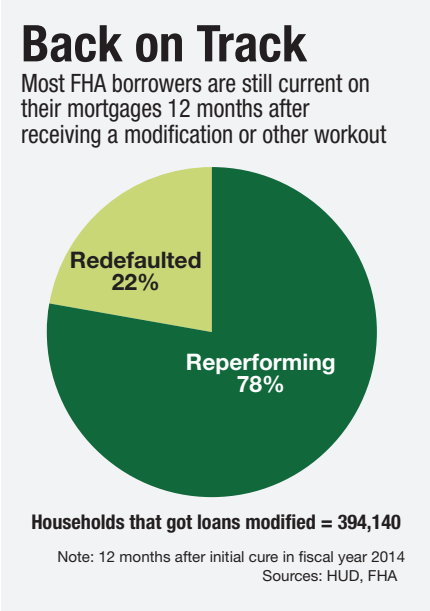
However, there have been significant concentrations of modified and reperforming loans in some types of contemporary Ginnie securitizations. Mods and loans that appear to be RPLs based on their weighted average loan age were more than 25% of recently originated Ginnie IIs at one point in 2015, according to the JPMorgan report.

There were 394,140 households that had trouble paying their Federal Housing Administration loans between Oct. 1, 2013, and Sept. 30, 2014, and received a modification or other type of cure for the first time during that fiscal year.

Seventy-eight percent of these remained reperforming after 12 months, and while 22% redefaulted within a year after the first cure, some in that category received multiple cures and may have reperformed later. In total there were 480,436 cures applied to FHA loans during fiscal year 2014.

Modifications are complicated for Ginnie issuers that service loans, or companies subservicing for them, so they may favor opting to use a new pool type if it results in a better price for, and return on, those loans.

When loans have been delinquent for more than 90 days, Ginnie servicers have to buy the mortgages out of pools or cover the payments, and then mitigate losses as specified by FHA rules. If borrowers start paying regularly after modification, the loans that have been removed can be reinstated in pools.



How Ginnie will define reperforming loans in its test pool remains to be seen, but it could require timely payments of somewhere between three and 12 months after the loss mitigation is applied.

What price investors are willing to pay for any new type of security or loan pool is typically uncertain because the new investment lacks a specific track record that buyers can use to size up its value.

"The market would receive any new [pool type] with interest, but they would want a lot of data on the performance characteristics on [Ginnie's or] FHA's own pool before they started to put numbers on the bonds," said Walter Schmidt, a senior vice president in FTN Financial Group's Chicago office.

FHA/Ginnie reperforming rates can vary widely depending on seasoning,

See Ginnie on Page 26 >>

Here's a Rare Sight: A Canadian CMBS Conduit

RBC Capital Markets is marketing what is likely to be one of very few offerings of Canadian commercial mortgage bonds this year.

Mortgage bonds play a much smaller role in Canada's economy than they do in the U.S., where conduit lenders account for about a quarter of all commercial real estate lending. And since the middle of last year, when declining oil prices roiled Canada's capital markets, it's been even harder to compete with traditional portfolio lenders such as commercial banks and insurance companies.

Thanks to weakness in the Canadian dollar, there's also competition from foreign players such as U.S. and Asian banks.

"In general borrowers [in Canada] have more choices, because there is so much capital available, and conventional lenders are very active," said Karen Gu, senior vice president, DBRS.

But Real Estate Asset Liquidity Trust, Series 2016-1, is notable for more than its scarcity. The $400 million deal also illustrates just how different lending standard in the U.S. and Canada really are.

Perhaps the most striking difference is the lack of interest-only lending. REALT 2016-1, which is being rated by both DBRS and Fitch Ratings, is backed by 55 loans secured by 91 properties. All of the loans were originated by RBC, one of the few conduit lenders currently active in Canada. And all of them amortize - for their entire loan terms.

Compare that with one of the most recently launched U.S. conduits, Wells Fargo Commercial Mortgage Trust 2016-C3, which is also rated by DBRS and Fitch: it is backed by a pool of loans that will only pay off 12.3% of their initial balance prior to maturity. As paltry as that sounds, it's more amortization than the average for CMBS rated by Fitch this year or last.

Mortgage bonds play a minor role in financing commercial real estate in Canada.

Two of the loans backing Wells Fargo's deal pay only interest, and no principal, for their entire terms, and 32 pay only interest for part of their terms; just 10 are fully amortizing.

The less amortization there is in a deal, the bigger the risk that it will be difficult to refinance the loans when they come due, potentially leading to maturity defaults.

Another big difference between commercial real estate lending in the U.S. and Canada is borrower recourse. Twenty-seven loans in RBC's deal, representing half the pool, provide lenders with recourse to individuals and real estate investment trusts or established corporates.

By comparison, U.S. commercial mortgages do not offer any recourse to the borrowers, with the exception of some smaller loans to landlords. Lenders only have recourse to the property itself.

