LAW360

Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Risk-Retention Reproposals Fail To Offer Relief

Law360, New York (September 19, 2013, 6:27 PM ET) -- Collateralized loan obligation (CLO) managers and lead arrangers of syndicated loans received special attention in a proposal jointly released by six federal agencies to implement the credit risk-retention requirements of Section 941 of the Dodd-Frank Act. Whether the new proposal will have its intended effect of minimizing the financial burden on CLO managers remains to be seen.

Introduction

On Aug. 28, 2013, the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, U.S.Department of Housing and Urban Development, Federal Housing Finance Agency and U.S. Securities and Exchange Commission approved a second notice of proposed rulemaking to implement Section 941 of the Dodd-Frank Act.[1]

In response to the low underwriting standards for the assets collateralizing asset-backed securities (ABS) that many believe contributed significantly to the recent financial crisis, Section 941 generally requires that "securitizers" retain at least 5 percent of the credit risk of any securitized assets.

In the original notice of proposed rulemaking related to Section 941, which the agencies released in April 2011, the agencies proposed general methods by which an ABS sponsor could satisfy this requirement. In response to comments, the second NPR includes a separate risk-retention option for "open-market CLOs," in addition to the standard risk-retention requirements, as described below.[2]

For CLOs, the proposed rules would go into effect two years after the date the final rules are published in the Federal Register.[3] The comment period for the second NPR closes on Oct. 30, 2013.[4]

Background

The first NPR required that a CLO manager, as the "sponsor" of the CLO, like all other sponsors, satisfy the risk-retention requirement by holding either (1) 5 percent of the par value of each tranche issued by the CLO ("vertical basis"), (2) 5 percent of the par value of the CLO in a first-loss tranche ("horizontal basis"), (3) a cash reserve account funded in an amount equal to the horizontal basis in lieu thereof, or (4) a combination of one-half of the required vertical basis and one-half of the required horizontal basis.[5]

Many commenters objected to this requirement being imposed on CLO managers, arguing, among other things, that CLO managers do not fit the definition of "securitizer" in the Dodd-Frank Act. Additionally,

commenters noted that many CLO managers are not sufficiently capitalized, nor do they have the financial ability to satisfy the significant burden imposed by the proposed risk-retention requirement.[6]

The agencies attempted to provide greater flexibility to CLO managers in the second NPR, but maintain that CLO managers are "securitizers" and must satisfy the risk-retention requirement. The second NPR provides an alternative means to satisfy the requirement in "open-market CLOs" by permitting the "lead arranger"[7] to hold the required credit risk exposure; however, the CLO must meet the definition of "open-market CLO" and the specific requirements set out below.

General Updates to Risk-Retention Requirement

The second NPR provides that the vertical basis and horizontal basis can be used in any combination to satisfy the risk-retention requirement, rather than applying the 50 percent-50 percent requirement that the first NPR provided. In addition, the measurement of the retained interest under the second NPR would be based on fair value, established in accordance with U.S. Generally Accepted Accounting Principles (GAAP), instead of par value as provided in the first NPR.

The second NPR also clarifies that a sponsor can transfer its interest to a majority-owned affiliate, which is defined as an entity that, directly or indirectly, controls a majority of, is majority controlled by or is under common majority control with, the sponsor. Majority control means ownership of more than 50 percent of the equity of an entity, as determined under GAAP.[8]

Lead Arranger Option for "Open-Market CLOs"

The second NPR defines an "open-market CLO" as a:

CLO (1) whose assets consist of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in open-market transactions … (2) that is managed by a CLO manager, and (3) that holds less than 50 percent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or originated by originators that are affiliates of the CLO.[9]

In addition, as discussed in the Supplementary Information section of the second NPR, it is contemplated that certain "senior, secured-term loan tranches within a broader syndicated credit facility would be designated as 'CLO-eligible' at the time of origination if the lead arranger committed to retain 5 percent of each such CLO-eligible tranche, beginning on the closing date of the syndicated credit facility[,]"[10] so as to facilitate purchases in the secondary market.

If a lead arranger in the underlying loan agrees to meet the risk-retention requirement for a CLO-eligible loan tranche, it must retain at least 5 percent of the face amount of each CLO-eligible loan tranche until the earliest to occur of the repayment, maturity, acceleration, payment default or bankruptcy default of such tranche, regardless of whether the tranche was purchased on the primary or secondary market or held at any time by an open-market CLO.[11]

Also, the legal documents governing the syndicated credit facility must grant the holders of the CLO-eligible loan tranches consent rights for, at a minimum, amendments, waivers or modifications that can adversely affect the fundamental terms of such tranches, and must provide for pro rata provisions, voting provisions and security that are not "materially less advantageous to the obligor than the terms of other tranches of comparable seniority in the broader syndicated credit facility."[12]

CLO Manager Requirements for Lead Arranger Option

In order for a CLO manager to satisfy the risk-retention requirements through the lead arranger option described above, its open-market CLO must meet other requirements, including a requirement that the

assets of the open-market CLO consist of senior, secured syndicated loans that are CLO-eligible loan tranches.[13]

