A local touch with a global reach.


FREDERICK BERG
SALES
EUROPE


ALAN GERAGHTY
GROUP VICE PRESIDENT
EUROPE


MARCUS HERKLE
COUNTRY MANAGER
GERMANY


EILEEN HUGHES
HEAD OF STRUCTURED
FINANCE UK


ANGELA ICOLARO
HEAD OF ITALIAN DESK


CAROLINE MAGEE
SALES
EUROPE


ALDO MINACAPELLI
ASSISTANT VICE PRESIDENT


CLIONA O'FAOLAIN
COUNTRY MANAGER
IRELAND


CHRISTOPHE SCHROEDER
HEAD OF SALES
EUROPE


PATRICIA SCHULZE
CLIENT DEVELOPMENT
U.S.


PATRICK TADIE
GROUP VICE PRESIDENT
U.S.


DANIEL WYNNE
DIRECTOR
SP SERVICES (LONDON)

WILMINGTON TRUST RENOWNED EXPERIENCE | STRUCTURED FINANCE

Our experience can be one of your greatest advantages.

We have the talent, resources, and infrastructure to handle all aspects of your deal.

DOCUMENT CUSTODY

OUR QUALITY STAFF, EFFICIENT PROCESSES, AND ACCURATE AND TIMELY REPORTING MAKE THE DIFFERENCE.

BACKUP SERVICING

OUR PROFICIENCY IN DEAL EXECUTION INSTILLS THE CONFIDENCE AND PEACE OF MIND YOU NEED WHEN CLOSING A TRANSACTION.

INDENTURE TRUSTEE

SELECTING A QUALITY CORPORATE TRUSTEE HAS BECOME AN INCREASINGLY COMPLEX TASK. OUR LONG-TENURED EXPERTS, CLIENT RETENTION, AND NIMBLENESS MAKE OUR TEAM THE CLEAR CHOICE.

INDEPENDENT DIRECTOR

OUR KNOWLEDGEABLE, RELIABLE, AND ACCESSIBLE INDEPENDENT DIRECTORS HAVE EXPERIENCE WITH A WIDE VARIETY OF STRUCTURED FINANCE AND SECURITIZATION TRANSACTIONS.

SPV ADMINISTRATION | ACCOUNTING SERVICES | TRUST AND AGENCY SERVICES
ESCROW SERVICES | LOAN ADMINISTRATION | INDEPENDENT DIRECTOR

Asset Securitization Report

www.asreport.com | @asreport

SourceMedia

EXOTICS

Summer is when things typically slow down. No better time to float some of the more esoteric asset classes

July/August 2018 | Volume 18, Number 5

Peering into the Future:
Anticipating and Influencing Regulatory and Legislative Change

The Political Report: Assessing Mid-Term Elections Scenarios

All Rise: Judicial Rulings and their Impact on the Market

Taming Zombie LIBOR

Hit the Hill

Meet the Regulators

FHFA Presenting the New GSE Conservator Capital Framework

Capital and Liquidity Advocacy

Heading into the End of the Cycle: What to Expect and What to Watch

Man Meets Machine: How Technology is Improving Origination, Underwriting and Investing

GSEs and Private Capital: New and Innovative Interaction

Trade Wars, Inflation & the Millennial Homebuyer

A Conversation With Dr. Janet L. Yellen

THE SFIG BOARD OF DIRECTORS INVITES YOU TO JOIN THEM AT SFIG DC:

Ally Financial | Alston & Bird | Bank of America Merrill Lynch
Black Knight | Chapman and Cutler | DBRS | Deloitte | Dentons | Discover Financial Services
Doubleline | EKap Strategies | Equifax | EY | Fitch Ratings | Freddie Mac | Guggenheim | JP Morgan
Katten Muchin Rosenman | Lending Club | Lord Capital | MetLife | Moody's | Morgan Stanley
Morgan Lewis & Bockius | Nationstar | Navient Corp. | Nomura | PGIM | PIMCO | PwC | RBC Capital Markets
Redwood Trust | Sallie Mae | Skadden, Arps, Slate, Meagher & Flom | Societe Generale | TIAA Investments
VantageScore | Wellington Management Company | Wells Fargo Securities | Wilmington Trust

www.sfindustry.org/events

Halftime Report

Nine years into the credit cycle, market fundamentals for structured products are still strong. Consumer credit remains healthy for the most part, and lower corporate tax rates are bolstering business expansion, which is supporting leveraged loans as well as commercial asset-backeds such as whole business, aircraft, and other kinds of equipment loans and leases. The commercial real estate market appears to be cooling, but is still stable.

After selling off on multiple occasions in the first half due to macroeconomic, events, the structured finance market has, for the most part, held its ground. Spreads on the highest rated tranches of deals have moved from two-year tights as the end of 2017, thought that's being partly attributed to increased supply.

Even as the broader securitization market takes a breather, however, unusual deals from off-the-run asset classes continue provide diversification – and the opportunity to move down in credit and pick up yield. Deutsche Bank recently increased its forecast for full-year issuance of esoterics, to $50 billion from $41 billion previously, citing the investor appetite for this paper and the favorable funding environment.

Our cover story looks at four. Two are asset classes that are making, or attempting, a comeback, legacy private student loans and precious metals. There have been several securitizations over the past year or so of private student loans originated before the credit crisis, when underwriting standards were much looser. The most recent, from FirstKey, an affiliate of Cerberus Capital Management, demonstrates how comfortable investors have become with this once-toxic asset. A-Mark, a precious metals dealer, is testing the waters for bonds backed by margin loans following litigation by the Commodity Futures Trading Commission.

The third deal is form Mosaic, a solar panel financing company that has tweaked its funding model; as a result, its latest bond offering was backed in part by loans it had previously sold Goldman Sachs.

There was also what appeared to be a real "first," a securitization of insurance premium commissions, by LTC Global.— **Allison Bisbey**

Asset Securitization Report

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

Editorial
Editor in Chief: Allison Bisbey
allison.bisbey@sourcemedia.com; 212.803.8271

Senior Editor: Glen Fest
glen.fest@SourceMedia.com; 817.847.8041

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

Contributors
Brad Finkelstein, Kevin Wack

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

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

Executive Director, Content Operations and Creative Services: Michael Chu
michael.chu@sourcemedia.com; 212.803.8313

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

Publishing
VP Capital Markets Division: Harry Nikpour
212.803.8638

SVP, Head of Media Sales: Dennis Strong
212.803.8372

Associate Publisher: Louis Fugazy
212.803.8773

Marketing
Marketing Manager: Leatha Jones
212.803.8374

SourceMedia™

Chief Executive Officer: Gemma Postlethwaite

Chief Financial Officer: Sean Kron

EVP & Chief Content Officer: David Longobardi

Chief Marketing Officer: Matthew Yorke

Chief Subscription Officer: Allison Adams

SVP, Conferences & Events: John DelMauro

SVP, Human Resources: Ying Wong

Contents

Subscription Information: help@sourcemedia.com | 212.803.8500; Bulk subscription | US/Canada $2,995 | Annual Rate (8 issues) International $3,035

Asset Securitization Report - (ISSN # 1547-3422) Vol. 18, No. 5, is published 8 times a year by SourceMedia, One State Street Plaza, 27th Floor, New York, NY 10004. Postmaster: Send address changes to Asset Securitization Report, SourceMedia, One State Street Plaza, New York, NY 10004. For subscriptions, renewals, address changes and delivery service issues contact our Customer Service department at (212) 803-8500 or email: help@sourcemedia.com. All rights reserved. Photocopy permission is available solely through SourceMedia, One State Street Plaza, 27th Floor, New York, NY 10004. For more information about reprints and licensing content from Asset Securitization Report, please visit www.SourceMediaReprints.com or contact PARS International Corp. (212) 221-9595. Asset Securitization Report is a general-circulation publication. No data herein is or should be construed to be a recommendation for the purchase, retention or sale of securities, or to provide investment advice of the companies mentioned or advertised. SourceMedia, its subsidiaries and its employees may, from time to time, purchase, own, or sell securities or other investment products of the companies discussed or advertised in this publication.

Room for improvement

There are signs of slippage in rep & warranty frameworks for new RMBS; Fitch Ratings would like to see the following changes

- More clearly defined materiality clauses
- More standardized reporting
- Better bondholder communication
- Reduced sway by controlling holders
- Clearer tracking of underwriting exceptions

Source: Fitch Ratings

Further Changes to RMBS Rep & Warranties Needed

Frameworks have largely improved, but there remains a lack of consistency and ongoing weaknesses that put off some investors

By Rui Pereira

The residential mortgage backed securities market is the securitized sector that has arguably taken the longest to emerge from the ashes of the financial crisis over 10 years ago. A vital component from those first post-crisis RMBS deals at the start of this decade needs to reassert its importance again today: Mortgage rep and warranties.

This is an area of RMBS that has never wavered in its importance as far as we at Fitch are concerned since we first brought attention to it five years ago. So we felt it was important to take a look back to fully ascertain how mortgage rep and warranty frameworks have evolved since then, and more importantly, how we feel they need to evolve going forward.

Project Restart was put in place by the industry in 2008 to help achieve a balance between protecting both lenders and investors in new RMBS deals by promoting transparency and incentivizing sound underwriting in new securitizations. As part of Project Restart, a rep and warranty model was introduced containing strong and effective safeguards for the investor and perhaps most importantly, reduced ambiguity. Fitch quickly adopted these principles into our formal criteria with the expectation that issuers would also follow the model.

In 2013, we began to notice and express concerns that some of the rep and warranty proposals in new deals coming to market could leave investors exposed to higher losses from weak underwriting and defective mortgage loans. For instance, one framework contained sunset provisions that relieved lenders from their repurchase obligations after less than three years. Others contained proximate cause language and materiality factors for determining if a breach had occurred. These provisions were beginning to introduce subjectivity and limitations that we were concerned would burden mortgage investors with additional risks and expenses.

Provisions are introducing subjectivity and limitations that could burden investors with additional risks and expenses.

Since proposed RMBS representation warranty and enforcement frameworks varied so widely, we approached each one holistically. Those deals with significant third party due diligence and strong credit quality borrowers would provide greater confidence that any future default risk would be driven by credit events and not operational weaknesses. And deals with weaker rep and warranty frameworks had higher credit enhancement levels to help shield investors from elevated risk of higher losses and defaults.

Fitch's analysis for new RMBS

CONTINUED ON PAGE 33

Adobe Stock

Fifth Circuit Avoids Decision on 'Golden' Shares

While the result is anticlimactic, the court's observations tend to reinforce doubts about this bankruptcy proofing mechanism

By Shmuel Vasser

The Court of Appeals for the Fifth Circuit missed an opportunity to address some important questions about golden shares, an alternative form of bankruptcy proofing that requires the consent of certain equity holder(s). On May 22, it affirmed the dismissal of a bankruptcy petition that was filed without obtaining the consent of the preferred shareholder, whose consent was required under the debtor's amended certificate of incorporation. In doing so, it side-stepped the main issue of interest, finding that the case did not involve a blocking provision.

