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What's Left on the SEC's Rulemaking Table?

CLOs and the Imminent Credit Risk Retention Final Rules

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At an open meeting on August 27, 2014, the U.S. Securities and Exchange Commission (SEC) unanimously adopted final rules substantively revising the offering process and reporting requirements for publicly issued, asset-backed securities. The final comprehensive amendments to Regulation AB ("Regulation AB II") were one phase of the new regulatory revisions intended to strengthen the regulatory regime governing the securitization market in the wake of the 2008 financial crisis. Unlike the 5-0 vote to adopt the amendments to Regulation AB II, the SEC commissioners' support of the proposed revisions by the Joint Regulators (defined below) to implement Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") requiring credit risk retention of some securitized transactions (the "Credit Risk Retention Rules") is not unanimous. Industry organizations submitted more than 150 objecting comment letters, and there is public disagreement among SEC commissioners about the proposed revisions. In short, the mechanics and levels of the final credit risk retention requirements are hotly contested. Are the proposed Credit Risk Retention Rules "workable" in a collateralized loan obligations (CLOs) market, what are the concerns of CLO industry participants and what impact might the proposed revisions have?

During the open meeting, the commissioners noted the SEC's intention to work alongside the Office of the Comptroller of the Currency, the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency and the Department of Housing and Urban Development (collectively, Joint Regulators) to finalize the Credit Risk Retention Rules by the end of 2014. Multiple announcements have since appeared implying that the rules will be finalized "imminently," and beltway insiders have predicted that the final rulemaking may arrive as early as late October 2014. Unlike the unanimous consent witnessed in voting in Regulation AB II, the SEC commissioners are much more divided on the Credit Risk Retention Rules. Some commissioners believe that securitizers do not have enough "skin in the game" to induce them to conduct meaningful due diligence over their asset pools and that Credit Risk Retention Rules are necessary to align the interests of securitizers with those of investors. Other commissioners expressed the view that the "Credit Risk Retention Rules are at best redundant in light of the Regulation AB II rulemaking" and that the rules "require the SEC to impose prescriptive risk management measures upon the securitization industry."[1]

Proposed Credit Risk Retention Rules and Industry Concerns

Simply stated, the goal of the Joint Regulators in implementing the Credit Risk Retention Rules is to require sponsors or securitizers to have skin in the game. The intention is to ensure that the sponsor or securitizer is economically affected in the same manner as the investors purchasing their products. The original credit risk retention rule proposal was introduced on April 29, 2011, and the re-proposal that extended the upcoming rulemaking to CLOs was introduced on August 28, 2013. Some of the main concerns with the current credit risk retention re-proposal raised by the CLO industry participants, trade groups and law firms in numerous comment letters are (1) whether CLOs should be subject to the Credit Risk Retention Rules as contemplated by the current re-proposal; (2) CLO managers are unjustifiably cast as "securitizers" as defined in the Dodd-Frank Act; (3) CLO managers are not economically equipped to retain the 5 percent horizontal/vertical equity slice required by the current credit risk retention rule re-proposal; and (4) shared risk retention by CLO managers with a lead arranger is not a commercially reasonable or workable alternative.

The Unique Structural Nature of CLOs

CLOs are considerably different from the "originate-to-distribute" securitization models regulators have blamed for the financial crisis. A managed CLO is structured by an investment advisor who selects, negotiates and purchases loans from lenders to be included in the CLO's portfolio. The investment advisor may engage an arranger (most commonly a bank or other financial institution) that will assist in originating, underwriting and structuring the CLO's portfolio. Unlike many other securitization transactions subject to the Credit Risk Retention Rules, CLO managers themselves do not originate the collateral loans prior to forming the CLO. The portfolio is then managed in accordance with criteria established by credit rating agencies.

CLOs also have a number of structured investor protections in place that arguably make the skin-in-the-game objective of the Credit Risk Retention Rules unnecessary and redundant. First, a significant portion of the CLO manager's fee is paid only after investors in the CLO's equity are remitted all of their investment plus a return driven by the current market. Second, the CLO manager must comply with the CLO's transaction documents that set forth the terms as to how, if and when the CLO manager buys, manages and sells loans on behalf of the CLO issuer. If the CLO manager fails to comply with the terms of the transaction documents, the CLO manager may under certain circumstances be replaced by the equity investors of the CLO. Third, because of the recent amendment to the Investment Advisers Act, most managers of CLOs sold to U.S. investors are required to be registered with the SEC and have legal duties to "(1) act in the best interest of their clients and to provide investment advice in their clients' best interests; (2) exercise undivided loyalty and utmost good faith; (3) eliminate or disclose all conflicts of interest; (4) provide full disclosure of all material facts to their clients and prospective clients and to present those disclosures in a fair manner; and (5) comply with restrictions with respect to principal trades and agency cross transactions."[2]

CLO Managers Are Not "Securitizers"

Section 941(b) of the Dodd-Frank Act mandates that the Joint Regulators "prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party." The Dodd-Frank Act defines a securitizer as either "(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer." Despite this clear statutory guidance, the 2011 proposal states that the "securitizer" of a CLO transaction would be the CLO manager; and the re-proposed rule confirmed that the CLO manager would be considered the only securitizer and must therefore satisfy the credit risk retention requirement, subject to certain specific alternatives.