This appears to exclude subordinated assets that commonly appear in CLOs, such as second-lien loans and first-lien last-out loans. In addition, the CLO manager of an open-market CLO may not receive any management fee or gain on sale at the time the CLO issues its ABS interests.[14]

The CLO manager must also provide certain disclosures to potential investors prior to the closing of the CLO and at least annually thereafter regarding the assets held by the CLO and, upon request, to its appropriate federal banking regulator, if any, and to the SEC.[15]

The CLO manager must disclose a list of every asset held by an open-market CLO (or if before a CLO's closing, in a warehouse facility set up for the CLO), including, among other items, information regarding the Standard Industrial Classification category code of the obligor of the loan, the face amount of the loan tranche held by the CLO, the price at which the loan tranche was acquired by the CLO and the name of the lead arranger.[16]

Projected Cash Flow Test

The agencies were also concerned that CLO managers may structure a transaction in which the "eligible horizontal residual interest" is projected to receive such a disproportionate amount of money that the CLO manager's interests are no longer aligned with investors' interests.[17]

To address this, the proposed rule requires that, on the securitization closing date, the "Closing Date Projected Cash Flow Rate" (the rate at which any cash is expected to flow out to the horizontal tranche) is not projected to exceed the "Closing Date Projected Principal Repayment Rate" (the rate at which the other ABS holders are expected to receive principal payments) for any given payment date.[18]

Since the Closing Date Projected Cash Flow Rate includes any cash flow, whereas the Closing Date Projected Principal Repayment Rate only takes into consideration principal cash flow, this mismatch would seem to forestall the standard CLO mechanic of allowing interest proceeds to flow out to the most subordinated tranche (the horizontal tranche) during the reinvestment period while the senior noteholders are receiving interest payments, but not principal payments.

The agencies are asking for comment on whether this calculation should in fact compare cash flow received by the horizontal interest with principal payments received by other interests, or whether the appropriate metric for other ABS tranches is also cash flow.[19]

We expect this component of the proposal to generate a number of comments and hope it will be modified to comport with how CLOs and other structured vehicles operate. If, however, the calculation retains the form it currently takes in the second NPR, some possible outcomes are:

- cash flows on CLOs would be restructured to include some principal payments on the senior tranches during the reinvestment period;

- the holders of the horizontal tranche would be forced to forego any payments during the reinvestment period (which may force them out entirely);

- CLOs would be “static” pools only in which there is no reinvestment period and principal payments are distributed to noteholders from the outset; or

- CLO managers would simply take the vertical tranche in every instance.

Grandfathered Securitizations

Although not stated explicitly, the Summary Information section of the second NPR suggests that CLOs closed prior to the effective date of the proposed rule would not be required to comply with the risk-retention requirement.

As an illustration, while discussing retention requirements with respect to revolving, master trust-type securitizations, the second NPR states that “[a]s a general principle, the agencies also do not seek to apply risk retention to ABS issued before the effective date of the regulations.”[20]

Although the second NPR does not address grandfathering directly, such a remark indicates a lack of intent on the part of the agencies to extend risk-retention requirements to CLOs issued before the proposed rules take effect.

Sunset on Hedging and Transfer Restrictions

As described in the Summary Information section of the second NPR, CLO managers would be required to satisfy the risk-retention requirement until the “latest of: (1) the date on which the total unpaid principal balance of the securitized assets that collateralize the securitization is reduced to 33 percent of the original unpaid principal balance as of the date of the closing of the securitization, (2) the date on which the total unpaid principal obligations under the [CLO] interests issued in the securitization is reduced to 33 percent of the original unpaid principal obligations at the closing of the securitization transaction, or (3) two years after the date of the closing of the securitization transaction.”[21]

Conclusion

Despite the manifest good intentions of the agencies in the second NPR to consider the concerns of CLO managers facing the risk-retention requirements, two things are clear: First, despite the numerous and compelling reasons to the contrary, CLOs will be subject to risk-retention requirements and second, the agencies have once again missed the mark in terms of crafting a viable open-market CLO exception.

Much like the first NPR, the second NPR fails to provide any meaningful relief because it is based on faulty assumptions about how the loan market operates. As one market participant has explained, “this is just not the way the market works.”

The second NPR purports to offer additional flexibility by adding another manner in which to satisfy the risk-retention requirements and inviting the participation of a new potential risk-retention provider — the lead arranger.

Thus, under the second NPR, there are effectively two ways for open-market CLOs to satisfy the retention requirements: (1) the originally proposed retention by the CLO manager of a vertical, horizontal or L-shaped 5 percent piece, or (2) a new option where the lead arranger of each loan included in the collateral pool holds 5 percent (or 20 percent at origination) of each of the relevant loans it syndicates.

While we are generally in favor of optionality and believe the more the merrier when it comes to potential retention providers, we fear that few, if any, lead arrangers will accept the invitation being extended by the agencies. Lead arrangers do not typically retain 5 percent (or 20 percent at origination) of a loan they syndicate and, when they do retain a portion of a loan, they tend to retain a different tranche than the tranche(s) that are syndicated.