Left unaddressed were several questions that the Bankruptcy Court for the Southern District of Mississippi had certified in the case, Franchise Services of North America. They include whether a blocking provision, i.e. a golden share, enabling a party to block a bankruptcy filing, is contrary to federal public policy and whether the veto right violates Delaware law.

Nevertheless, the opinion is noteworthy for several of its observations.

First, the facts.

Before filing for bankruptcy, the debtor retained a financial advisor in connection with an acquisition. The acquisition turned badly, and the financial advisor was not paid its $3 million in fees. To assist in financing the acquisition, the financial advisor set up a wholly owned subsidiary, "Boketo," that invested $15 million in the debtor in exchange for convertible preferred equity, which, upon conversion would represent 49.76% of the debtor's equity. As a condition of the investment, the debtor reincorporated in Delaware and its new certificate of incorporation required the consent of the majority of its common stockholders and preferred stockholders, voting as separate classes, for a bankruptcy filing. Boketo was the sole preferred shareholder. The debtor filed for bankruptcy without asking for the required consents. The financial advisor and Boketo moved to dismiss the petition as an unauthorized filing and the bankruptcy court dismissed the case.

Left unaddressed were several questions that a Bankruptcy Court for the Southern District of Mississippi had certified.

Was federal public policy violated?

The debtor argued that the majority approval requirement was akin to a waiver of Bankruptcy Code's protections, which many courts have found to violate public policy. The circuit court disagreed.

First, the circuit held that it should narrow the certified questions, since the case did not really involve a blocking provision; the majority approval require-

CONTINUED ON PAGE 34

EXOTICS

Summer is when things typically slow down. No better time to float some of the more esoteric asset classes

By Allison Bisbey

Even as the broader securitization market takes a breather, unusual deals from off-the-run asset classes continue to provide diversification and the opportunity to move down in credit and pick up yield.

Some of the esoterics that made it to market this summer are not necessarily brand new, just reimagined. A recent securitization of legacy private student loans by Cerberus Capital Management is not only for its size – at $400 million, it's twice as large as any others completed over the past year – but because it demonstrates how comfortable investors have grown with this once-toxic asset class. And A-Mark, a precious metals trading company, is testing the market for bonds backed by margin loans following litigation by the Commodity Futures Trading Commission. Mosaic, a solar panel financing company, has tweaked its funding model; as a result, its latest bond offering was backed in part by loans it had previously sold to Goldman Sachs. This gave investors some additional factors to consider, according to Kroll Bond Rating Agency. There was also what appeared to be a real "first," a securitization of insurance premium commissions, by LTC Global.

CREDIT LINE HERE

‘Opportunistic’ deals demonstrate renewed appeal of legacy private student loans.

Private student loans made before the financial crisis were once considered a toxic asset. A recent transaction by Cerberus Capital Management shows how much things have changed.

In June, the distressed debt specialist securitized a $414 million portfolio of seasoned loans it had acquired (via its FirstKey affiliate) in December 2017 from Bank of America; the deal’s strong reception could help revive demand for this asset class, encouraging more banks to shed their holdings, much as they have unloaded federally guaranteed student loans.

Toxic no more

There may be more than $19 billion of private student loans made in 2008 or earlier available for securitization; data as of March 31

- **Total outstanding balance: $113.21B**
- **Held by report participants: $70.81B**
- **Report participants’ pre-crisis loans: $24.64B**
- **Participants’ pre-crisis loans, securitized: $5.55B**
- **Participants’ pre-crisis whole loans: $19.08B**

Source: MeasureOne

Towd Point Asset Trust 2018-SL1 wasn’t the first securitization of legacy private student loans since the financial crisis, but it was by far the largest. Since December 2016, DBRS has rated several other deals consisting of this type of collateral, none of them half as big. These include three transactions for Goal Structured Solutions, and transactions for Loan Science and EdLinc.

All were “opportunistic” deals with collateral from several different pre-crisis private student loan originators that are no longer in business, according to Jon Riber, DBRS’ senior vice president, U.S. ABS.

“This is definitely something people are exploring,” Riber said.

FirstKey is Cerberus’ securitization arm; previously it had only used the Towd Point platform to acquire and securitize nonperforming and reperforming mortgages; 2018-SL1 was its first student loan deal. The transaction is also notable because much of the collateral was originated by Bank of America under an agreement with First Marblehead (now Cognition Financial) that funneled loans into a now-defunct platform called National Collegiate Student Loan Trust. Recently, the Consumer Financial Protection Bureau reached a settlement with several NCSLT trusts and their debt collectors over allegations that included violating consumer laws by pursuing collections for debts they could not prove were owned.

The association did not appear to impact demand for FirstKey’s deal, however. In its presale report, DBRS stated that it does not believe that TPAT 2018-SL1 will have similar documentation issues related to loan ownership because Bank of America has held the student loans now in the trust on its balance sheet since origination. Moreover, FirstKey “will generally be obligated to purchase a loan out of the TPAT 2018-SL1 transaction, or otherwise indemnify the issuing trust, if the loan is missing its executed promissory note,” the presale report states.

Underwriting standards for private student loans were much looser before the financial crisis, as lenders counted on being able to bundle them into collateral for bonds. But when the securitization market ground to a halt, those left holding these loans – typically in some kind of a warehouse facility – were stuck with them.

Riber explained that, “in the event of a default, the warehouse lender, or its investors, usually has options to liquidate the underlying collateral, which is typically done through whole loan sale or securitization take out.” However, once the entire securitization market dried up, this option became too costly. And as it was common for pools to be priced at much less than par, many lenders thought, “we’ll just sit on it until things hopefully improve,” he said.

Ten years later, these loans are more seasoned and are performing much better, making them a better candidate for securitization. The student loans in Cerberus’ deal have been in active repayment for more than 97 months, with initial disbursements occurring from 2001 to 2009.

Some 3.3% of the trust student loans are delinquent more than 30 days, and DBRS expects that a large percentage of these loans will be charged off; another 3% are in forbearance and 3.2% are in deferment. The rating agency expects 15.3% to default over the life of the transaction, in its base-case scenario.

It helps that the student loan refinance market has evolved and is performing very well, which has stoked demand for student loan ABS in general, and there have been fewer securitizations of newly originated in-school loans. Sallie Mae Bank, Navient and College Ave. are tapping the securitization market, but two other big holders, Wells Fargo and Discover, have kept the loans they make on balance sheet.

"There's a lot of demand, but not as much securitization as there was before the financial crisis," Riber said.

There's still a significant amount of pre-crisis seasoned private student loan collateral on banks' and other holders' balance sheets that could potentially be available to be securitized. MeasureOne estimates that the figure is $19 billion, though this only includes holders that report to the company.

Riber thinks the total amount outstanding could be higher, perhaps $25 billion to $30 billion. He said these loans have been paying down fairly rapidly recently, in part because of the increasing availability of refinance loans for borrowers with good credit and high incomes.

Court ruling clears way for more precious metals ABS.

A-Mark, a precious metals trading company based in El Segundo, Calif., is turning to the securitization market in order to boost margin lending to its clients.

The company is selling $100 million of bonds backed by a revolving pool of loans secured by precious metals as well as some of its own inventory of cash and gold, silver, platinum, and palladium.

It's an asset class that was pioneered at another precious metals company, Monex, in Newport Beach Calif., which has completed nine deals to date. Two bankers who worked on Monex's transactions while at Piper Jaffray, Chris Flannery and Tom Baurle, are leading A-Mark's deal from their new firm, Oak Ridge Financial.

The practice of using a commodity as collateral for a loan is being litigated by the Commodity Futures Trading Commission, which sued Monex last year, claiming it was engaged in illegal, off-exchange transactions. In May, however, a California federal judge rejected the CFTC's claims, ruling Monex's trading fell outside the agency's authority.

Morningstar Credit Ratings, which rated Monex's most recent securitization, in 2016, is rating A-Mark's deal as well. In its presale report, the rating agency stated that the litigation is unlikely to pose a risk to A-Mark's transaction, even if the CFTC appeals.

AM Capital Funding Series 2018-1 consists of two tranches of notes maturing in December 2023; a $72 million senior tranche is provisionally rated AA – the same rating as the senior tranche of Monex's most recent transaction – and a $28 million subordinate tranche is rated BB.; the deal was expected to price July 19 and close July 24.

A-Mark plans to transfer approximately 70% of its loan book to the securitization trust, according to its bankers. This will allow the company to do more lending and also diversify its sources of funding. Right now it relies on large lines of credit with banks.

There are two different types of loans in the pool, according to Morningstar: on-demand loans with a maximum term of five-year term and shorter-term loan that are usually payable within 180 days. To obtain either type of loan, the borrower must invest a minimum of 20% equity and must maintain a minimum 10% equity.

The collateral will revolve over most of the five-year term of the transaction, followed by a six-month wind-down.

Credit enhancement consists of a cash reserve and the value of the collateral in excess of the note balance, marked to market daily. This means that the sponsor

"If there are insufficient assets to cover notes, not only can you liquidate inventory, you can increase margin requirements."

may have to contribute additional assets in the event of a decline in metals prices; alternatively, it can remove collateral from the trust in the event metals prices appreciate.

"If there are insufficient assets to cover notes, not only can you liquidate inventory, you can increase margin requirements [on the loans] or liquidate the loans," Flannery, a managing director at Oak Ridge, said in a telephone interview. "That's different from a deal backed by mortgages or auto loans."

One difference between the structure of A-Mark's deal and deals completed by Monex, according to Flannery, is that A-Mark's deal has the ability to hedge the value of inventory.

Morningstar noted in its presale report that the securitization trust will establish a futures brokerage account with ADM Investor Services to hedge the metals inventory with net short futures positions. While the trust is not obligated to hedge, hedged metals inventory will be valued at 95% of the wholesale value and unhedged metals inventory will be valued at 80% of the wholesale value.

Among other strengths of the deal, in Morningstar's view, are the liquidity of the collateral – silver, gold, platinum and palladium – which is traded around the clock on different exchanges, and the strong performance of A-Mark's loan portfolio, which has yet to sustain a loss.

The exposure to any single obligor is limited to 5% of all eligible loans plus metals inventory, and total exposure to obligors outside U.S. and Canada is limited to 10% of all eligible loans and metals inventory. There is also a 5% country limit to the aggregate exposures of obligors in any single country that is not U.S. or Canada. Any amount over the concentration limits will not count toward the adjusted eligible pool balance.

Adobe Stock

However, the transaction does not set concentration limits on the underlying metals collateral. In its presale report, Morningstar noted that changing consumer preferences may significantly alter the concentrations of the four metals. In analyzing the riskiness of the transaction, it assumed that the pool consists entirely of silver, the price of which historically has been the most volatile of the four eligible metals.

Other risks include a potential change in margin call level and possible delays in liquidation during servicing transfer.

Then there's the regulatory risk.

In its lawsuit against Monex, the CFTC asserted that the documents transferring title to the metal held in a third-party depository does not constitute an actual delivery. If that were the case, the agency would have jurisdiction over the transfer and sale of the metals as off-exchange futures transactions.

If the CFTC eventually wins its case against Monex, A-Mark's transaction will wind down in an orderly liquidation of the issuer's assets, according to Morningstar. The transaction will be able to pay timely interest and principal prior to the legal final maturity date.