Although CLO managers do not sell or transfer the assets to issuers, the Joint Regulators stated in the proposing release that a CLO manager organizes and initiates the transaction because it "has control over the formation of the CLO collateral pool" and a CLO manager transfers the underlying assets to the CLO issuer indirectly "typically by selecting the assets and directing the CLO issuing entity to purchase and sell those assets."[3] The widely publicized motive behind the Credit Risk Retention Rules is to require securitizers to retain exposure to assets a securitizer has an incentive to originate and distribute. CLO managers typically do not own loans. Often loans are purchased from lenders and then lenders transfer the loans directly to the issuer. In the comment letters, many CLO managers expressed the view that selecting assets for the CLO could not be considered indirectly transferring assets because the actual owners of the assets must independently agree to sell and relinquish all economic ownership of those assets to the CLO after the loans have been selected by the CLO manager.[4]

Most CLO Managers Are Not Equipped to Retain 5 Percent Equity

Under the current proposal, CLO managers may satisfy the credit risk retention requirement by retaining an interest in the most subordinate class of asset-backed securities equal to 5 percent of the fair value of the CLO (the "horizontal option"). The horizontal option may be satisfied via a reserve account that holds liquid funds equal to 5 percent of the value of the transaction. CLO managers may also opt to retain 5 percent of the fair value of each class of asset-backed securities issued by the CLO (the "vertical option"). CLO managers may also hold a combination of the horizontal and vertical options to achieve the 5 percent risk retention requirement.

Very few CLO managers will be able or willing to comply with the credit risk retention requirements if adopted as proposed. CLO managers merely receive a performance fee, most of which is payable only after investors have recovered their investment with a pre-negotiated return. There is not a large excess of capital at the CLO manager level as a result of its participation in any CLO transaction. The Loan Syndications & Trading Association (LSTA) submitted a letter on July 29, 2013, that suggests very few CLO managers will be able to self-fund or obtain non-recourse funding from third parties to satisfy the required risk retention percentage. Further, if a CLO manager resigns or is removed, investors will find it very difficult to obtain a replacement manager that will be willing to assume the risk retention requirement. Studies commissioned by the LSTA show that 99.6 percent of the likely losses are borne by the bottom 20 percent of the CLO capital structure. The requirement to retain 5 percent of the fair value of the CLO would require CLO managers to hold approximately 10 times the minimum required credit risk without any justification for such a disproportionate requirement.[5]

Shared Credit Risk Retention with the Lead Arranger Is Not Viable

A "lead arranger" is an arranger that originates, syndicates and assists the CLO manager in structuring at least 20 percent of the underlying commercial loans the CLO manager selects to be in the CLO portfolio. Once the Joint Regulators recognized it may be burdensome to require CLO managers to satisfy the credit risk retention requirements in accordance with the original proposal, the Joint Regulators created an alternative option to satisfy the retention requirement for certain "open market" CLOs. In open market CLOs, all assets are senior, secured syndicated loans, but less than half are syndicated or originated by the CLO's affiliates.[6] In these open market CLOs, the credit risk retention requirement would be satisfied if the lead arranger were to retain 5 percent of the true value of the tranche of such lead arranger originated loans being purchased by the CLO (the "arranger option"). One CLO industry participant comment letter very succinctly pointed out three key reasons why the arranger option is "unworkable":

(1) The requirement for the lead arranger to retain 5 percent of the tranche, when combined with the prohibition on hedging, transferring and pledging the retained interest, would not correlate with the arranger's risk management practices.

(2) The arranger option would expose the arranger to potential liability to CLO investors.

(3) The arranger option would increase the capital and FDIC assessment charges lead arrangers would have to endure, requiring them to increase the pricing of CLO-eligible tranches.[7]

Likely Impact of the Credit Risk Retention Rules on the CLO Industry

Given the pace the Joint Regulators are being urged to finalize the rules, we believe that there are realistically only three outcomes: (1) the rules are adopted as proposed (likely); (2) the rules are not adopted (unlikely); or (3) the rules are adopted but exclude CLOs (unlikely).

