

Risk Retention and CLOs

Overview

Last week a Notice of Proposed Rulemaking (“NPR”) was issued regarding credit risk retention in securitizations and the exemption from the risk retention requirements for certain securitizations that include only conservatively underwritten assets.¹ For CLOs the proposed rules would go into effect in 2013, two years after publication of the final rules. Comments on the proposed rules are due June 10, 2011.

Although the proposed 5% credit risk retention rules should not have a significant impact on most middle market CLOs or other balance sheet CLOs sponsored by loan originators, they will have a negative impact on broadly syndicated CLOs. In addition, the exemption from risk retention for static pool CLOs consisting solely of qualifying commercial loans, cash and cash equivalents is unlikely to be useful for the CLO market.

As currently proposed, the NPR will negatively impact the broadly syndicated CLO market by limiting managers to those who (or whose consolidated affiliates) are able to purchase and retain the 5% risk retention required by the NPR. The same may not hold true with respect to middle market or other balance sheet CLOs where originators or their consolidated affiliates

routinely own more than 5% of the credit risk of the transaction. In addition, the exemption from the 5% risk retention for CLOs structured to include only “qualifying commercial loans,”² cash and cash equivalents as collateral is not representative of the current underwriting for many commercial loans included in CLOs and may not meet the return requirements needed for these transactions. Furthermore for a CLO with “qualifying commercial loans” as collateral to be exempt, it may not have a reinvestment period, thus limiting such CLOs to relatively static pools after a short initial ramp-up.

The “originate to distribute” model for securitization that is the primary focus of the NPR does not appropriately address broadly syndicated CLOs in which managers do not originate the loans but rather select and purchase broadly syndicated loans in the secondary market nor does a 5% risk retention requirement tied to the aggregate balance of the assets securitized appropriately reflect 5% of the credit risk of a CLO. Current CLO standards and structures including, among other things, collateral manager subordinate and incentive fees, adequately align the credit risks sought to be addressed in principle by the NPR. Whether this nuanced presentation can be developed through the comment period as opposed to the “one size fits all” approach currently being taken by the NPR (modified by asset class) remains to be seen.

¹ Section 15G of the Securities Exchange Act of 1934 (15 U.S.C. § 78o-11) as added by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) required that the Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the U.S. Securities Exchange Commission, the Federal Housing Finance Agency, and the Department of Housing and Urban Development (collectively, the “Agencies”) prescribe regulation within 270 days of enactment to implement its new credit risk retention requirements.

² A “commercial loan” is any secured or unsecured loan to a company or an individual for business purposes, other than purchasing or refinancing a one-to-four family residential property, financing agricultural production, or a loan that is expected to be repaid primarily (50 percent or more) from rents collected from non-affiliates. A “qualified commercial loan” must meet the underwriting and other standards set forth in § __.18(b) of the NPR.

One unanswered question is whether the 5% credit risk retention rules apply to warehouse and term loan facilities extended by lenders to special purpose subsidiaries of loan originators or managers, the payment of which depend primarily on cash flow from the assets that collateralize the facilities. It is not clear in the definition of asset-backed security added by Dodd Frank as new Section 3(a)(77) of the Securities Exchange Act of 1934 whether or not such a facility constitutes an asset-backed security. Clarifying that such facilities are not considered asset backed securities is an issue that trade associations may want to raise in their comment letters.

The Proposed Credit Risk Retention Rules for CLOs

The NPR requires that a “sponsor” retain at least five percent of the credit risk of the assets collateralizing asset-backed securities, other than those collateralized solely by “qualifying” assets, cash and cash equivalents. A “sponsor” is one who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate. CLO collateral managers will be considered “sponsors” for CLOs due to their role in selecting and managing the commercial loans to be included in the collateral pool.³ The 5% risk retention requirement may be met by the sponsor retaining (a) a vertical slice, (b) an “L shaped slice, (c) a horizontal residual interest, (d) a cash reserve fund funding first loss or (e) retention of a representative sample of assets materially similar to those in the CLO selected from a designated pool of at least 1,000 assets. If an originator that originated at least 20% of the assets securitized agrees to do so, the sponsor may lay off a portion of a vertical or horizontal risk retention to such originator but in no event more than the proportionate amount of the assets so originated that are included in the CLO. In addition, a sponsor may transfer all or a portion of its retained risk to an affiliate whose financial statements are and remain consolidated with the sponsor. The sponsor and any originator or consolidated affiliate who assists the sponsor in satisfying the credit risk retention requirements must retain their respective interests for the life of the transaction, may not hedge the credit risk

³ NPR footnote 42, pg. 30.

retained and may not pledge such interests other than on a full recourse basis.