In its presale report, Morningstar noted that A-Mark delivers metal to a depository of the customers' choosing, pursuant to a consent order with the CFTC; therefore the rating agency believes that the theory raised by the CFTC in the Monex litigation would be unlikely to pose the same risk to A-Mark's transaction.

Nevertheless, the CFTC remains active in enforcing these boundaries, and litigation against A-Mark's transaction could even result in an event of default, the presale report states

.

Solar finance company Mosaic takes page from marketplace lenders' book

Mosaic's latest solar loan securitization includes an unspecified portion of loans that it previously sold to Goldman Sachs.

In September, the solar loan provider inked an agreement to sell $300 million of loans to Goldman on a forward flow basis. The deal provided Mosaic, which has been growing rapidly but is still losing money, with an additional source of funding, as well as a vote of confidence.

In June, Goldman is contributing some of those loans as collateral for the $317.5 million Mosaic Solar Loan Trust 2018-2-GS. It's a strategy that the bank and some of its peers have used to invest in consumer loans made by marketplace lenders such as CommonBond.

Goldman is making its mark on the deal in other ways, too. It's the lead manager of the offering and the initial purchaser of the notes (which will then be distributed to other investors). Goldman is also holding onto a portion of each tranche of notes to be issued in order to comply with risk retention rules.

Each month, 95% of available funds from interest and principal payments on the collateral will be allocated to the "distribution account" to be paid to notes sold to third-party investors and 5% will be allocated to the "retained interest distribution account" to be paid to the notes held by Goldman. Kroll stops short of saying that the collateral itself is segregated into loans supporting the risk retention interest and loans supporting the other notes, though it comes pretty close. The presale report says that it is "useful to consider a divided collateral pool." The rating agency believes that this structure is "unique" and "creates an additional level of complexity that investors must consider."

The presale report does not elaborate, but these complexities might include the fact that the credit characteristics of the loans Goldman is contributing are slightly different than those Mosaic itself is contributing. Namely, they are more seasoned, 10 months, on average, versus six months for the loans that Mosaic is contributing, according to Kroll. Other credit characteristics, however, including FICO scores, principal balance, original term and state concentration, are similar.

The structure of MSLT 2018-2-GS is "unique" and "creates an additional level of complecity that investors must consider."

Kroll assigned an A- rating to the senior tranche of Class A notes that were issued by Solar Mosaic 2018-2-GS, one notch lower than the A it assigned to the senior tranche of Mosaic's three previous deals. That rating applies equally to the 5% of notes retained by Goldman and the 95% that will be distributed to other investors.

The overall pool of loans backing Mosaic 2018-1 is slightly riskier than that of Mosaic's previous deal by at least one measure: The borrowers have a lower weighted average credit score (741 versus 743). Partly for this reason, the rating agency expects gross defaults to be slightly higher, at 7.20% over the life of the deal, versus 7% for the previous deal. The loans that have a similar weighted average choice rate (4.55% versus 4.52%), however.

The presale report reiterates additional risks that Kroll cited for Mosaic's previous transactions, including limited performance data and use of proxy data, the impact of manufacturers, installers or performance guarantors failing to honor their warranty/guarantee, collateral with interest rates and/or monthly payments that may increase, longer-term consumer loans and changing technology.

Future deals could include collateral contributed by other investors; Mosaic recently completed a $300 million forward flow whole loan purchase commitment and has a bespoke program to originate loans on a new partner's lending platform for potentially as much as $550 million.

A new type of insurance ABS

LTC Global, a Florida-based insurance services firm, sponsored its first securitization of a "relatively new" asset esoteric class: insurance sales commission receivables.

The $129.7 million Insurance Commission Receivables Backed Notes Series 2018-A, which closed on June 25, is secured by a stream of commission receivables from the in-house or third-party distribution of LTC-branded life and long-term healthcare products, or the acquisition of commission payment streams from other insurance agencies marketing life, healthcare and Medicare insurance products.

All of the in-house policy originations are through an LTC affiliate, ACSIA Long Term Care; the acquired commissions include those from a host of distribution companies the privately held LTC has acquired since 2002, according to a presale report from DBRS.

The note proceeds are paying for the acquisition of the receivables originally financed through its bank credit facility, according to DBRS.

Insurance ABS deals of any kind are rare, and to date most have involved receivables from consumer premiums such as PFS Corp. or sponsored by firms like J.G. Wentworth that acquire rights to structured-settlement insurance claims.

A single tranche of notes with a preliminary A rating from DBRS will be issued. The notes are backed by $202.7 million in estimated commission receivables from 171,666 existing insurance policies. That amounts to an average actuary-estimated $1,180 per policy; the estimate does not include future annual service commission receivables averaging $193 per policy. Those valuations, based on independent review of contract details and past commission statements, are used to determine the "appropriate" price that LTC pays for a block of commission-stream assets. DBRS, using its methodology for determining commission applied a steep haircut to that valuation estimate to just $169.4 million in its review of the deal, although that level still provided a 23.4% overcollateralization level to secure the necessary enhancement for the single-A rating.

The weighted average age of insured at the time the policies were taken out is 59 years of age; with an average 10.1 years seasoning, the current age of policyholders of the products in the collateral pool is 69.

DBRS said the insurance commission asset acquisition and finance industry "remains relatively new, with few participants." LTC itself acquired only long-term care insurance commission assets in its first six years before buying up United Insurance Group Agency in 2008 to expand into Medicare-related insurance commission assets, according to DBRS.

The company has made more than two dozen insurance agency acquisitions since 2003 to build out six insurance distribution brands. The two most recent deals involved the June 2017 takeover of life insurer Pacific Southwest Financial & Insurance Services and the April 2018 acquisition of The Smith Cos.

Who Won, Lost Supreme Court's Credit Card Ruling

Here's what the outcome of the antitrust battle with the government means for other cards, banks, retailers and consumers

By Kevin Wack

Whether they take the form of cash, miles or points, credit card rewards have become a staple of U.S. consumer culture. Many households, particularly at the upper end of the income spectrum, charge just about every purchase, mainly so they can collect rewards with each swipe.

Between 2010 and 2016, the nation's six largest card issuers more than doubled their spending on rewards, according to one study published last year. Many of those perks were funded through increases in the fees that banks and card networks charge to retailers that accept their cards.

On June 2,5 the U.S. Supreme Court ruled in favor of American Express in a 5-4 decision that enshrines the economic model upon which credit card rewards rely.

The Obama administration and numerous states had sued Amex, arguing that provisions in the company's contracts with retailers were harmful to competition. Amex's contracts essentially bar merchants that accept American Express cards from steering consumers to pay with rival cards that charge lower fees.

If the government's argument had prevailed, retailers that accept American Express but aren't happy about the fees Amex charges could have encouraged customers to use Visa, Mastercard or Discover, perhaps by posting a sign near the cash register in an effort to influence which card the customer pulls out of the wallet.

But in an opinion written by Justice Clarence Thomas, and joined by the rest of the court's conservative bloc, the court sided with Amex, and said that the New York-based company can ban steering practices in its contracts with retailers.

The decision is likely a win for consumers who are avid users of credit card rewards programs. But for consumers who typically pay with cash or debit cards, it may be a loss, since merchants contend that they pass along the cost of higher swipe fees to their customers.

The decision is also a setback for retailers, which persuaded Congress to rein in debit card swipe fees in 2010, but have been unable to replicate that success in the credit card market. The impact on Discover, Visa and Mastercard, as well as banks that issue credit cards on the latter two networks, is murkier.

While the case involved arcane legal concepts that are the bailiwick of antitrust scholars, the court's decision relied on a fairly simple idea — that judges need to consider the impact of Amex's contracts on not only retailers, but also consumers. "If a merchant accepts the four major credit cards, but a cardholder only uses Visa or Amex, only those two cards can compete for the particular transaction," Thomas wrote. "Thus, competition cannot be accurately assessed by looking at only one side of the platform in isolation."

Justice Stephen Breyer wrote a dissenting opinion in which he argued that Amex should be required to compete with other card networks on the price of the fees they charge to merchants.

The government's lawsuit was filed eight years ago, when the credit card industry was still contending with mountains of consumer debt that went bad during the financial crisis.

The Obama administration initially prevailed in U.S. District Court in 2015, but that ruling was tossed out by a three-judge panel of the Second Circuit Court of Appeals in 2016

After the Trump administration declined to appeal that ruling, 11 states that were co-plaintiffs asked the Supreme Court to hear the suit.

The ruling drew praise from Amex and others in the credit card industry. "The Supreme Court's decision is a major victory for consumers and for American Express," CEO Stephen Squeri said in a statement.

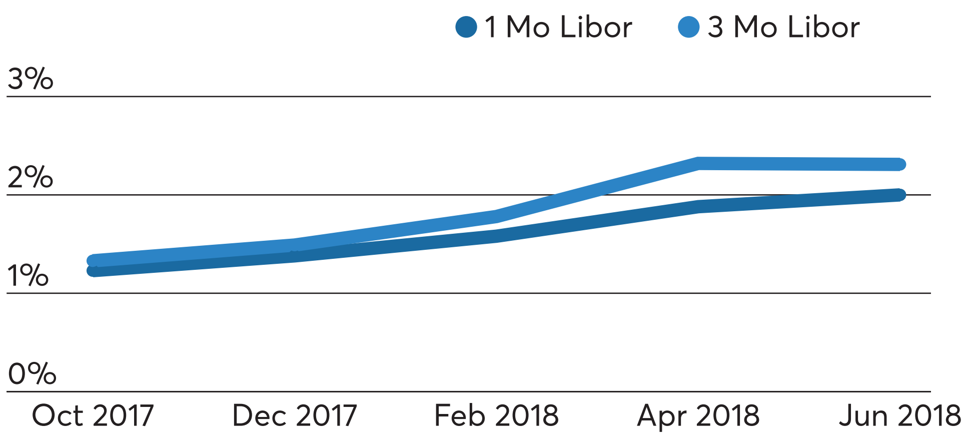
"By maintaining the status quo, the lack of transparency and competition will lead to higher prices."

Retail industry groups were most critical of the court's decision, arguing that the fees that merchants pay get passed along to consumers. "The United States has the highest costs and most fraud-prone payments card market in the world," Mark Horwedel, CEO of the Merchant Advisory Group, which represents retailers in the payments sphere, said in an email. "By maintaining the status quo, the lack of transparency and competition in the U.S. will lead to higher prices at point of sale."

Bill Carcache, an analyst at Instinet, argued in a research note that even if the ruling had gone against Amex, merchants likely would have been hesitant to steer customers to a particular credit card for fear of antagonizing shoppers and consequently losing sales. **ASR**

Separate ways

The difference between 1M and 3M Libor has widened from 10 basis points in October 2017 to as much as 45 basis points in mid-May



Source: global-rates.com

CLOs' Other Libor Problem

Since the start of the year, a widening spread basis between one- and three-month benchmark rates has raised costs for managers

By Glen Fest

Libor's eventual demise isn't the only kind of headache this benchmark is giving the CLO market. Even as they start to consider a suitable replacement, managers of collateralized loan obligations are dealing with a more immediate problem: A divergence between the one-month and three-month London interbank offered rates is eating into their profit margins.