After banks, CLOs are the second-largest source of term loans to American businesses. As noted in a report from the Center for Capital Markets, "CLOs are responsible for almost $300 billion in funding to American companies and comprise nearly half of all non-bank loans. CLOs are an important source of credit for mid-size businesses, many of which do not have access to the traditional bond markets."[8] The LSTA surveyed managers running 70 percent of U.S. CLOs, asking whether they could manage CLOs if they were required to retain 5 percent of the fair value of any new CLOs. The managers of more than 500 CLOs responded that they would only run approximately 70 CLOs if the risk retention rules went into effect as originally proposed. The LSTA survey projected the CLO market would shrink by 75 percent in the aftermath of the final rulemaking.[9] A separate survey sponsored by the LSTA and conducted by the firm Oliver Wyman also predicted that the potential CLO market contraction could increase annual interest costs on business loans by approximately $3.2 billion. The report calculated that only 10 of the 30 largest CLO managers could hold 5 percent of their existing CLO assets under management on their own balance sheets.[10] The number of CLO managers that would continue CLO issuances–considering the disproportionate risk CLO managers will be required to endure–is even fewer. These reports indicate that the risk retention rules, if adopted as proposed, will chill the U.S. CLO market.

Impact of EU Credit Risk Retention Rules–Prediction of the Future?

The European Union's (EU) credit risk retention framework was passed into law in January 2014 and went into effect in July 2014 in accordance with the new capital requirements regulation, the accompanying directive and the related Regulatory Technical Standards (collectively, the "EU Credit Risk Retention Rules"). While the intricacies of the EU credit risk retention rules will not be addressed here, the 5 percent credit risk retention requirement is similar, and the impact of the rules are helpful in understanding how the U.S. CLO market may be impacted after the Joint Regulators adopt the final U.S. Credit Risk Retention Rules.

As reference, 94 U.S. CLOs totaling about $46 billion were issued in the first seven months of 2013. In the EU, only 10 deals totaling roughly €3.4 billion ($4.5 billion) were issued. The LSTA's July survey showed that EU CLO formation had virtually collapsed by November 2013, due in large part to the introduction of the risk retention rules.[11] Since the end of 2013, the European CLO market has changed significantly. While the total issuance of European CLOs is on the rise, the number of total issuances is lower than prior to the introduction of the EU credit risk retention rules. There are few CLO managers that can reasonably deal with retaining 5 percent equity on their balance sheets, and it appears as though there is significant market concentration developing in the EU. With the number of issuances down, small-to-medium sized CLO managers may no longer be able to compete in the EU CLO market, and issuances will continue to be dominated by larger CLO managers.[12]

What's Next?

The final rulemaking on the Credit Risk Retention Rules is "imminently" upon us. With the Joint Regulators hoping to settle the final rules as soon as possible, the chances for a re-proposal or a reopened comment period are slim. We are already seeing specific disclosure and "risk retention agreements" from commercial mortgage-backed security (CMBS) securitizers seeking to preemptively address the upcoming credit risk retention requirements. CMBS securitizers clearly do not operate in the CLO market and typically originate or aggregate sufficient collateral so as to satisfy the 5 percent risk retention requirement. This option is unavailable for CLO managers, who cannot economically justify maintaining the 5 percent risk retention on their balance sheets. Change is coming soon. Ideally, the Joint Regulators will recognize that the CLO structure is already secure and exclude CLO transactions from the anticipated Credit Risk Retention Rules.

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1 U.S. Securities and Exchange Commission Open Meeting, August 27, 2014.

2 Structured Finance Industry Group Letter Comment, October 30, 2013.

3 Department of the Treasury, Officer of the Comptroller of the Currency, 12 CFR § 43, Credit Risk Retention, August 28, 2013.

4 Symphony Asset Management Letter Comment, October 30, 2013.

5 Loan Syndications & Trading Association Letter Comment, August 1, 2013.

6 Securities Industry and Financial Markets Association Letter Comment, October 30, 2013.

7 The Clearing House Letter Comment, October 30, 2013.

8 Center for Capital Markets Competitiveness, CLOs and Credit Risk Retention Rule, accessed at: http://www.centerforcapitalmarkets.com/keyissuesclos-and-credit-risk-retention-rules/ on July 8, 2014.

9 Loan Syndications & Trading Association Manager Survey, July 2013.

10 Loan Syndications & Trading Association, Structured Finance Industry Group and Securities Industry and Financial Markets Association Letter Comment, January 10, 2014.

11 Loan Syndications & Trading Association Manager Survey, July 2013.

12 *Forbes*, "New CLO Managers Start to Appear in Europe, Continue to Ramp in US," July 2, 2014.

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