CLO Market Update For 2011

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INTRODUCTION

"An optimist stays up until midnight to see the new year in. A pessimist stays up to make sure the old year leaves." - *Bill Vaughn*

At the beginning of 2010, most CLO market forecasters adopted the slogan of "cautious optimism." At the time, despite a track record that validated the technology and structures used, there was little visibility in terms of whether there would be new CLO issuance and, if so, what the deals would look like. This was due in large measure to investor wariness with securitized products and, more specifically, with the taint that the asset class has unfairly borne in the minds of some due to the troubles experienced in the subprime ABS CDO transactions, among other things. Dragging down the overall outlook was a rash of rating downgrades as the rating agencies continued to "update" their criteria in what some might say was an overreaction to public perceptions that they had been too lax in assigning previous ratings. After what was by all accounts a solid 2010, there is less caution and more optimism as we look ahead to 2011. At many institutions, CLO teams are being rebuilt and both existing and new teams are being given mandates to pursue new business. Forecasters are projecting that 2011 broadly marketed CLO issuance volumes will triple those of 2010, with estimates in the $12-20 billion range. In addition to the broadly marketed CLO business, a larger and growing private CLO market has developed fueled by the desire of some institutions and investors for exposure to the asset class in bespoke structured loan (or loan to SPV) transactions.

MOMENTUM DRIVES 2011 CLO EXPECTATIONS

Although the U.S. CLO market in 2010 started slow, by the end of the year 11 new CLOs had been issued, raising $4.3 billion. Of those 11 deals, six were priced after October 1. Most market players expect this positive momentum to carry into 2011. In a recent JP Morgan survey of 120 active clients in the CLO market, 58% of investors plan to buy new CLOs and only 12% plan to reduce their CLO holdings. Investor confidence appears to be growing as the credit quality of CLO portfolios has been steadily improving. For instance, at the beginning of 2010, the loan default rate was just below 10%; it is now around 2.25%. In addition, with less CCC loans and improving credit fundamentals, the percentage of CLOs failing OC tests is now around 8%, down from 35% at the beginning of the year (Barclays).

The downgrade overshoot, decreasing default levels and improving OC tests have caused both Moody's and S&P to begin to upgrade CLO tranches. These upgrades are starting to attract new ratings-sensitive investors and helping to fuel the forecasts of CLO market expansion in 2011.

CLO STRUCTURES POST-CRISIS

In comparison with the highly levered and multiple tranche look seen in most CLOs from 2006 to 2007, most players expect 2011 CLOs to be more simply structured (with perhaps only two or three senior tranches), less levered (with an equity tranche of 20% or more) and to adopt shorter reinvestment periods. This forecast is attributable in part to the expectation that new and returning investors will attempt to distance themselves from the complex and highly levered investment vehicles seen circa 2006 and 2007.

Another way in which CLO structures have changed in light of the lessons learned from the downturn is the new focus on provisions regarding note cancellation. In light of the several CDOs/CLOs in which junior noteholders who also held equity positions surrendered their junior notes for no consideration to cure or prevent failures in OC tests during 2009, investors and rating agencies are asking for and incorporating specific prohibitions on such cancellations. Such clarifications are especially timely given the *Concord Real Estate CDO 2006-1, Ltd et al. v. Bank of America, N.A.* case in which the Delaware Chancery Court ruled that an investor could tender notes for no consideration and that such notes would no longer be deemed "outstanding" for purposes of the denominator in the OC tests. (This ruling is currently on appeal.) Although this decision may encourage other equityholders of vintage CLOs to take similar actions in the coming years, we expect to see fewer of these note cancellations given both the overall improvement of OC ratios in CLOs and the stigma in the marketplace associated with managers who undertake such practices.

RISK RETENTION AND DISCLOSURE

Both the European and U.S. CLO markets are faced with uncertainty as some regulatory reform has focused on risk retention requirements. In the U.S., the Dodd-Frank Act requires that a "securitizer" retain 5% of the credit risk of the assets that are securitized. In addition, the Act states that the regulators may require the securitizer to share the risk retention with the "originator." This risk-retention language and its applicability to CLOs has created two major questions. First, who is the securitizer and who is the originator? Second, most CLO managers already retain 5% equity in a CLO structure, is that sufficient or is some sort of vertical slice or horizontal slice of the tranches needed?

Amidst the uncertainty and per a Dodd-Frank mandate, the Federal Reserve released a study on risk retention this past November. The Fed's report recommended that a blanket risk retention rule would not be prudent. The report highlights that the equity retained by managers in the CLO structure is an interest-aligning mechanism that has helped CLOs perform better than other types of asset-backed securities during the crisis.

In addition to the Fed's report, the current SEC proposal for risk retention would only apply to certain public debt executions which would not impact private market (Rule 144A) placements. The FDIC safe harbor rule appears to not be applicable to collateral purchased by arbitrage cash flow CLOs, but there is still some uncertainty as to its applicability to balance sheet CLOs. Despite some lingering anxiety, most CLO players are becoming more confident that after the risk retention smoke settles (mid-April 2011), it will be business as usual.

On the other hand, in the European CLO market there is more concern and uncertainty surrounding the "skin in the game" requirements. In Europe, Article 122a goes beyond the scope of Dodd-Frank by stating that banks that own securitizations face high capital charges if the originators, sponsors or original lenders do not meet the appropriate risk retention requirements. Some commentators believe that Article 122a could prevent European banks from participating in new issue CLOs.

In addition to risk retention, lawmakers have focused on additional disclosure requirements for investment vehicles and securities. The SEC's Proposed Rule 15Ga-2 is an attempt to require disclosure for unregistered offerings of asset backed securities. This proposed rule would direct an issuer or underwriter to disclose, within five business days prior to the first sale in the offering, the findings and conclusions of any third party engaged for purposes of performing a review. CLO market participants are seeking clarification from the SEC to ensure that CLO managers are not considered a "third party" for purposes of the rule.

Lastly, the Foreign Account Tax Compliance Act ("FATCA"), which goes into effect after March 18, 2012, requires a 30% withholding tax on any "withholdable payments" made to a foreign financial institution ("FFI"). The FATCA language encompasses offshore CLOs that invest in loans to U.S. companies. To avoid the tax a FFI must report information about each U.S. account holder. New CLOs have added provisions designed to deal with the requirements; however, for pre-existing CLOs the issue is more troublesome since they will generally not have access to the required information. CLO advocates have submitted comments urging the IRS to exempt existing CLOs from FATCA and to consider U.S. clearing systems or U.S. financial institutions as compliant FFIs. (FFI payments to other compliant FFIs are not subject to FATCA reporting).

CONCLUSION

With momentum from the second half of 2010, the road to recovery continues and enthusiasm looking forward seems to be tempered only by the uncertainty surrounding impending regulations. Based on the performance of CLOs over the last two years, expect new and returning risk-averse investors to expand the CLO market and increase issuance in 2011.

Dechert was the most active law firm in the CLO securitization space in 2010