The floating-rate securities issued by CLOs pay rates pegged to three-month Libor, while the leveraged loans that collateralize them can be tied to one of four different rates, ranging from one-month to six-month Libor. What's more, corporate borrowers typically have the ability to switch from one Libor rate to another from month to month.

For the better part of a decade, the potential mismatch did not matter much, because there was relatively little difference between one-month and three-month Libor. But since last October, this difference has widened from just 10 basis points to as much as 45 basis points in mid-May, as three-month Libor increased more than did one-month Libor. The difference, or spread, has since narrowed a bit, to around 25 basis points (as of July 6).

No surprise, as the cost of borrowing at a rate benchmarked to three-month Libor has risen, more corporate borrowers have switched to one-month Libor, lowering their funding costs. Yet CLOs continue to pay interest on their securities based on three-month Libor.

Over half of U.S. leveraged loans (57%) held by CLOs now reference one-month Libor, according to S&P Global Ratings.

This has whittled away at the "excess spread" in CLOs – essentially a manager's profit margin

Half of CLO assets pay one-month Libor; the mismatch is borne entirely by equity holders and amounts to a 1% decrease in yield

– because there is less cash left over at the end of each quarterly payment period. These leftover funds go to the most subordinate securities issued by CLOs, known as the "equity," which is typically held at least in part by managers themselves.

Equity pays the price

"If you assume all rated CLO bonds are priced at three-month Libor and half the assets to one-month Libor, then that mismatch is borne entirely by equity and should amount to about a 1% decrease in yield," said Berkin Kologlu, a senior portfolio manager at Angel Oak Capital Advisors.

For now, Kologlu said, CLO managers should still earn enough on their loan portfolios to at least pay the interest on rated tranches of CLO securities. So equity holders are the only ones getting squeezed.

Two things could worsen the situation, however. The spread between one-month and three-month Libor could widen further or more corporate borrowers could switch to one-month Libor.

If either happens, there's not much CLO managers can do. They have no way to compel their own investors to accept a different benchmark (and a lower yield).

Particularly for senior CLO noteholders, "it's a nonstarter," said Robert Villani, a partner at the law firm Clifford Chance. Managers "can't go there," he said.

Holders of senior, triple-A-rated CLO notes are the most reluctant because they have the most to lose. Switching to one-month Libor would reduce the interest rate on these securities, which his spring averaged 103 basis points, by one-third.

Villani says managers are more likely to have successful negotiations with junior noteholders. On the more subordinate, double-B-rated notes, a 30-basis-point swing on the in CLO soread would be far less impactful on their average spread price that averaged approximately 573 basis points in June (according to figures from Thomson Reuters LPC).

CLO managers have more to worry about than shrinking profit margins, however.

Stressed tests

The wider spread between the two benchmarks is causing many deals to run afoul of various tests designed to protect investors, such as the minimum weighted average between cost of funds and loan proceeds or the cushion needed on returns to cover interest costs.

Managers' profit margins are being eroded by a number of factors, so concerns about declining excess spread are nothing new.

Not so interest coverage ratios, however. Wells Fargo noted in a May report that this metric is currently at the "lowest level in post-crisis history."

Analysts at Wells Fargo used an "extreme" scenario on a 2016 vintage CLO to see what would happen if all of the loans used as collateral switched to one-month Libor, when this benchmark was at its peak level of May. They determined that the CLO would pass its interest coverage test, but only barely; the interest-coverage cushion fell by 18 basis points to 109%, still above the minimum cushion of 105%.

Some managers are feeling more pain than others. Ivy Hill Management, which manages middle-market CLOs, saw a 60-basis-point reduction in the weighted average spread levels on its deals as borrowers whose loans they held switched to one-month Libor, according to managing director Stephen Alexander. (Alexander made his remarks at a roundtable event hosted by S&P, which published a transcript of the event n May.)

The CLO market has been here before, briefly. In 2008, at the height of the financial crisis, there was a 100-basis-point spike in three-month Libor. According to S&P, it caused 7% of CLOs outstanding at the time to fail their interest coverage tests early in the fourth quarter of that year, resulting in interest payments diverted from CLO equity and junior notes to pay principal on the senior notes.

The crisis dissipated within a quarter as the spread quickly returned to more typical levels and largely stayed there until last October.

Complicated solutions

While there's little CLO managers can do to mitigate the impact of Libor mismatch on existing CLOs, some new deals issued since March allow managers to switch benchmarks, according to S&P.

It's one of many "equity friendly" features that managers have been able to negotiate as a result of the strong demand for CLO securities, including fewer restrictions on purchasing covenant-lite loans and looser cushions on spread tests and asset quality.

Not every manager has been successful in securing the ability to switch benchmarks in new deals, however.

"Unless the basis between the one- and three-month rates flattens, we anticipate this could be an ongoing source of tension between equity and debt investors," S&P stated in the May report.

There are other potential solutions.

Neeraj Shah, a senior manager at EY, thinks CLO managers might consider negotiating for the ability to switch benchmarks under limited circumstances, such as sudden hitting a threshold for the percentage of assets paying one-month Libor.

'Unless the basis between the one- and three-month rates flattens, we anticipate this could be an ongoing source of tension between equity and debt investors.'

"Another solution could be to put basis hedges on top of your deal," he said at an industry conference in May, "but that could be expensive given the widening of the basis right now."

Even if holders of senior CLO securities were to agree to switch their benchmark to one-month Libor, it's not clear how the payments would be calculated. Interest on the securities could still be paid quarterly using a blended one-month note average over the course of the quarter; alternatively the interest rate on the CLO securities could be reset monthly and paid monthly.

"But to the extent that there were three-month loans in the deal, there would need to be a cash flow smoothing mechanism," one market observer said. "There are a lot of variations on the possibilities out there."

The problem is pretty speculative, however.

"Equity investors do not want to lose return, and note investors want three-month Libor paid quarterly," this person said. "So at the moment, there is somewhat of a standoff." **ASR**

Bond Buckets May Be Back

Federal regulators are considering a rollback of the Volcker Rule that has effectively kept CLOs from holding anything but loans

By .Glen Fest

Changes that federal regulators are contemplating to the Volcker Rule could pave the way for CLOs to resume investing in high-yield bonds, something they have not been able to do for the last three years without putting themselves off limits to banks.

On May 30, the Federal Reserve Board of Governors issued a 373-page proposal that would materially loosen restrictions on proprietary trading by banks as well as investments in "covered funds," a category that, as currently defined, includes both hedge funds and collateralized loan obligations.

While the Fed did not take a position on whether banks should be able to own CLOs that hold bonds, the request for comments show it is back in play. These include the definitions of "covered fund," "ownership interest" and "loan securitization."

As the Loan Syndications and Trading Association noted in a report published on its website, "changes to any of these definitions could result in the end of the current prohibition."

The proposal has since received the backing of the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Federal Deposit Insurance Corp. and the Commodities Futures Trading Commission.

To recap how Volcker, as currently written, impacts CLOs: CLOs are considered to be covered funds because they rely on the same exemption from securities law as do many hedge fund and private equity funds from registering with the Securities and Exchange Commission. Banks, which are among the biggest CLO investors, are prohibited from holding equity stakes in covered funds.

Former Fed Chairman Paul Volcker

In its original interpretation adopting the Volcker Rule for CLOs, the Fed stated even holding senior debt securities issued by noncompliant CLOs (i.e., those still with bond collateral) can represent ownership status because these securities confer the ability to hire or fire an investment manager.

Notwithstanding the fact that they are covered funds, CLOs can qualify for an exemption from the Volcker Rule available to securitizations backed exclusively by loans, and not by bonds or other kinds of securities.

CLOs can qualify for a Volcker exemption available to securitizations backed exclusively by loans, and not by bonds or other kinds of securities. Since the Volcker Rule took effect in 2015, the vast majority of CLOs have put themselves into compliance by eschewing or unloading bonds.

Among the questions the Fed is now asking is whether regulators should permit "a loan securitization vehicle to hold 5% or 10% of assets that are considered debt securities rather than 'loans.'" In the past, bonds typically accounted for no more than 5% to 10% of the collateral for CLOs, so such a change would put the market right back where it was before 2015.

It's not the first time a federal agency has contemplated changes to the Volcker Rule that would put bond buckets back in play. A proposal was floated a year ago by the then-acting U.S. comptroller of the currency, Keith Noreika, with the possibility the OCC might act on its own to reinterpret the prop-trading ban.

The proposal "goes a long way in simplifying a very complicated rule," particularly for community and mid-sized banks.

"It seems clear that the agencies are opening up a real debate and consideration" on changes that could allow bond assets which "fit within the constraints of the Volcker Rule," analysts at Deutsche Bank said in a report published June 5.

In a May 31 client alert, Cleary Gottlieb stated that the proposed rulemaking "represents a first step toward simplifying and clarifying the Volcker Rule."

The day after the Fed's board approved the proposed changes, the FDIC's board unanimously approved the plan as well.

The board includes Comptroller of the Currency Joseph Otting, who said the proposal goes "a long way in simplifying a very complicated rule," particularly for community and midsize banks.

Regulators maintain that the type of risky trading originally banned under the rule first envisioned by Volcker, the former Fed chairman, would still be banned.

(*Rachel Witkowski of American Banker contributed to this article.*) **ASR**

Futures Pioneer Bets on Successor to U.S. Libor

Richard Sandor says Ameribor does what the London interbank offered rate is supposed to do: Represent the true costs of funds

By Glen Fest

Richard Sandor helped develop the first interest rate futures in the 1970s as chief economist at the Chicago Board of Trade; in the 1990s he founded the Chicago Climate Exchange, the world's first exchange to facilitate the reduction and trading of greenhouse gases.

Since 2012, he's been working on what could be a successor to the London interbank offered rate for U.S. assets: An interbank lending rate called Ameribor. This homegrown benchmark is already being used by nearly 100 community and regional banks to price wholesale, unsecured funding between institutions in place of Libor.

Ameribor does what Libor is supposed to do: represent the true cost of funds. It is set by overnight, open-market transactions on the Chicago-based American Financial Exchange (AFX), offering what Sandor describes as a "fully transparent" benchmark using "actual transactions" under trade regulations of the Chicago Board Options Exchange.

"This is a rate just like a stock price is determined by continuous order flow, between lenders and borrowers that occur during the trading day," said Sandor, who is also a distinguished lecturer at the University of Chicago School of Law.

Now that Libor appears to be on its way out, Sandor and his team are promoting Ameribor's expansion for further bank borrowing as well as for use in futures and options contracts. (The AFX publishes an overnight Ameribor rate, and is preparing the launch of a 30-day rate).

In Sandor's his vision, Ameribor could be among several benchmarks – including the Secured Overnight Funding Rate (SOFR), published by the New York Fed – that will be used in place of Libor should that latter disappear after 2021 when panel banks will no longer be required to submit quotes for its publication.

Richard Sandor

Sandor recently spoke with Asset Securitization Report about the development of this new index and its potential as a benchmark for all kinds of assets, including asset-backed securities. An edited transcript follows.

ASR: Explain why the American Financial Exchange wants to develop a new benchmar?