One thing RBC's deal has in common with recent U.S. transactions is a complete lack of exposure the oil industry, or anywhere in the province of Alberta. On May 10, Fitch warned that the wildfire in Fort MacMurray has further challenged the already stressed market for the six oustanding Canadian CMBS its rates with exposure to properties in Fort MacMurray.

So why is RBC comning to market now? One reason could be the large amount of loans in CMBS coming due this year: 22 deals with 478 loans totalling $3.4 billion.

CMBS can also appeal to borrowers for the longer terms available – 10 years, versus five for mortgages from most conventional lenders, according to Gu. Borrowers with heavy funding needs, in particular the bigger real estate investment trusts, may also turn to conduit lenders because other borrowers don't want too much exposure to a single name. — *AB*

PERK

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cause borrowers often have several different loans, and payments have to be carefully allocated between them.

"For the employer to try to administer this," Elliott warned, "I would wave them off from it six ways from Sunday."

Gradifi Chief Executive Tim DeMello said that his firm is currently working with just over 100 companies, and has been approached by another 180 or so that are interested in offering loan repayment assistance. Employers pay Gradifi $36 to $60 annually for each employee in the program.

"There's been a lot more interest than even I expected there to be," DeMello said.

One obstacle to more widespread adoption by corporations involves the tax treatment of student loan assistance. Unlike contributions to a 401(k), loan assistance dollars are currently treated as pretax income. That status makes them less attractive as a benefit.

Legislation has recently been introduced in both the House and Senate to change the tax treatment. "I think when that happens, the demand will go up tenfold," DeMello said.

In the meantime, firms that refinance education loans are exploring how they can benefit from the fledgling efforts of employers to help their workforce pay down its debt.

SoFi said that it developed its benefit administration platform for an unnamed company that is in the top 10 of the Fortune 500. The San Francisco-based company is now looking to administer the loan assistance benefit for other smaller firms.

"It really is a differentiating benefit," said Catesby Perrin, SoFi's head of business development. "I know I should be saving for my retirement, but that benefit is pretty attenuated for me. I don't expect to see that money for 40 years, or 30 years."

Citizens Financial hopes that its new partnership with Gradifi will help win the attention of more borrowers. As part of the deal, Citizens may seek to encourage borrowers to refinance by offering them a one-time cash payment.

Brendan Coughlin, the head of consumer banking at Citizens, said the program offers borrowers the chance to win twice — first by getting cash assistance, and second by refinancing into a loan with a lower interest rate.

"This is obviously an emerging need for Americans, in terms of managing their student loan debt down," he said.

Many borrowers are unable to refinance at a lower interest rate, and even those who do qualify should be aware that they will lose certain protections by switching from a federal student loan to one that is privately backed.

Often the best candidates for student loan refinancing are folks with graduate or professional degrees, since the government loan program that many of them use to finance their education carries comparatively high interest rates.

In recent years, some private student lenders have partnered with professional organizations and alumni groups in an effort to make more borrowers aware that refinancing may be an option. The new wave of marketing toward borrowers who are getting a valuable employee benefit is another step down the same path.

"I do see this as an opportunity for lenders," said Stephen Dash, CEO of the student loan comparison site Credible. — *Kevin Wack*

GINNIE

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modification type, vintage and coupon, according to JPMorgan research and separate FHA data. So how investors may react could depend on the test pool's composition.

Investors pricing the bonds will look particularly closely at how modifications and RPLs have prepaid due to refinancing or redefaults. Historically, the prepayment profile of mods and RPLs has been "mixed," Tozer said.

During the housing downturn, the rate of 90-day delinquencies that occurred within three months of a modification or other type of loss-mitigation measure was 9.76%. In more recent fiscal years, the equivalent FHA redefault rate three months after cure has been about 3%, and the redefault rate 12 months after cure has been closer to 22%.

Although there is considerable performance variation within the universe of modified or reperforming FHA loans, the two categories of mortgages still might have a better prepayment profile than recent production.

"Given the relatively high levels of voluntary refinancing in the market, the prepayment advantage provided by the low rate sensitivity of [Ginnie] mods and reinstateds outweighs the cost of high redefaults," JPMorgan researcher Matt Jozoff said in a report on 2015 securitizations.

Overall home loan refinancing rates have trended downward over time, but refis still constitute more than 50% of home loan applications, according to weekly Mortgage Bankers Association surveys.

Given such current market conditions, former Ginnie Chairman Joe Murin thinks it may be worth it for Ginnie to test out the new pool type. "An alternative liquidity instrument makes sense. They just don't know how that's going to work yet and whether there would be an appetite for it in the marketplace," said Murin, who is currently chairman of the investment advisory firm JJAM Financial LLC in Pittsburgh. "They'll see how it goes, and if it goes well they'll continue." — *Bonnie Sinnock*

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