Abiding by the new proposal would materially change the economics and capital charges on lead arrangers. In addition, other sources of liquidity that are not subject to risk-retention requirements, such as retail loan funds and other funds, will continue to absorb non-CLO-eligible loan tranches. Thus, we do not believe lead arrangers would feel compelled to change the way they operate in order to participate in originating "CLO-eligible loan tranches."

Accordingly, we believe the second NPR, if implemented in its current form, would be likely to have the following impacts:

- *Cost and availability of corporate credit*: We expect that the cost and availability of below investment-grade corporate credit would be detrimentally affected.

- *"Too big to fail" managers*: Given that only the largest, best-capitalized managers would be able to fund the required "risk retention," we expect a new wave of consolidation and other partnership arrangements to occur among managers, thus leading to fewer managers, less competition and less selection for investors.

Nonetheless, CLO managers in the United States may find ways to retain vertical slices of CLO capital structure as a way to satisfy risk-retention requirements in a manner similar to that used by their European counterparts to meet their obligations under Article 122a of European Union Directive 2006/48/EC (as inserted by European Union Directive 2009/111/EC).

A "vertical slice" of a CLO would include highly rated tranches, which may make it easier to finance a vertical slice than a horizontal slice.[22] CLO managers may also partner with third-party investors to form "majority-owned subsidiaries" to purchase the CLO equity (horizontal slice), with outside investors funding the remaining near-50 percent of the affiliate.

While it is to be expected that the CLO market will generate some creative structuring approaches to the second NPR, if implemented, one factor likely to temper some of this creativity is the nature of the requirements themselves.

Unlike Article 122a, the proposed risk-retention requirements in the United States do not fall on investors, but on the issuer and its controlling parties. The SEC, which is charged with enforcing Section 941 of the Dodd-Frank Act, has a myriad of sanctions (including disciplinary actions and injunctive relief) it can pursue to police violations.

In addition, investors would have an ability to bring private causes of action to the extent that disclosure about the approach to credit risk retention being pursued was inadequate.

We encourage interested readers to comment directly or through appropriate trade associations.

--By John M. Timperio and Ahmad Elkhouly, Dechert LLP

John Timperio is a partner and Ahmad Elkhouly is an associate in the firm's Charlotte, N.C., office.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] See Second Notice of Proposed Rulemaking to Implement Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Credit Risk Retention), August 28, 2013).

[2] See Richard J. Osterman, Jr., et. al., Memorandum to the FDIC Board of Directors, Federal Deposit Insurance Corporation (Aug. 19, 2013) at 19.

[3] Supra note 1 at 19.

[4] Osterman, supra note 2 at 2.

[5] See id. at 5, 12-14.

[6] Supra note 1 at 142.

[7] The second NPR defines "lead arranger" as any institution that "(1) [i]s active in the origination, structuring and syndication of commercial transactions … and has played a primary role in the structuring, underwriting and distribution on the primary market of the CLO-eligible loan tranche …(2) [h]as taken an allocation of the syndicated credit facility under the terms of the transaction that includes the CLO-eligible loan tranche of at least 20 percent of the aggregate principal balance at origination, and no other member (or members affiliated with each other) of the syndication group at origination has taken a greater allocation … and (3) [i]s identified at the time of origination in the credit agreement and any intercreditor or other applicable agreements governing the CLO-eligible loan tranche; represents therein to the holders of the CLO-eligible loan tranche and to any holders of participation interests in such CLO-eligible loan tranche that such lead arranger and the CLO-eligible loan tranche satisfy the requirements of [§ __.9 of the proposed rule]; and covenants therein to such holders that such lead arranger will fulfill the requirements of clause (i) of the definition of CLO-eligible loan tranche." Id. at 434.

[8] Id. at 401.

[9] Id. at 435.

[10] Id. at 147.

[11] See id. at 147.

[12] Id. at 437.

[13] The second NPR defines "senior, secured syndicated loan" as a "loan made to a commercial borrower that …(1) [i]s not subordinate in right of payment to any other obligation for borrowed money of the commercial borrower, (2) [i]s secured by a valid first priority security interest or lien in or on specified collateral securing the commercial borrower's obligations under the loan, and …(3) [t]he value of the collateral subject to such first priority security interest or lien, together with other attributes of the obligor (including, without limitation, its general financial condition, ability to generate cash flow available for debt service and other demands for that cash flow), is adequate (in the commercially reasonable judgment of the CLO manager exercised at the time of investment) to repay the loan in accordance with its terms and to repay all other indebtedness of equal seniority secured by such first priority security interest or lien in or on the same collateral, and the CLO manger certifies as to the

adequacy of the collateral and attributes of the borrower under this paragraph in regular periodic disclosures to investors." Id. at 435-436.

[14] Id. at 437.

[15] See id. at 151 and 438.

[16] See Id.

[17] See Id. at 51.

[18] See Id. at 404-406.

[19] See Id. at 58.

[20] Id. at 80.

[21] Id. at 210-211. The measurement from the closing date of a CLO would delay sunset provisions becoming applicable to partially ramped CLOs.

[22] Any financing of the vertical slice or horizontal slice would have to be on a full-recourse basis (to the sponsor or the pledging affiliate). See id. at 175.