Sandor: In 2012, when we trademarked Ameribor and filed our first patents, we had three hypotheses. Hypothesis one was that zero interest rates were not sustainable. They were a policy born out of a crisis, but not sustainable and that interest rates would normalize. In that normalization process, a poll of a benchmark was not the best way to do it, and that Libor would be criticized and would have to change dramatically or fail.

The second hypothesis – the Fed funds market had disappeared, and the role of a government being the sole lender and borrower would eventually disappear. Interest on excess reserves would be lowered while peer to peer lending and electronic exchange with interest rates competitively determined would have a high-value proposition.

The third hypothesis – broad representation maximizing the true cost of funds for community banks, regional banks, domestically oriented banks in general. These are the banks that disproportionately lend to small businesses, the mainstay of job creation in America.

What are the next steps?

We have several banks that are interested in adopting, on a pilot basis, Ameribor as the benchmark for commercial and industrial loans. We'll be working on trying to do that in the next quarter. As Ameribor gets accepted and as we build its credibility, a pilot program on interest-rate swaps based on Ameribor will emerge. Then we will launch a futures contract and then option contracts which will facilitate the hedging of swaps. This will provide instruments tailor-made for bank asset-liability management.

What's given you the confidence you can get wider acceptance and adoption of Ameribor?

We feel that this represents to domestic banks a tool which represents unsecured borrowing and lending rates, and we feel that would be quite different from SOFR, which is a fully secured risk-free rate not that applicable to bank lending. We have people in both the banking side and the investment side that would like a floating rate truly tied to bank funding costs.

And based on transaction data?
Absolutely. Actual transactions, fully transparent and regulated by an SRO, the CBOE. Anti-manipuation rules, compliance, no spoofing. It will be a private-sector rate that is independently calculated and the compliance department of the CBOE will oversee that the trades are conducted according to the anti-manipulation rules specified and contained with the Ameribor rulebook. While Ameribor will be a weighted average of all trades during a month, the individual transactions can ultimately be audited.

How is the rate derived between the two counterparties?
The same way that Apple stock is [priced]. There are bids and offers between 7 and 5 central time, and it's a continuous market like derivatives and equities. When bids and offers cross, the transaction occurs. It's not preset. That's the important point. This is a rate just like a stock price, bond price, or financial future that is determined by continuous order flow between lenders and borrowers that occur during the trading day.

How would it transition into ABS?
Ameribor or SOFR-based assets that are floating rate would be easily placed in asset-backed securities the same way that is done with Libor today. Those floating-rate assets could then be swapped into fixed rates with liquid hedging mechanisms as Ameribor futures and options emerge.

What asset classes would you say it is most suitable for, and why?
It will likely first start with commercial loans. Our member banks may identify customers to use Ameribor in new loans. The same may happen when another financial player wants to do a swap based on Ameribor. The adoption will be gradual – especially as the market becomes more robust and grows after the launch of futures and options.

Will Ameribor eventually develop longer tenors?
I don't think so, because I think if you have an overnight, 30-day, maybe a 90-day, you can swap or use futures to synthetically create longer tenors. That's what the Eurodollar futures market does. If you have a 30-day or a 90-day or both, you can list them out three years and synthetically create a one-year or two-year. If you have an active and successful futures market, you don't need a one- or two-year rate because it's redundant.

If ICE Benchmark Administration decides to continue publishing Libor past 2021, could Ameribor co-exist in that market?
Absolutely. That in fact may be where it ends up, where you have three choices. SOFR, Ameribor and perhaps a modified Libor. There will be financial institutions that want to use SOFR for the derivatives market, Ameribor for domestic banks or even Libor for the multinationals.

Are there use cases being developed to convince big banks to begin lending on the higher Ameribor rate?
Yes, we started working with community and regional banks. Now we are moving to the super-regionals, and it will only grow. It could be a tool for any banks if it is stable and hedgeable.

Why would they choose Ameribor so long as the overnight or 30-day Libor is lower?
Multiple benchmarks serving different market niches are a good thing. Secondly, banks make their money on what they charge above a benchmark, so the issue of which benchmark is higher is less important. I would also point out that Ameribor is not really higher except when international currents distort Libor. More important, banks will be drawn to a benchmark that is stable and hedgeable.

What makes Ameribor's basis as a U.S.-based rate important for borrowers and lenders?
It is a more realistic depiction of their actual cost of borrowing. It can become more of a bellwether because it takes into consideration transactions from a wide array of institutions in various parts of the country, doing business in different regions, which have their own characteristics and different economic factors.

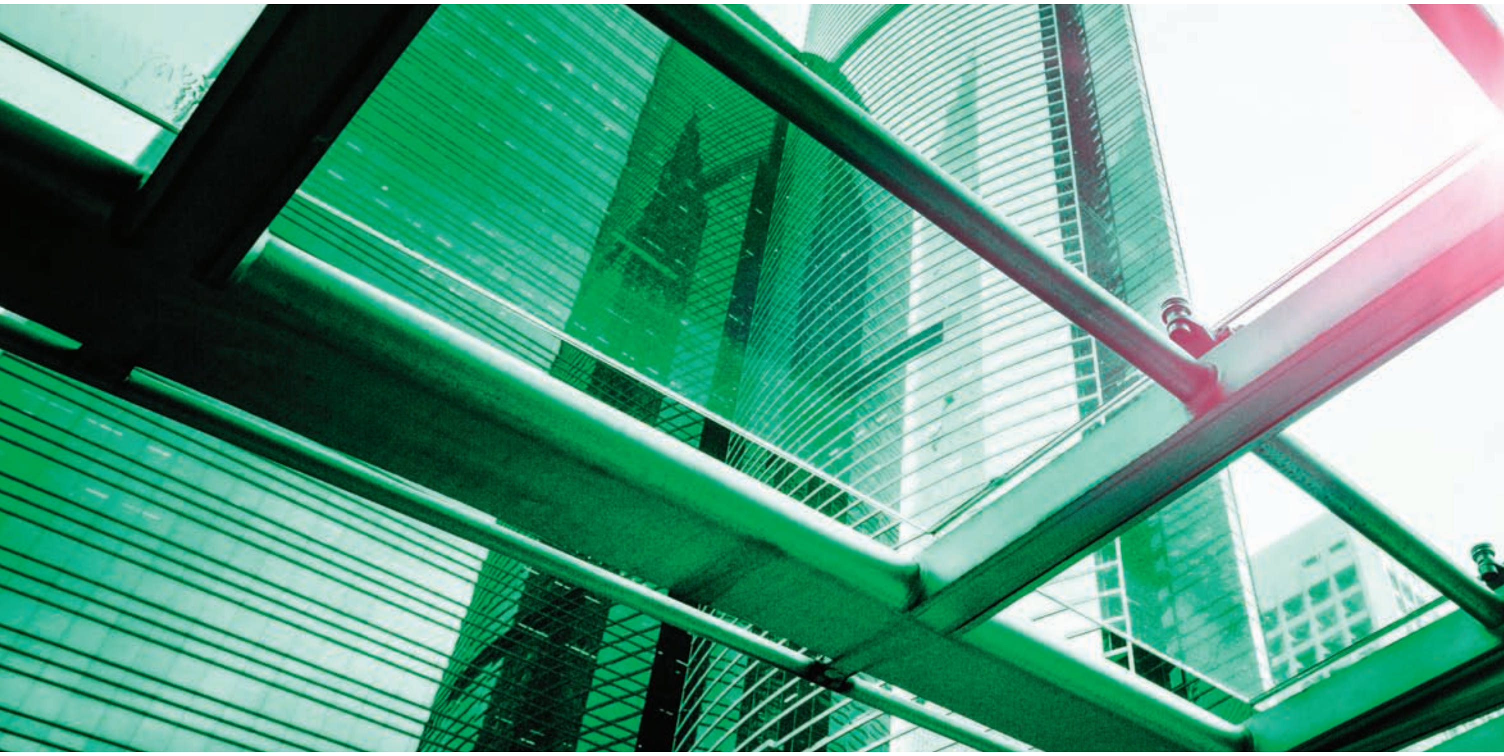
How would Ameribor avoid the volatility that's occurred with Libor?
A broad enough market, as we have designed this to be, compresses that volatility. If you have a limited number of players, you're likely to have more volatility. And that's true in finance throughout. Thin markets tend to be volatile, and more liquid markets, other things being equal, tend to be less volatile. Now if the underlying dynamics cause volatility as it did in 1979, or 2007, it might suppress it a little but it's not going to be a cure; it's just a way to have an efficient market so that there is a minimization of spikes which don't reflect underlying supply and demand.

What are challenges to building up liquidity in and adoption of Ameribor-based transactions?
My experience is it takes a decade for real adoption. I started working on interest financial futures in 1969. We launched the first futures six years later [through the Chicago Board of Trade] ... and I would say it took a decade through the Volcker tightening in the late '70s. So it's a decade-long process and we've got six years in [Ameribor] by now. **ASR**

VISIONARIES
IN THE CLO MARKET

A SUPPLEMENT PRODUCED BY SOURCEMEDIA MARKETING SOLUTIONS GROUP

SourceMedia MARKETING SOLUTIONS GROUP | Asset Securitization Report



CLO Market 2018: Exceeding Already High Expectations

Collateralized Loan Obligation (CLO) new issuance is running 55 percent ahead of last year's exceptionally strong pace: as of May 7, 2018 it stoods at $43 billion dollars, according to Thomson Reuters figures. In addition to new paper coming to market, the CLO market is also characterized by a frenzy of refinancing and resetting activity. All speak to the strength of the CLO structure. By any metric, CLOs are hot.

"We didn't anticipate the first quarter to be so strong, even though we already had bullish estimates," says Hugo Pereira, Senior Market Analyst at Thomson Reuters. If the pace of new issuance continues, it would exceed the even the most bullish estimates of $140 billion for the year, though it is anyone's guess if the market will moderate during the second half of the year.

There are multiple factors driving the burst in activity seen in CLOs. On the demand side, investors are seeking yield, as well as a way to hedge the anticipated raise in interest rates. CLOs, given their attractive historical yields and floating rate features, are a compelling solution. But there are also positive economic conditions propelling the activity in refinancing and resets. Perhaps most significantly, there have been important recent regulatory changes that analysts believe will be favorable to the CLO market going forward.

End of Risk Retention Rules

The biggest change impacting CLOs is that effective April 3, 2018, the risk retention rule that required CLO managers to retain five percent of the fair value of the CLO has been

(Continued on page A4)

The impact of risk retention rules going away is broadly healthy for the market.

—Sean Solis, Partner, Dechert LLP

(Continued from page A2)

vacated. The elimination of the rule could open the CLO market to new managers who had been pushed to the sidelines, potentially improving deal flow as a result.

"CLO managers can now focus on optimizing the structure of their deals with a complete credit focus on the underlying loans, which is all debt and equity investors should want them doing rather than focusing on constantly having to raise risk retention capital," says Sean Solis, partner, Dechert, LLP. Previously, managers had to scramble to raise this capital required by the rule. This posed problems for smaller or less well-known managers. Additionally, managers might have eaten through the capital they had already raised, holding back further deals. Now the playing field will be leveled, allowing entrants who are adept at managing credit but not be as successful at raising risk retention capital.

