"We don't like their sound, and guitar music is on the way out."
- Decca Recording Company, rejecting The Beatles, in 1962

CLOs 2011: The Long and Winding Road

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INTRODUCTION

On the long and winding road to recovery for structured products, 2011 marks a year of modest improvement in the CLO space. While storm clouds and speed bumps continue to loom on the horizon in the form of unpredictable regulatory developments, a weakening economy and European contagion, it is becoming more evident that a market whose very existence was once threatened to be subsumed is reemerging from the ashes of the recent financial crisis.

PROGRESS

Activity in the Rule 144A/Reg S CLO space continued its rebound in 2011 with approximately $10 billion in closed or projected-to-close deal volume. This is up from roughly $5 billion in 2010, but on the low end of the range analysts had predicted. Throughout the year, CLO liability spreads have continued on a downward march (with some recent hiccups) and the investor base for all tranches of the capital structure (including, in some instances, even CLO equity) has expanded as (i) awareness continues to grow about the differences between CLOs backed by senior secured US corporate credit and CDOs backed by RMBS and ABS, however similar the acronym used to denominate the deals, (ii) an increasing number of investors desired to gain exposure to US corporate credit and (iii) more investors are becoming aware of the risk-adjusted opportunity in the CLO space relative to other types of ABS investments. Despite these positive developments, a CLO collateral manager's ability to speak for a substantial portion of the equity remains a key differentiator in getting deals done.

CLO NEXT GENS

In terms of the technology, CLOs proved their worth over the past three years with the structures performing as designed. The CLO "Next Gens" of 2011, in comparison with the "Classic" CLOs of 2004-2007, feature lower leverage, higher credit support, shorter reinvestment periods, maturity and non-call periods, smaller CCC buckets and higher spreads. Less leverage and higher credit support has allowed for greater flexibility in deal structures (i.e., in recent deals we have seen slightly larger buckets for covenant lite loans and deferrable securities). Despite such differences, we expect CLO Next Gens to slowly trend towards convergence with many of the attributes of Classic CLOs, as new and returning investors have been attracted by the resiliency of the CLO structure during the downturn. Additionally, a quick scan of the CLOs of 2010 and 2011 also show an uptick in business development companies ("BDCs") entering the CLO market. BDCs, similar to venture capital and private equity funds, are created to help grow small companies in the initial stages of their development. In constant need of liquidity, some BDCs are looking to the CLO market as an attractive alternative to warehousing arrangements with banks due to a cheaper blended cost of capital, lack of market value triggers, greater trading flexibility and higher implied advance rates.

REGULATORY UNCERTAINTY

The CLO market continues its attempt to digest legal and regulatory developments in the US and abroad. In the US, joint regulators are still working out the parameters of risk retention in CLO transactions. In Europe risk retention rules became effective on January 1, 2011 pursuant to Article 122a of the European Union's Directive 2006/48/EC ("Article 122a"). As a result, European credit institutions, managers and investment banks are working out compliance strategies with the requirements of Article 122a. Uncertainty surrounding the requirements of Article 122a will continue until more European CLOs are issued.

OBSERVATION

THE ZING CASE

Recently, a distressed debt investor purchased the most senior tranche of notes issued by Zais Investment Grade Ltd. VII ("Zing"), an offshore CDO-squared vehicle, while Zing was in default. The investor's objective was to liquidate Zing's assets as quickly as possible to realize a prompt return on its investment. However, liquidation under Zing's indenture required approval from 66.67% of each class of rated notes, and all tranches junior to the investor's objected to such liquidation, preferring to wait for any left over runoff from the collateral, rather than accepting the likely result of being left with no distributions. In furtherance of its strategy of forcing liquidation, the

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investor filed an involuntary chapter 11 petition against Zing, citing the fact that the indenture's non-petition clause did not restrict the most senior tranche from filing. The bankruptcy court allowed this petition to proceed, holding, among other things, that despite its off-shore incorporation, Zing is a "debtor" in the US due to its on-shore investment, record-keeping and reporting activities.

The Zing case is significant to the CLO market because a sizable minority of existing CLO indentures, like the Zing indenture, contain non-petition provisions that do not preclude the most senior tranches from filing. A simple antidote to the Zing result is making sure that non-petition provisions in deals restrict all tranches from filing. Other recommended approaches to prevent the enforceability of non-petition provisions from being challenged by any tranche include (i) giving other noteholders the right to seek equitable relief to prevent the filing and (ii) requiring the CLO issuer to contest the filing.

CONCLUSION

With increased issuances in 2011, the future of CLOs looks brighter as new and returning investors begin to recognize the consistent value offered by CLOs. Overall, we expect modest improvement in the CLO space to continue in 2012.

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value. Another possible solution, Morningstar said, may be for regulators to mandate the disclosure of the preliminary ratings NRSROs develop to compete for ratings assignments, as long as they can somehow also be compensated for them.

The **Council of Institutional Investors** (CII) noted in its comment letter that it has not publicly endorsed a system or model to assign NRSROs to rate securities. It suggested compensating NRSROs over the life of the securities they rate and tying compensation to a rating's performance over time.

Laurel Leitner, a senior analyst at the CII, said the numerous regulations approved over the last few years regarding NRSROs, including Rule 17g-5, require more time before their impact can be fully gauged. One overlooked issue that could spur competition and potentially bring more smaller NRSROs into the mix, however, is that currently there's the lack of a standardized way to compare the performance of NRSROs' ratings.

The NRSROs must disclose their ratings performance statistics over set time intervals, but they each calculate those statistics in different ways. "There should be a standard method for computing those statistics, and they should all be readily available in one place, in an easily understandable format," Leitner said, adding that would enable investors to compare the quality of NRSROs' ratings, whether solicited or not.

The **American Federation of State, Country and Municipal Employees** (AFSCME) appears to be the only other party submitting comments to the SEC besides Morningstar that viewed establishing an entity to assign ratings as a potentially effective way to reduce NRSROs' conflicts of interest. **Gerald McEntee**, the international president, wrote that it is unlikely either issuer- or subscriber-paid fee models can sufficiently reduce NRSRO conflicts of interest, since in the latter case they may pressure the NRSRO not to downgrade a security they hold.

The AFSCME said that an entity that assigns ratings could be designed to provide economic incentives to NRSROs to produce high-quality ratings, as defined by input from investors and other users of ratings. "NRSROs that produce the highest quality ratings could be eligible for a larger number of assignments, thus fostering competition on ratings quality rather than accommodation of issuers, as is currently the case," McEntee said. — *John Hintze*