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CLO Market Booms as Regulatory Uncertainty Abates

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Collateralised loan obligations ("CLOs") have provided over $515 billion in financing to non-investment grade corporates in the US since 2011, and over €75 billion to European corporates since 2013.[1] Following a slower 2016 as the market adjusted to the advent of the US risk retention rules, 2017 will be another strong year for CLO new issuance in both the US and the EU, with new US issuance of $71.97 billion to date (as compared with $37.84 billion YTD 2016) and new EU issuance of €12.44 billion (€11.34 billion YTD 2016). Factoring in refinances and resets, which have hit all-time highs this year (with $116 billion of refinancings and resets in the US and €20 billion in the EU to date), the CLO market on both sides of the Atlantic has already smashed through its post-crisis records and the all-time record for USD issuance set in 2014. The CLO market's expansion and long-term viability are major positives for global M&A and leveraged borrowers more generally since CLOs provide around 30% of the financing to leveraged borrowers in the EU and around 60% to leveraged borrowers in the US.

Regulatory Update

One of the reasons for the CLO market's return to record-breaking strength has been a noticeable reduction in regulatory uncertainty in both the US and the EU over the course of 2017; for the first time since 2008, the tone at the Global ABS Conference in Barcelona in June was not dominated by concerns over future regulatory changes which could stifle the market.

The introduction of US risk retention rules at the end of 2016 caused a slowdown in the US market last year, with only $72 billion in new issuance (compared with $98 billion in 2015). However, most managers now have at least interim risk retention strategies in place, with 70 managers having priced new US CLOs in 2017, a 52% increase on 2016.[2] As discussed further below, many managers are now working to implement permanent risk retention structures which are compatible with both the US and EU risk retention rules (although with the election of Donald Trump there is the possibility that certain aspects of the Dodd-Frank Act, including risk retention and the Volcker Rule, might be repealed or reformed to exclude CLOs entirely).

[1] Source for all figures unless otherwise specified: LCD Global Databank, 31 August 2017.

[2] Source: Creditflux, 31 August 2017.

Similarly, with the publication of the final agreed draft of the new Securitisation Regulation on 26 June 2017, the EU appears to have finally turned a corner in its attitude towards securitisation by rejecting a number of potentially problematic amendments proposed during the parliamentary committee stage. These included proposals to increase the baseline retention requirement from 5% to 10% (the initial committee report recommended increasing the retention requirement to up to 20%) and to require the retention holder, as well as all of the investors in a securitisation, to be EU-regulated entities. Such reforms, if adopted, would have had a chilling effect on securitisation in the EU, eliminating the ability of non-EU managers to use 'manager originator' retention structures (discussed below) to sell to EU investors, and severely restricting the liquidity of EU securitisations.

Happily, the final agreed draft of the Securitisation Regulation, which will apply to securitisations issued on or after 1 January 2019, retains the 5% baseline retention requirement under the current EU rules, and does not require participants in securitisations to be EU-regulated entities. It introduces a single set of risk retention requirements which, like the US risk retention rules, will apply directly to the sponsor or originator or a securitisation, replacing the current fragmented set of risk retention rules which apply separately to EU-regulated banks and investment firms, fund managers and insurance companies which invest in securitisations (although investors will still face regulatory capital sanctions for failure to perform due diligence). The Securitisation Regulation will also expand the list of eligible risk retainers to include non-EU banks and non-EU investment firms where the Commission has acknowledged the regulatory equivalence of a non-EU investment firm's home jurisdiction.

Dual-Compliant Risk Retention Structures

These changes, which are largely neutral or positive for the securitisation industry, are likely to strengthen the desire of managers in both the EU and the US for dedicated dual-compliant risk retention structures now that the US rules have come into force.

One of the advantages of a permanent risk retention structure is that it makes it much easier for managers to raise third-party funding to finance their holding of retention notes. This is particularly important for CLOs because CLO managers are not typically the originators of the underlying exposures, and so they must raise additional capital to satisfy their retention holding obligations.

Under the US risk retention rules, the retention holder must either be the sponsor of the securitisation (for a CLO, this means the manager) or a majority-owned affiliate (an "MOA") of the sponsor. For an entity to qualify as an MOA, the sponsor must either hold 50% of the equity or have a 'controlling financial interest' as determined by US GAAP. Although ultimately a question of accounting, it is possible for an entity to be considered an MOA despite the sponsor holding significantly less than 50% of the equity. The controlling financial interest approach typically allows 80% or more of the risk retention capital to come from third parties, reducing the amount of capital required to be contributed by the manager to 1% or less of the size of the CLO (i.e. 20% of the 5% retention requirement).

The EU risk retention rules allow the risk retention to be held by the sponsor (restricted to certain types of EU-regulated entities, such as EU investment managers) or by a non-EU-regulated entity which is an 'originator' that either (i) established and is managing the securitisation (a 'manager originator'), or (ii) established the securitisation and originated over 50% of the assets (a 'non-manager originator'). An entity can qualify as an originator if it purchases the assets for its own account and then securitises them. In the CLO market, this requirement is typically satisfied by having the originator remain exposed to the credit risk (but not the market risk) of loans acquired in the secondary market during their settlement period (generally 10 to 15 business days).

Manager originators became increasingly popular in the EU CLO market after the UK's referendum to leave the EU because they allow UK-based managers who have acted as sponsor originators to remain eligible to hold the risk retention in the event that the UK leaves the single market without an agreement that would preserve their ability to act as sponsors under the EU rules. Furthermore, by structuring the manager originator as an MOA of the sponsor for US risk retention purposes, a single entity can act as risk retainer under both the US and EU risk retention rules. White & Case have advised on several of these dual-compliant risk retention structures for a variety of US and EU-based managers, and expect demand for such structures to remain strong into 2018.

Conclusion

The outlook for CLOs for the rest of 2017 is strong in both the US and the EU, as pent up demand has tightened spreads on EUR AAAs inside E+90 bps, and on USD AAAs inside L+130 bps. After years of regulatory uncertainty following the financial crisis, the attitude of policymakers towards securitisation on both sides of the Atlantic appears to be softening, and the continued investment in dual-compliant risk retention structures by managers in the US and the EU is an indication of the industry's confidence in the relative stability of the regulatory landscape over the foreseeable future.

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