Solis points out the Circuit Court's decision only directly applies to open-market CLOs; it excludes what are known as "balance sheet deals," which are CLOs which implicate the sale or transfer of assets from an entity that organizes and initiates the CLO transaction. Balance sheet CLOs are a financing option for middle market platforms that securitize loans on their balance sheet by transferring or selling such loans (and the related credit risk of such loans) to a CLO issuer. Balance sheet CLOs require compliance with the risk retention rules.

One argument in favor of the risk retention rule is that it aligned the incentives of CLO managers and investors because it forced managers to have skin in the game. However, Solis argues managers do in fact still have skin in the game because of the cash flow waterfall structure. Their subordinated management and incentive fees are paid at the bottom of the waterfall right above the equity portion of the capital structure.

From a public policy perspective, Solis says, "the impact of risk retention rules going away is broadly healthy for the market. The key note to keep track of going forward is whether the elimination of the risk retention rules will facilitate higher quality credit loan selections given that the manager no longer has to spend precious time, effort and resources in the constant hunt for more risk retention capital."

The industry trade group, the Loan Syndications & Trading Association, known as LSTA, was instrumental in getting the rule lifted. LSTA General Counsel Elliot Ganz says of the new result, "It's good for the market and investors." Philosophically, he argues Congress never really intended the rule to apply to open market CLOs as these weren't originating and selling loans. Practically the change brings new fairness to the market, because smaller managers had been most impacted.

Ganz's assessment: "this is a very good result. While the CLO market is very hot with a lot of capital coming into it, markets change. This frees up managers who were otherwise challenged from doing deals because of risk retention rules."

Not all analysts believe the end of the rule will be a true game changer for the CLO market. Christopher Testa, managing director, head of research, National Securities Corporation, says, "Investors in CLOs are accustomed to and like seeing CLO managers put their own skin in the game in terms of the five perecent rule." He argues this explicit alignment of incentives is one of the factors that increased institutional investor interest in CLOs. Therefore, he says, "I think what you will see is that regardless of the law, institutions will demand that managers still keep five percent risk retention in the structure as a show of good faith."

Testa also doesn't think the elimination of the rule will expand the universe of managers substantially. "I don't see a lot of new entrants. It will take a lot of time

(Continued on page A8)

The Beat of the CLO Market

With more than $350bn in assets under administration, Virtus Partners is the premier provider of front, middle and back-office solutions for alternative asset managers and banks in the Structured CLO and Leveraged Loan market. Paul Livanos is a Director at Virtus Partners responsible for leading business development efforts across multiple business verticals including Credit Portfolio Management, Middle Office Managed Services, Fund Administration, CLO Trustee Services, and Loan Agency & Settlements. Mr. Livanos has over 12 years of experience in Structured Finance. Outside of work he is a classical guitarist and avidly appreciates music. To learn more about Virtus Partners, please visit us at www.virtusllc.com or email Paul.Livanos@virtusllc.com

—Paul Livanos, Director, Business Development, Virtus Partners, LLC

What explains the upsurge in investor interest in CLOs?

Virtus Partners provides key services and technology to our clients in the structured credit and leveraged loan space. We have very close relationships with our clients and we often share our views on the market. There are a few forces behind increased demand for CLOs. First, rising interest rates are driving demand as CLO assets and liabilities are floating rate instruments. Second, CLO returns are more attractive compared to other assets at the same entry point. Investors are getting around 3.5% on AAA rated CLO debt compared to the 10-year Treasury, which is now 3%. Finally, CLOs are a proven and successful asset class. We're seeing more investors and managers coming into the CLO market.

Where are interest rates headed?

Broadly speaking the expectation is that there will be more rate hikes and LIBOR will continue to rise. Rising rates are good for CLO investors because the liabilities are floating rate. CLO debt is overcollateralized and the residual goes to the equity, so an increase in LIBOR can be good for equity investors as well. One headwind to CLO equity is the spread differential between 90-day and 30-day LIBOR. The underlying loan issuers are able to choose the reference rate for their debt. Almost two-thirds of loans held by CLOs are now referencing 30-day or 60-day LIBOR. The spread differential between to two rates is about 45 bps. On a CLO that is 10 times levered that will have a material impact on equity cash flow. The hope is that rates will normalize over time but this could be a problem that lingers for a while.

Where are some of the best opportunities in the CLO market right now?

According to the structured credit investors we work with there has been demand for all tranches recently. With debt there is no arbitrage risk and the assets are more liquid since they're rated. Towards the beginning of the year, the spread on AAA's tightened to LIBOR+90's. Then in April they widened to L+110-L+115. This is mostly due to the surge in supply that resulted from a wave of refinancing. Many investors are expressing interest in shorter dated paper. Also, investors who are looking for exposure to CLOs will invest in the warehouse equity.

What are the recent regulatory changes impacting CLOs in terms of risk retention?

The repeal of Risk Retention made it easier for managers to refinance and reset deals since they don't need to comply with the regulation. CLO platforms are less capital intensive and manager can focus on running the business and credit selection. Another byproduct is the CLO market is more competitive with more deals coming to market. On the down side, there's already been a lot of inflow to loans and the supply-demand imbalance is slightly worse. One positive result of Risk Retention is that it brought long-term capital into the asset class. Top-tier managers successfully raised awareness of the CLO story and the economics of these vehicles.

What should investors focus on when considering a CLO management platform?

Investors should understand how managers make buy and sell decisions. Credit selection is going to be key to the performance of a CLO. It's also important to understand the depth of a manager's resources. They need to ask 'Who will maintain the necessary resources to properly manage their deals during the next downturn?' Lastly, a big factor is alignment of interests between the manager and the investor.

Morningstar Credit Ratings highlights trends and risks in the CLO market

Morningstar Credit Ratings, LLC is a nationally recognized statistical rating organization (NRSRO) that has earned a reputation for innovation and excellence. Our goal is to help institutional investors identify and understand credit risk. Our analytical approach stresses transparency of the ratings process, strong fundamental credit analysis, and comprehensive investor-focused reporting that provides a concise Morningstar perspective on credit risk. Our ratings business currently covers CLO, ABS, RMBS, CRT, SFR, CMBS, corporate and financial institution ratings, and REIT.

—John Nagykery, Assistant Vice President, ABS, Morningstar Credit Ratings

What are some of the major themes explaining the upsurge in investor interest in collateralized loan obligations?
Unlike most corporate or securitized debt, which pays interest at a fixed rate, CLO debt provides a natural hedge against rising rates because of its floating-rate nature. The underlying corporate loans are floating rate, which helps maintain the excess spread in the transactions at a relatively stable level.

The CLO structure has proven to be durable, exiting the recent financial crisis with no losses on senior rated debt and relatively low losses on junior rated debt.

The large volume of CLO refinancings after their noncall period has allowed for more short-duration investors to enter the market.

What are the current trends in the CLO market?
After significant tightening over the past few years, the spreads on CLO liabilities have recently widened, partly because of a surge in new issuance, with first-quarter 2018 alone accounting for over $30 billion in issuance. In addition, asset spreads continue to come in because of the high volume of refinancings on the underlying leveraged loans.

The spread between the one-month and the three-month Libor has historically been approximately 10 basis points apart, but it has recently widened to over 40 basis points. This has an impact on the economics of the CLO equity, as approximately half of outstanding leveraged loans are tied to either one- or two-month Libor, while approximately 90% of the CLO liabilities are tied to three-month Libor.

The increased refinancing activity has helped leveraged loan borrowers extend their near-term maturity obligations and push out the overall maturity wall of leveraged loans. While the long-term trend is still to be seen, it is a positive for the short-term loan market volatility.

Finally, leveraged loan defaults have been creeping higher, with a large spike in March following iHeartCommunications, Inc.'s $6.3 billion default.

Are there any potential risks that Morningstar Credit Ratings, LLC is watching?
The repeal of risk retention for U.S. CLOs and the potential repeal of the Leveraged Lending Guidance may increase the number of CLO managers and may lead to originating riskier loans with higher leverage ratios.

With new managers and investors entering the CLO market, along with their need to be constantly invested to avoid the cash drag, we expect even greater demand for the underlying leveraged loan collateral, giving leveraged loan issuers more flexibility in negotiating credit terms. Record covenant-lite loan issuance and more adjustments to earnings before interest, taxes, depreciation, and amortization are a few examples of such impact. In April, this trend has led to at least three CLOs paying down part of their senior notes during their reinvestment periods, potentially because there wasn't collateral available that complied with the transactions' eligibility requirements. Looser CLO transaction documents are also on the rise, with CLO asset managers increasingly looking for ways to maximize their flexibility and improve equity returns. Managers are looking to increase their concentration limits by changing definitions; increasing their ability to invest in current pay obligations, participations, and so on; or by adding provisions to leak excess par to equity holders during certain events. While we have seen these features in very few transactions, it appears that managers are positioning for the next leg of the credit cycle.

"For CLOs, Morningstar Credit Ratings monitors several performance metrics monthly, so we can alert investors of trends and perform surveillance on the ratings if the trends are significantly different than our initial expectations."

Are there any positive trends in the CLO market?
While Libor has been rising, the underlying corporate issuers have been successful at lowering the spreads on their loans through refinancings. This has helped offset the rising rates and continues to allow leveraged loan borrowers to post very strong interest coverage ratios on their debt.

While leveraged loan defaults have been increasing, the market is still in a relatively benign credit environment, and corporations should benefit from the growing economy, low unemployment, and, for some corporations, the tax cuts.

What is Morningstar's outlook and how are you tracking potential risks?
The current trends highlighted in question 2 may hurt the CLO arbitrage and lower issuance in the short term, but in the medium to long term, Morningstar expects resilience in the CLO market. Morningstar is committed to providing the highest level of transparency and responsiveness possible. We strive to provide leading indicators to assist investors in the event of a credit disruption with a borrower, asset class, or industry. For CLOs, we monitor several performance metrics monthly, so we can alert investors of trends and perform surveillance on the ratings if the trends are significantly different than our initial expectations.

While the CLO market is very hot with a lot of capital coming into it, markets change.

—Elliot Ganz, General Counsel LSTA

(Continued from page A4)
before you see someone on the margin coming back into the space."

Economic drivers

Beyond this change in regulation, continued US economic growth has also been good for CLOs. Moody's "US 2018 CLO Outlook," published at the end of last November, argued, "a stable economy and solid liquidity will continue to support the performance of U.S. CLOs." The outlook did warn that CLO collateral quality is likely to weaken but the strength of the CLO structure "will mitigate the negative impact."

At the same time, Testa observes the last few years, starting in 2016, have been challenging for CLO reinvestment, because assets have been highly priced. The vast majority of leveraged loans are trading at par. The lack of market dislocations has created an unfavorable reinvestment environment.

