CLO Risk Retention: The Headline Hurts; the Hit, Not So Much

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More than a year after the Office of the Comptroller of the Currency of the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Department of Housing and Urban Development and the Federal Housing Finance Agency issued a re-proposal (the "**Re-Proposed Rule**")[1] to govern risk retention in asset-backed securities ("**ABS**") transactions, on October 21 and October 22, 2014 the regulators voted to adopt final rules (the "**Final Rule**")[2] implementing a risk retention regime as mandated by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").[3] The Final Rule brings to a close a prolonged period of discussion and lobbying by CLO market participants with the regulators. The Final Rule becomes effective in two years, giving the CLO market time to consider all necessary changes. Of all segments of the ABS industry, perhaps none anticipated the Final Rule with more trepidation than the CLO market, whose members went to great lengths to explain the potentially damaging effects that the Re-Proposed Rule threatened to inflict upon the CLO industry. Now that the Final Rule has been implemented, will the long-term outcome be as dire as CLO market participants feared?

At first glance, the answer to this question may appear to be "yes." The industry, after all, had its sights on an exemption that would have allowed the market to continue to operate largely as it does currently. However, certain key aspects of the Final Rule should give comfort to the CLO market that its long-term prospects, though not without challenges, remain strong.

One of the regulators' clear motivations in adopting the Final Rule was to chart a new course, at least with respect to the leveraged loan assets purchased by CLOs. Although leveraged loans never appeared to be a particular focus of Congress in the Dodd-Frank Act's adoption, or of the regulators in either of the first two iterations of the risk retention rules, the leveraged loan market was very much on the regulators' minds when adopting the Final Rule. They devoted numerous pages of discussion in the Final Rule to their perceived risks of the leveraged loan market, including a comparison of the originate-to-distribute model of mortgage-backed securities, which was a leading cause of the recent financial

1 78 Fed. Reg. 57928 (September 20, 2013).

2 Credit Risk Retention (finalized October 21, 2014) (to be codified at 12 C.F.R. pt. 43, 12 C.F.R. pt. 244, 12 C.F.R. pt. 373, 12 C.F.R. pt. 1234, 17 C.F.R. pt. 246 and 24 C.F.R. pt. 267), available at http://www.sec.gov/rules/final/2014/34-73407.pdf (last visited October 28, 2014).

3 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

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crisis, to CLOs. Presumably, they included the discussion to justify the imposition of risk retention on CLOs with the hope that risk retention will result in a curtailment of the leveraged loan industry or, alternatively, an improvement of the underwriting standards used by arrangers to originate leveraged loans in the first place. The regulators' theory is that if CLO collateral managers are required to put their own money at risk, they will be more selective as to the leveraged loans CLOs purchase. This selectivity will, in turn, cause the arrangers of leveraged loans to tighten their underwriting standards or be left holding loans that they will be unable to syndicate.

Notwithstanding the focus on reining in (or reforming) the leveraged loan market, the regulators made a monumental concession to the CLO market that should leave the industry optimistic that deals can continue to flourish under the Final Rule: the limitation in the Re-Proposed Rule on cash distributions to a sponsor holding the horizontal retention piece of an ABS transaction was removed from the Final Rule. With full cash flows permitted to be distributed to the retention holder, the investment profile for a horizontal retention piece is now nearly identical to the popular CLO subordinated note. Applying a technical reading to the language of the Final Rule, the combination of the cash flow concession with the sponsor's ability to retain risk through a majority-owned affiliate (a feature that was included for the first time in the Re-Proposed Rule), appears to have two key results: (1) the majority-owned affiliate retainer may now pass through to third parties economics that are extraordinarily similar to the economics of CLO subordinated notes and (2) collateral managers will receive cash flows that can be used to purchase current that and future risk retention obligations. An example of a structure that appears to fall within the wording of the Final Rule is included as Annex A.[4] We are aware of other structures and believe additional structures will develop.

Even if a portion of the retention piece can be financed with outside capital, some collateral managers may be unable (or unwilling) to source capital in the amount necessary to purchase the retention piece. Thus, some collateral managers may exit the industry and, given the cost and capital burden of regulatory compliance, a short-term CLO market contraction appears inevitable. However, the flexibility to finance a portion of the mandatory risk retention with third-party capital should ease the burden for many collateral managers who wish to continue to manage CLOs. After a few years into risk retention, the CLO equity returns plus the increased management fees from new deals should begin to cover the risk retention investment requirement, especially to the extent the chosen structure reduces the cash investment of the collateral manager.[5] As a result, the Final Rule does not, on its face, condemn the CLO industry to the extensive contraction originally feared by the market if the Re-Proposed Rule had been adopted as written.

