Bloomberg BNA

BNA's Banking Report™

VOL. 105, NO. 9 SEPTEMBER 14, 2015

Financial Instruments

In Part One of this article, we analyzed the recent increase in the risks to lenders for U.S. broadly syndicated leveraged loans that serve as the primary source of collateral for CLOs. Part Two of this article presented evidence that heightened risks in the collateral underlying CLOs do not necessarily imply comparably higher risks for investors in CLO tranches (especially senior tranches). Yet, as we explain in Part Three of this article, new regulations may be a (potentially significant) threat to CLO investors.

BNA INSIGHTS: Potential Regulatory Impacts on CLOs

BY CHRISTOPHER L. CULP AND J. PAUL FORRESTER

Enacted into law in July 2010, the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) has occurred at a very slow pace. According to a widely cited tracker, as of December 31, 2014, only 231 rule-makings out of a total 395 (around 58 percent) had been completed, with a total of 277 rule-makings missing the related statutory deadline. Of those, a total of 176 rules (around 63 percent) were finalized after the applicable deadline. The balance of rules either have been proposed but not adopted or have not even yet been proposed.

Dr. Culp is Senior Advisor at Compass Lexecon, a Research Fellow at the Johns Hopkins Institute of Applied Economics, Global Health, and Study of Business Enterprise, and an Adjunct Professor at the Swiss Finance Institute.

Mr. Forrester is a Partner at Mayer Brown LLP, an international law firm.

The next two sections discuss two of the most important regulations adopted pursuant to the Dodd-Frank Act that impact U.S. CLOs.

The Volcker Rule

The ''covered fund'' prohibition under the so-called Volcker Rule was finalized in December 2014, and is intended to prohibit banking entities from sponsoring or investing in private equity or hedge funds. Despite strong industry objections, the regulators used a definition for a ''covered fund'' that includes a wide range of entities that are not properly regarded as private equity or hedge funds. Although the final rule includes a number of exclusions or other exceptions to the covered fund prohibition, many of those depend on an institution's regulatory status under the Investment Company Act of 1940 (40 Act) that is often not evident from the relevant documentation or is not otherwise readily determinable by affected banking entities. As a result, affected banking entities have been forced to spend extraordinary amounts of time and resources to make

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these difficult determinations to determine if there is a prohibited investment or relationship and then to determine if one of the available exclusions or exceptions might apply.[1]

In addition, the meaning of the final Volcker Rule is at crucial points relatively unclear, and the accompanying regulatory preamble is at best unhelpful and at worst contributes to the uncertainty that the rule inflicts on market participants. Relevant to CLOs, this crucial uncertainty was compounded by the surprise inclusion in the final rule of a new and unexpectedly expansive definition of the term ''other similar interest'' in connection with impermissible ''ownership interests'' in covered funds.

This uncertainty and lack of clarity in the final rule occurred despite initial comments from trade associations, individual financial institutions, and others in over 18,000 comments on the original proposed rule in October 2011. Almost 18 months after an extended comment period closed in February 2012, the final adopting release/preamble and common text for the final Volcker Rule was 978 pages long (272 pages in the *Federal Register* version). So far, this uncertainty and confusion have resulted in several interim final rules and a number of corrective/amending FAQs, as well as several official statements announcing the actual or intended extensions of the related conformance period permissible under the final rule.

Almost immediately after the adoption of the final Volcker Rule, several trade groups sued to forestall the otherwise required divestiture by affected banking entities (including a number of community banks) of bank trust-preferred CDO investments, which resulted in the Federal Reserve issuing an interim final rule in January 2014 that permits affected banking entities to retain these investments. Several trade associations responded with strong criticisms, emphasizing that affected banking entities often lacked required information regarding the 40 Act status of related entities (on which the definition of a ''covered fund'' frequently turns) to determine if the prohibition applied to a particular transaction and, even if it did, whether one or more of the permissible exclusions under the final Volcker Rule might apply.

More recently, in December 2014 the Federal Reserve announced that it was granting an extension of one year (to July 21, 2016) for the compliance period with respect to certain legacy covered fund investments and relationships. The Federal Reserve further indicated that it intended to grant relief to affected banking entities that were otherwise making substantial efforts to bring their affected portfolios into conformance by providing a further one-year extension of the related compliance period to July 21, 2017.

[1] For a more general discussion, *see, e.g.*, E. Ganz, ''The Volcker Rule: The Long and Winding Road to a Mixed Result for CLOs,'' *Journal of Structured Finance*, Vol. 20, No. 3 (Fall 2014).

Even these *ex post* corrections and other relief, however, have not fully obviated the need for many banking institutions to restructure various structured credit transactions that now are required to comply with or avoid the final Volcker Rule and its ''covered fund'' prohibition. Many structured credit transactions have been (and going forward will be) structured (or restructured) to take advantage of an available exclusion (for example, the ''loan securitization'' exclusion) from the prohibition or to ensure that a different 40 Act status applies to the related issuer (*e.g.*, Rule 3a-7 or section 3(c)(5) under the 40 Act) to avoid having a prohibited ''covered fund.'' Such restructurings will often include additional costs and add transactional complexity.