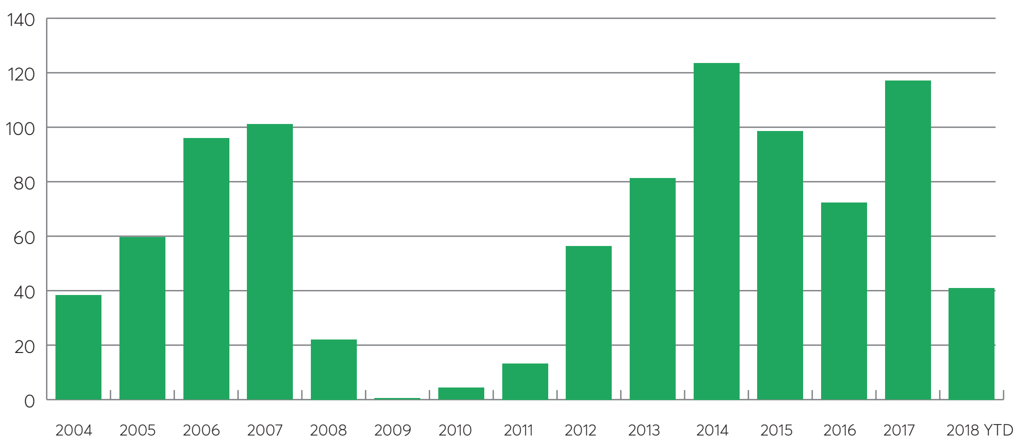
"On the debt side, the saving grace has been the optionality of the structure which allows managers to refinance and reset," Testa says. Furthermore he argues spread compression has slowed and possibly bottomed out, which could create a tailwind for CLOs going forward. Coupled with cheaper refinancing, this abatement in spread compression has translated into a modest pickup in yields in CLO equity. Though CLOs are very hot right now, their best years might still be to come. The reason is that, as Testa points out, CLOs are a countercyclical investment. The structure can offer the highest expected yields during periods of volatility and market dislocations, which create opportunities for CLOs managers.

Dislocation or volatile are not words to describe recent market conditions. Though investors are piling into the asset class in a quest for yield for yield or as a hedge for rising interest rates, they might be overlooking the challenging reinvestment environment facing CLOs. Testa says, "we are pretty much at peak pressure at yield on CLOs."

If, or more accurately, when market dislocations return, CLOs should benefit. It will take knowledgeable investors – with strong stomachs – to be able to ride out the volatile market conditions, but these could lead to significant improvement in yields.

Which is to say, CLOs have this additional attractive albeit overlooked feature, of being able to take advantage of times of market stress, as seen in their performance during the recent financial crisis. Should this happen again, as Testa put it, "people say there is nowhere to hide, CLOs could be a place to hide."

U.S. CLO New Issuance ($Bils.)



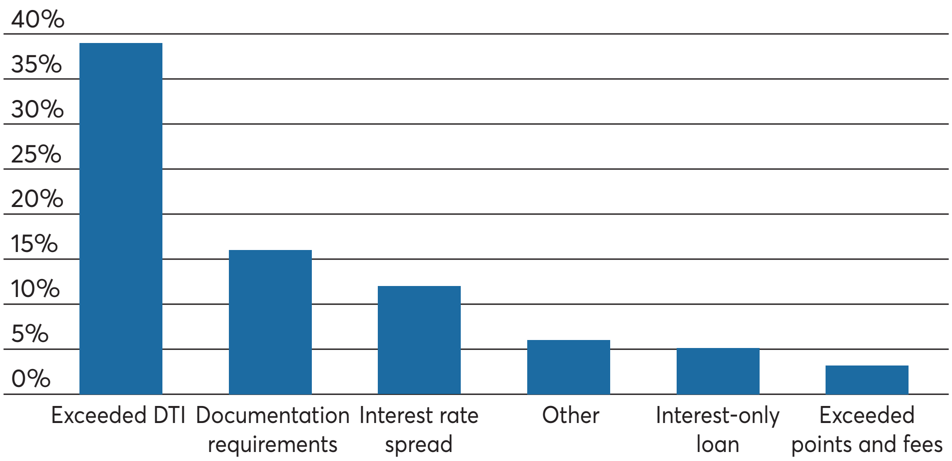
Source: Wells Fargo, Thomson Reuters LPC

PRODUCED BY

SourceMedia™ MARKETING SOLUTIONS GROUP | Asset Securitization Report

Non-QM status

Banks cited the following as the leading reasons on how a loan become a non-qualified mortgage



Source: American Bankers Association

Beating the GSEs at Their Own G ame

A broader definition of a Qualified Mortgage could help put a dent in the market share of Fannie Mae and Freddie Mac

By Brad Finkelstein

Since its inception, the qualified mortgage rule has been synonymous with loans purchased by the government-sponsored enterprises or guaranteed by federal agencies like the Federal Housing Administration and Department of Veterans Affairs.

The recent growth in the non-QM market and concurrently, in private-label securitizations, is a result of participants across the loan life cycle becoming more comfortable with the risk characteristics of these loans, especially as interest rates rise.

There are lenders that have or will securitize agency-eligible mortgages in the private-label market now because they can get a better execution. A change to the QM definition could provide a boost to those securitizations.

The current administration would like to pull back the government guarantee on certain types of loans such as cash-out refinancings, high-balance loans, second home mortgages and investor loans, said Peter Norden, CEO of HomeBridge Financial Services. The Trump administration would prefer the private sector own the paper and take the risk, rather than the government giving an implied or explicit guarantee, he added.

It is one of the reasons HomeBridge is working on a deal where it would securitize otherwise agency-eligible paper in the private market.

HomeBridge wouldn't be the first. Some recent private-label deals that included agency-eligible paper were from loanDepot, which did a $299.8 million securitization in March made up of 226 prime jumbo loans and 227 high-balance GSE-eligible loans, while Flagstar did a $329 million transaction consisting of 1,077 agency-eligible loans secured by investment properties.

"It's going to turn out differently ... We're going to make sure our borrowers understand what they're getting themselves into."

"The private-label execution on some QM loans that qualify for the agencies that have a lot of loan-level adjusters can be as good as or better than the agencies," Norden said.

Nor does he see an expanded definition of the QM rule as a zero-sum game. In a changed environment, both the non-QM and expanded definition QM private-label markets can thrive.

"The paper that is eligible for the agencies will in fact be cut back and become part of the private-label securitization market going forward," Norden said. "And whether or not they change the definition of QM on those loans or not remains to be seen."

What he is wary of, though, is the potential size of the market for private-label securitizations of lower-credit-quality mortgages.

"I, for one, have no desire to go back to where we were prior to 2007 from an underwriting perspective because I do not think that would bode very well for the entire mortgage banking industry or for the consumer," Norden said.

There are people who have lower credit scores but also have the income to make the payments and they should be able to get a loan. But those loans should not be combined with a high loan-to-value ratio.

"I am hoping we have some amount of common sense in this business going forward and that we really are driven towards helping the consumer in any way we possibly can as well as helping our overall mortgage-banking community," Norden said.

Carrington Mortgage Services started concentrating on originating mortgages to borrowers with credit scores under 640 about four years ago, serving them through government-guaranteed loan programs. It has now rolled out a suite of non-QM products to lower-credit-score borrowers.

"It's going to turn out differently because we learned something from the last decade. We're going to make sure our borrowers understand what they're getting themselves into," said Carrington President Ray Brousseau.

The default risk falls on Carrington because it will retain these loans through affiliates and service them in-house. It has a long-term incentive to ensure these loans continue to perform.

When it went into the government space, it introduced a proprietary credit learning program called My Loan Detail. Borrowers go through answering a series of questions about the loan transaction, the terms of the loan, their income and even the consequences if they don't make payments.

Any changes to QM should not impact the Carrington program, added Carrington Executive Vice President Rick Sharga. "It depends on what aspects of the QM rules are relaxed, and I can't imagine they'd be relaxed so significantly that we'd see a significant impact on the volume of loans in the non-QM space.

"There is nothing in the QM rules or in the ability-to-repay guidelines that says a low FICO score borrower can't get a loan. There is no FICO minimum for a QM loan. The problem is that most lenders, particularly the depository banks, decided not to participate with those borrowers," he said.

If the CFPB widened the QM tent, it would theoretically be a net benefit to lenders like Carrington, said Sharga. But on other hand, it also might increase the number of lenders that participate in the lower-credit-score space and make it more difficult to maintain market share.

"There's still a comfort level that whatever the expansion in the credit spectrum and in the requirement spectrum by the CFPB is, good loans can still get made," said John Vella, chief revenue officer of Altisource Portfolio Solutions. "Because let's face it, the CFPB is probably seeing it too."

And that is a positive for the entire nonagency spectrum. "With more volume, there's more incentive for the secondary market and there's more financial upside for all the players in the entire spectrum," Vella said, explaining that increased volume offsets costs and brings in revenue for everyone involved in the transaction.

Verus Mortgage Capital is a correspondent aggregator of whole loans affiliated with investment management firm Invictus Capital Partners. Its market is "expanded nonagency," including jumbo loans, self-employed bank statement borrowers, single-family rental and fix-and-flip loans, said Dane Smith, president of the Washington, D.C.-based firm.

It has 145 approved clients with 72 active sellers. Verus purchased about $2 billion in closed loans, both QM and non-QM, since the company started in business and it did $400 million in acquisitions in the first quarter of this year.

"The QM designation doesn't have a huge impact … We're looking for well-underwritten borrowers with attractive credit risk profiles," said Smith.

Securitization is the way that many lenders get term financing on a non-QM loan because of the risk retention requirements.

"People used to think of securitization as a risk transfer; it's no longer a risk transfer, it's a financing," Smith said. "There's significant skin in the game; the non-QM issuers have significant skin in the game today."

There is a secondary market developing because "liquidity begets more liquidity. As more buyers enter the market, the more comfortable originators become originating," he said.

Yet the non-QM business is at a crossroads. In 2017, the non-QM borrower was someone who applied for a loan and was surprised if an application was denied, Smith said. Now, it's starting to consist of people who are discovering they have access to credit after all of the negative news of the past few years.

"We're moving into a period where people will start actively sourcing and generating leads around this space. We're starting to see that with our customers," Smith said. This shift will continue through this year and into next. "It's takes a while for this industry to move forward."

If the QM rules are changed on the margins, conforming lenders could open their underwriting box. But none of the proposed changes raised in the comment process impact Verus' business. If the GSE patch ended, it "actually creates more opportunity for us," Smith said, as fewer loans would be sold to Fannie Mae and Freddie Mac.

"ATR is really the guiding light for the whole industry," he said. The QM rule establishes the legal threshold for which someone needs to prove the case to challenge whether the lender properly assessed the ability to repay. "But ATR itself is essentially the metric." **ASR**

CONTINUED FROM PAGE 6

includes a detailed review of the following:

• Does the proposed framework meet Fitch criteria and industry standards?

• Do deviations weaken the deal structure and/or dilute investor protection?

• Are the risks quantifiable?

Rep, warranty and enforcment constructs that incorporate industry best practices receive no incremental adjustment in our RMBS analysis. However, if the answers to the above questions raise concerns, Fitch may adjust its loss expectations, apply a rating cap or may decline to rate the transaction.

So what has changed over the last five years? The private-label RMBS market is certainly more active than it was back in 2013. While issuance still remains well below the high-water marks we were seeing pre-crisis, originators are certainly warming to securitizing in greater numbers. Whereas super-prime quality deals were the go-to credit profile five years ago, the pendulum is swinging back to deals using collateral that it not as pristine.