Although the potential to finance the retention piece is an important development for the CLO industry, the Final Rule still presents some challenges to overcome. First, in the near term, there are uncertainties of the Final Rule that are yet to be worked through. Even after these issues are settled, for collateral managers that wish to finance the retention piece, finding willing financing sources may prove easier for some than others. Inevitable costs are involved in not only obtaining and servicing third-party capital but in setting up a compliant structure (e.g., Annex A's example could involve two offerings). These costs impact the collateral manager's and, potentially, the CLO's profitability. In addition, the Final Rule imposes compliance obligations unrelated to the financial retention obligation, such as detailed investor disclosures. The costs associated with those obligations will impact returns to the CLO equity which, in turn, will make the first wave of risk retention-compliant deals more challenging.

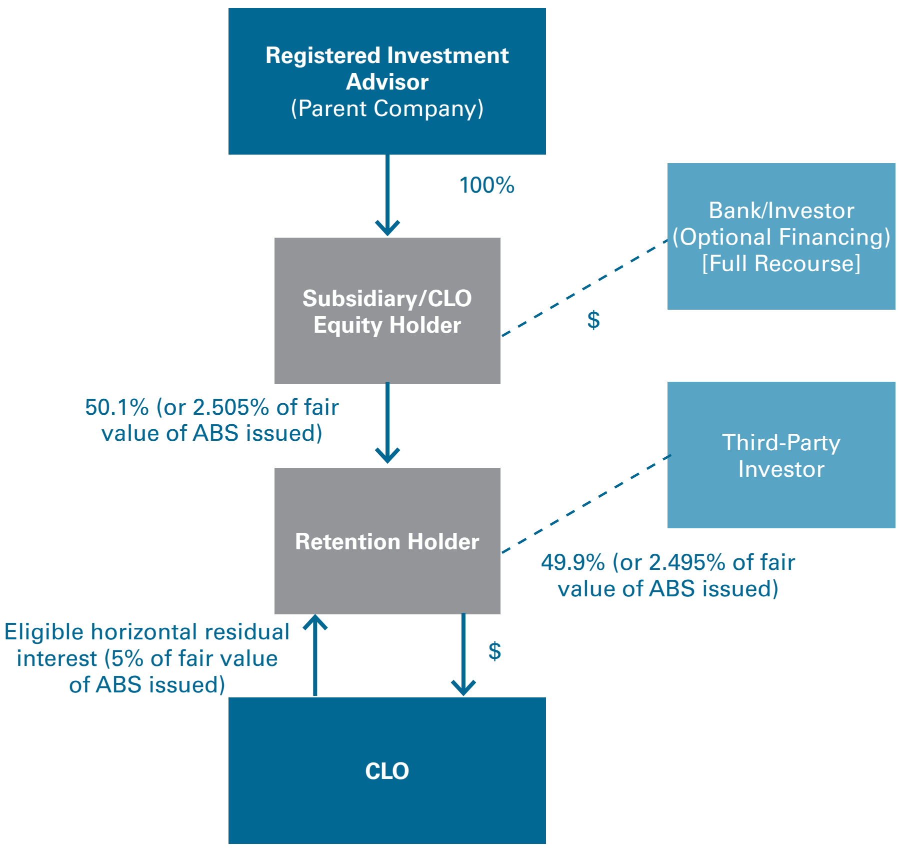
On the other hand, the flexibility afforded by the Final Rule could also lead to new strategies and uses for capital to finance retention pieces for multiple CLOs organized by the same collateral manager, or across multiple collateral managers, including for US CLOs and CLOs structured to be compliant with European risk retention.

In the end, the Final Rule may represent a victory for the regulators because they asserted regulatory authority over the CLO industry while seeking potential additional influences over the leveraged loan market. However, the removal of the limitation on cash distributions to the horizontal retention piece would also appear to provide important flexibility to the CLO market, even if it was not the market's ideal outcome. Although the Final Rule will change the game, present some new challenges and cause a level of frustration in the CLO industry, we believe the significant efforts made by the CLO industry to educate regulators were not made in vain and the flexibility achieved in the Final Rule will prove instrumental to the CLO market's long-term prospects.

4 It should also be noted that under the definition of "majority-owned affiliate" in the Final Rule, a collateral manager can hold the retention piece through an entity in which the collateral manager has a controlling financial interest, as determined by GAAP. This raises the possibility that the required cash-funded obligation of the collateral manager could be even less than a majority (i.e., less than 50%) of the mandated 5% retention piece.

5 This back of the envelope calculation will obviously vary for collateral managers and depends heavily on base management fees and cash-on-cash CLO subordinated note returns, as well as a collateral manager's financing costs and taxable income.

Annex A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