Although the 5% risk retention requirement is not a problem for most middle market and other balance sheet CLOs sponsored by loan originators, it is a serious problem for managers of broadly syndicated CLOs. The retention of a vertical or L-shaped slice likely will not fit the economic return profiles needed for managers to invest using either of these risk retention options and while a representative sample designated pool of at least 1,000 “similar” assets may work for securitizations of small, fungible consumer receivables such as credit cards and auto loans, it does not work for commercial loans. Finally, few broadly syndicated CLO managers have the resources to retain 5% of the aggregate balance of the loans as equity in the CLOs they manage. This could lead to further consolidation of collateral managers.

Exemption for Qualifying Commercial Loans

For a CLO to be exempt from the 5% risk retention requirement, it must be collateralized solely by commercial loans meeting certain standards, cash and cash equivalents and it cannot have a reinvestment period. For commercial loans to be qualifying commercial loans, the primary source of repayment must be revenue from the borrower’s business, the loan must be funded within six months prior to the closing of the CLO and the loan must be current at the time of the CLO closing.

The proposed underwriting standards focus primarily on the borrower’s ability to repay the loan. The originator must (i) verify and document the financial condition of the borrower as of the end of the borrower’s two most recently completed fiscal years and (ii) conduct an analysis of the borrower’s ability to service its overall debt obligations during the next two years, based on reasonable projections. The originator must confirm that for the borrower’s two most recently completed fiscal years and the two-year period after the closing of the commercial loan, the borrower had and is expected to have: (a) a total liabilities ratio of 50% or less; (b) a leverage ratio of 3.0 or less and (c) a debt service coverage ratio of 1.5 or greater. Loan payments must be made at least quarterly based on straight-line amortization over a term not exceeding five years.

Covenants must be included in the loan that (i) prohibit the borrower from retaining or entering into debt arrangements that permit payments-in-kind, (ii) limit the borrower's transfer of its assets, (iii) limit the borrower's ability to create other security interests on any of its assets and (iv) limit any changes to the borrower's name, location or organizational structure or of any other party that pledges collateral for the loan. The borrower must provide at least quarterly financial information to the originator, subsequent holders and the servicer on an ongoing basis.

For a secured commercial loan, (i) the originator must obtain a first-lien security interest on the pledged property and (ii) the loan must include covenants that the borrower (a) maintain insurance that protects against loss on any collateral at least up to the amount of the loan, and that names the originator or any subsequent holder of the loan as an additional insured or loss payee; (b) pay taxes, fees, charges and claims where nonpayment might give rise to a lien on any collateral; (c) take any action required to perfect or protect the security interest of the originator or any subsequent holder of the loan in the collateral or the priority thereof, and defend the collateral against claims adverse to the lender's interest; (d) permit the originator or any subsequent holder of the loan, and the servicer of the loan, to inspect the collateral and the books and records of the borrower and (e) maintain the physical condition of any collateral for the loan.

The preliminary feedback we have received from loan originators is that many loans that currently collateralize CLOs will not meet these underwriting criteria.

The depositor of the qualifying commercial loans in a CLO must certify that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all such loans meet the

mandated requirements and has concluded that its internal supervisory control are effective as of a date within 60 days of the date for establishing the asset pool collateralizing the CLO. The sponsor must provide a copy of such certification to potential investors a reasonable period of time prior to sale of the CLO securities. This requirement is consistent with having a static pool CLO, not a revolving transaction.

The NPR seeks comment on (i) whether the proposed standards are appropriate for a qualifying commercial loan; (ii) whether the proposed standards are sufficient and appropriate to ensure that qualifying commercial loans are of very low credit risk and (iii) whether the metrics to measure a borrower's financial capacity, and the specified parameter for each metric, are appropriate standards. It also seeks comment on whether a sponsor should be required to repurchase the entire pool of loans collateralizing an exempt securitization if the amount or percentage of loans that are required to be repurchased for failure to meet underwriting standards exceed a certain threshold and, if so, what threshold would be appropriate.

We encourage interested readers to comment directly on the NPR or through trade associations.



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