CLOs have historically relied on the 40 Act exemption under section 3(c)(7) and, as a practical matter, need to do so since the trading restrictions under Rule 3a-7 are not workable for the majority of CLOs. As a result, post-Volcker CLOs are being structured (or, in the case of pre-Volcker CLOs, are being supplemented and amended) to satisfy the requirements for the ''loan securitization'' exclusion. Assuring compliance, however, requires additional restrictions on permissible eligible investments and the elimination of otherwise typical bond and structured credit ''buckets'' (among other things). Many CLO managers contend that such restrictions inhibit their ability to capture relative value and result in cash inefficiencies because the related CLO may be required to hold cash longer until eligible replacement loan investments can be made.

The Credit Risk Retention Rule

The final Credit Risk Retention Rule, adopted in October 2014, was intended to address moral hazard in originate-to-distribute securitizations – *i.e.*, the risk that loan originators would have an incentive to originate riskier loans if they did not bear a sufficient amount of ongoing risk exposure to those loans. The Credit Risk Retention Rule, based on language in the Dodd-Frank Act, essentially requires loan originators and sponsors of subsequent related securitizations to retain an ongoing risk exposure of at least 5 percent to the subsequent performance of the collateral underlying the sponsored securitization. The rule was initially proposed in April 2011 and was re-proposed in September 2013, and the final rule was adopted in December 2014.

An ironic result of the Credit Risk Retention Rule is that the types of RMBS that many contend played an important role in the transmission of the recent financial crisis from U.S. mortgage markets to global credit markets are effectively exempt from any required risk retention. Yet, ABS based on collateral that had little or nothing to do with the causes of the financial crisis – including CLOs – are subject to the rule's risk retention requirements.

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The application of the rule to CLOs is especially troubling given that the majority of CLOs are not originate-to-distribute securitizations. On the contrary, most CLOs today are open market CLOs in which the underlying portfolios are not originated but are instead typically acquired in secondary market transactions and are transactions in which the related CLO manager selecting the CLO collateral is a registered investment adviser.

In addition, numerous commenters noted that the so-called ''lead arranger'' option for CLOs that was first surfaced in the re-proposed rule was unworkable for CLOs. Insofar as the rule's restrictions on sales or hedging retained risk were concerned, moreover, the rule is fundamentally at odds with prudential banking regulation. Nevertheless, the final rule retains this likely useless option.

Compounding this perversity, these risk retention requirements will be borne unevenly across CLO managers, with the larger and more active CLO managers having a sufficient size and scale that will make it relatively easier for them to arrange required risk retention capital. Smaller and less active CLO managers, however, will inevitably find it harder to do so. Recognizing this significant and disparate impact, the LSTA provided a total of six comment letters to regulators during the course of consultation and accompanied these with a study by Oliver Wyman of the impact of these requirements on the CLO market in particular and to leveraged loan markets generally (because of the significance of the CLO market to it).[2]

The study showed that the imposition of the requirements on CLOs would substantially reduce the number of CLO managers and materially curtail CLO formation and, indirectly, leveraged lending volume, on which many borrowers depend because they lack access to other public capital markets.

In addition, the LSTA submitted a report indicating that the rule's risk retention requirements are effectively about 10 times stricter than those needed to reflect the statutory minimum 5 percent of the related credit risk.[3] In November 2014, the LSTA predictably sued the Federal Reserve, seeking a finding that the final rule is arbitrary and capricious as applied to CLOs and, as a result, should be set aside. A ruling in this case is not expected before the Autumn of 2015.

Conclusion

The market for broadly syndicated U.S. leveraged loans that serve as collateral for most CLOs has experienced a notable recovery following the financial crisis. In recent years, the risks of such loans have returned to and, indeed, surpassed the risks to which pre-crisis investors in institutional tranches of leveraged loans were exposed. Nevertheless, we do not see any indications that these heightened risks in broadly syndicated U.S. leveraged loans translate into higher potential losses for investors in senior CLO liabilities that hold such loans as collateral. On the contrary, post-crisis structural changes in CLOs, seemingly better risk-based pricing of CLO liabilities, and greater collateral manager stratification all provide better protections to investors in senior CLO 2.0 and 3.0 notes than were present in pre-crisis CLO 1.0 offerings.

Yet, significant ongoing regulatory uncertainties pose real threats to the future of the U.S. CLO market. Post-crisis changes in CLOs resulting from the Volcker and Credit Risk Retention Rules do not necessarily provide protections to investors that are justified relative to the significant potential costs of such regulations.

[2] For an example of one such comment letter from the LSTA, *see* Loan Syndications and Trading Association, *Comment Letter to the SEC, FDIC, OCC, FRB, FHFA, and HUD on Credit Risk Retention Notice of Proposed Rulemaking* (April 1, 2013). For the Oliver Wyman study, *see* Oliver Wyman, *Risk Retention for CLOs: A Square Peg in a Round Hole?* (Nov. 2013).

[3] V. Ivashina, Appendix A to Loan Syndications and Trading Association, *Comment Letter to the SEC, FDIC, OCC, FRB, FHFA, and HUD on Credit Risk Retention Notice of Proposed Rulemaking* (April 1, 2013).