While rep and warranty frameworks established post-crisis have features intended to protect investors from the operational risks that were prevalent in pre-crisis RMBS, some new RMBS deals and issuers coming to market of late have rep and warranty frameworks that are showing signs of slippage at a time when they should be taking on greater importance since we're at the end of a very positive (and unprecedented) credit cycle.

Of late, there is a more concerted push among RMBS issuers towards providing only sample due diligence. While most rep and warranty frameworks have safeguards to protect investors from misrepresentation risk on the non-reviewed portion of loans, some frameworks are not conducive to a sample due diligence review. This is particularly true in the non-QM space, where 100% due diligence is viewed as a key offset to the weaknesses in the rep and warranty frameworks. As diligence review sample sizes and scopes weaken, more RMBS investors will be exposed to rep and warranty weaknesses that could become evident if mortgage defaults increase. In short, some of the rep and warranty frameworks evident in select RMBS deals leave room for improvement.

An initiative by the Structured Finance Industry Group called RMBS 3.0, which established consistency among various issuers' loan level reps, was a step in the right direction. Importantly, the working group advanced a "best practices" approach with standardization and ways to easily identify differences as well as clawback provisions for loan level reps with knowledge qualifiers, which helped address issuer liability concerns without diluting investor protections. Though the initiative was never fully implemented, Fitch viewed it as a positive and constructive change. Other improvements that have been discussed widely by market participants but have not yet to be implemented include adding a deal agent, which should address weaknesses Fitch believes still exist with regards to investor reporting and communication.

Fitch's focus and assessment of each rep and warranty framework for RMBS deals it is asked to rate is a core component of its rating analysis. Increased loss protection has been one way Fitch has worked to address weaknesses. These credit enhancement adjustments, together with loan loss model assumptions should help protect investors against misrepresentation risk greater than that observed historically.

Here's what needs to change in reps and warranties going forward:

Materiality clauses may need to be more clearly defined. Some contain a testing construct where the defaulted loan reviewer determines if the breach test passes or fails. We at Fitch view this as a weakness due to reviewer subjectivity. Clarity around what constitutes "materiality", while subjective, can add certainty and help with the administration of the trust.

Some transaction documents do not precisely define the reporting or investor disclosure and in some cases investors are only provided limited information through trustee reports. A standardized and more robust template can make it less difficult for investors to easily assess the breach reviewer's conclusion.

Despite being developed post-crisis, few transactions include bondholder communication provisions for RW&E. The inclusion of a deal agent in new RMBS could help to serve as a central point of contact for facilitating investor communication.

Some issuers function as controlling holders within the RMBS transaction and the potential exists for them to make loan review decisions which may not be always be beneficial for all investors. This could prove detrimental to some deals over time.

Some issuers do not provide a loan-level mapping to specific underwriting guidelines, potentially making it difficult for breach reviewers to accurately reference. Also, items listed as compensating factors for underwriting exceptions need to more directly address the exceptions.

Rep and warranty frameworks have by and large improved since the crisis, but there remains an ongoing lack of consistency and some recurring weaknesses that keep some traditional U.S. RMBS investors on the sidelines. We will continue to work to make distinctions between RMBS issuers, account for weaknesses through higher credit enhancement, and provide with transparent guidance on each deal's risk.

Rui Pereira is head of structured finance for the Americas at Fitch Ratings

CONTINUED FROM PAGE 7

ment was part of an equity investment granted to a bona fide shareholder. The fact that the shareholder (or its parent) was also an unsecured creditor seemed irrelevant to the court, especially since it lacks credibility to argue that the creditor made a $15 million equity investment to protect its $3 million debt claim.

The circuit emphasized the importance of the bona fide status of the shareholder. "We are not confronted with a case where a creditor has somehow contracted for the right to prevent a bankruptcy or where the equity interest is just a ruse," the decision reads. In fact, the court specifically observed that the result might be different if the veto power was held by a creditor with no equity stake or that the creditor took an equity stake as a ruse to guaranty repayment of a debt.

Second, the circuit found that the majority approval requirement does not violate federal law. As the circuit put it: "[T]his case does not involve a contractual waiver of the right to file for bankruptcy. Instead, this case involves an amendment to a corporate charter, triggered by substantial equity investment, that effectively grants a preferred shareholder the right to veto" a bankruptcy filing.

The court also rejected the argument that for the veto right to be respected, the holder must have a fiduciary duty finding no legal or logical rationale for such a requirement.

Does the veto right violate Delaware Law?

Finding no violation of federal public policy and consistent with the longstanding principle that for entities organized under state law, state law governs their authority to file for bankruptcy, the court turned to examine Delaware law.

First, the court discussed whether the shareholder consent provision in the certificate of incorporation violated the Delaware General Corporation Law. While noting that Delaware corporate

law is viewed as the most flexible in nation and that a "provision is not contrary to Delaware law just because it withdraws traditional power from the board," the court nevertheless refused to resolve the issue since the debtor waived the argument.

Yet, although the court assumed that the provision passed muster under Delaware law, it noted that neither the parties, nor the court's own research identified any Delaware cases on point.

Second, the debtor argued that due to its ability to block a bankruptcy filing, Boketo would be deemed a controlling minority shareholder under Delaware law and the fiduciary duties imposed on it would invalidate its attempt to veto the bankruptcy filing. The circuit found that Boketo did not qualify as a minority controlling shareholder since domination through actual control of the corporation's conduct is required. The debtor failed to prove that Boketo actually dominated its conduct.

Interestingly, the court held that even assuming that Boketo qualified as a minority controlling shareholder, the proper remedy for a breach of fiduciary duty is not to disregard the corporate charter; state law is the source of remedies for breach of fiduciary duties and bankruptcy courts do not gain jurisdiction over a bankruptcy case whose filing was not properly authorized.

Implications for the usefulness of Golden Shares

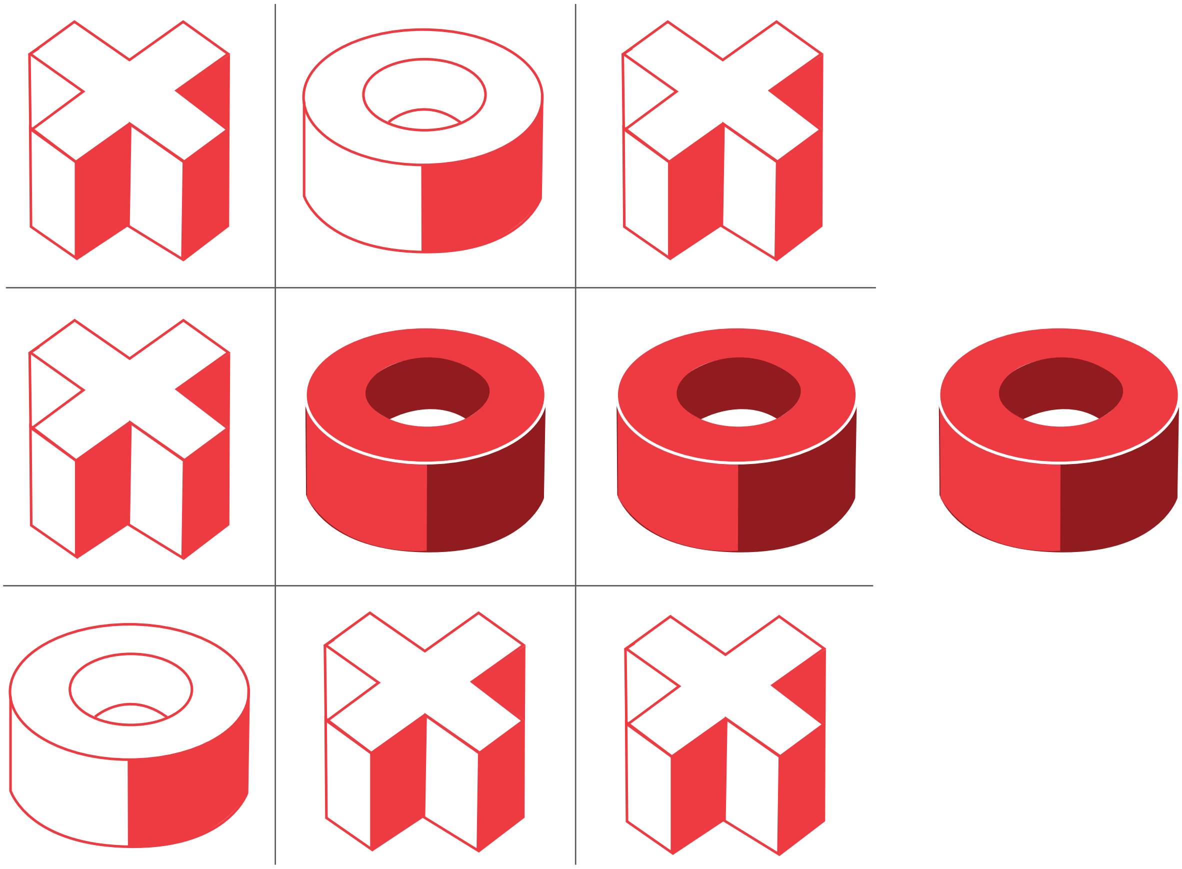
In light of the certified questions, the court's opinion is rather anticlimactic. The court's observations, however, are a lot more interesting. The court's indication that the result may be different, i.e. federal public policy may be implicated, where the veto power is given to a creditor or to a creditor who is given equity as a ruse, seems to support the doubts we expressed in our earlier note as to the usefulness of the golden share.

Was the court merely conservative in its judicial approach, or was it shinking light on an issue of first impression?

Next, by discussing the legality of shifting from the board to the shareholders the power to authorize a bankruptcy filing but not resolving it due to debtor's waiver and lack of precedent, was the court merely conservative in its judicial approach or was it shining light on an issue of first impression?

Finally, the holding that a breach of fiduciary duty (to the extent that such a duty exists), may not serve as a basis for the bankruptcy court to deny a motion to dismiss based on lack of proper authorization, might significantly enhance the utility of bankruptcy blocking provisions, to the extent that a particular veto power provision survives the federal public policy test. In those circumstances, the putative debtor is not in bankruptcy, the automatic stay does not apply and the creditor who negotiated for the provision is free to exercise remedies.

Shmuel Vasser is a partner at law firm Dechert. His practice includes bankruptcy issues concerning structured finance transactions; derivative instruments, including swaps, forward contracts, and repurchase agreements; and other sophisticated financial products.



1,400+ Issuers & Investors Already Confirmed!

Featured Keynote Speakers:

Solita Marcelli
Managing Director & Global Head of Fixed Income, Currencies and Commodities
J.P. Morgan

Amanda Pullinger
Chief Executive Officer
100 Women in Finance

William Lee
Chief Economist
Milken Institute

James Sweeney
Chief Economist & Regional CIO Americas
Credit Suisse

James Comey
Director (2013-2017)
Federal Bureau of Investigation

Lead Sponsors:

Bank of America Merrill Lynch
citi
Credit Suisse
Deutsche Bank
J.P.Morgan
Morgan Stanley
Wells Fargo

www.imn.org/abseast
For sponsorship opportunities, contact Chris Keeping at ckeeping@imn.org or 212-901-0533