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November 13, 2013

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Alternative Investments Group Client Alert: CLO 1.0 vs. 2.0: Part III of a Series: The Risk Retention Factor

I. INTRODUCTION

This is the third in a series of our U.S. collateralized loan obligation ("CLO") client alerts examining important distinguishing features of post-credit crisis CLOs ("CLO 2.0"). Risk retention rules that originally took effect in Europe in January 2011, and that were revised in May 2013 for implementation from January 1, 2014, have had a profound impact on the structure of and market for CLO 2.0 transactions that target European credit institution investors. One result has been that relatively few CLO 2.0 transactions are being structured to be compliant with the EU risk retention regime.[1] Just as CLO market participants have begun to adjust to the new European rules, U.S. federal regulators have recently taken a step closer to implementing U.S. risk retention rules. There is unfortunately little overlap between the European regime and the U.S. regime as currently proposed.

II. THE U.S. RULES AS RE-PROPOSED

On August 28, 2013, the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Department of Housing and Urban Development, Federal Housing Finance Agency, Office of the Comptroller of the Currency, and Securities and Exchange Commission (collectively, the "Agencies") re-proposed rules (the "Modified Proposals") for implementing the requirements of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the comment period for which expired on October 30, 2013. The Modified Proposals take into consideration comments received on the rules originally proposed in April 2011 (the "Original Proposals").

In general, Section 15G of the Securities Exchange Act of 1934, as added by Section 941(b) of the Dodd-Frank Act, requires the Agencies to prescribe regulations that (1) require "securitizers"[2] to retain at least 5 percent of the credit risk of any securitized assets (the "Retention Requirement") and (2) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk required to be retained.[3] The Retention Requirement is intended to provide an incentive for the securitizer to actively monitor the

quality of the assets that are being securitized and, thereby, align the interests of the securitizer with the interests of investors.

The Modified Proposals make the controversial assertion that in a CLO, the CLO manager is a securitizer because it "indirectly transfers the underlying assets to the CLO issuing entity typically by selecting the assets and directing the CLO issuing entity to purchase and sell those assets"[4]. Industry trade groups have submitted comment letters vigorously disputing this statutory interpretation, arguing that in CLOs that are not balance sheet transactions, the CLO manager should not be considered a securitizer because it neither sells nor transfers assets to the CLO. If the Modified Proposals are implemented as proposed, the CLO manager (or its majority-owned affiliate)[5] will be the only participant in a CLO that can satisfy the Retention Requirement.

III. METHODS OF RISK RETENTION

The Original Proposals would have allowed sponsors to satisfy the Retention Requirement by vertical risk retention, horizontal risk retention or L-shaped risk retention. Under the Modified Proposals, the Agencies have consolidated these options into a "combined standard risk retention option that would permit a sponsor to satisfy its risk retention obligation by retaining an 'eligible vertical interest,'[6] an 'eligible horizontal residual interest,'[7] or any combination thereof, in a total amount equal to no less than 5 percent of the fair value of all ABS interests in the issuing entity that are issued as part of the securitization transaction"[8]. The horizontal option can also be satisfied by the implementation of a reserve account into which cash equivalent to the 5 percent requirement is deposited.

The Modified Proposals introduce a new problematic requirement for CLO sponsors that elect to comply using the horizontal residual interest retention option. They must demonstrate that the projected cash flows of the CLO will not result in the retention holder receiving cash payments to recover the fair value of the horizontal residual interest at a faster rate than the rate at which principal is paid on all CLO notes. This requirement would effectively preclude any payments—including quarterly "interest" payments of excess spread—to the holder or holders of the horizontal residual interest until after the CLO's reinvestment period has ended and regular principal payments on the most senior notes begin. CLO industry participants have expressed concern over this new requirement, which they contend will further impede CLO formation due to the attendant anticipated material reduction in equity returns.

IV. ALTERNATIVE RISK RETENTION OPTION FOR OPEN MARKET CLOS

In response to comments questioning the balance sheet capacity of most CLO managers to satisfy the Retention Requirement, the Agencies have proposed an alternative risk retention option (the "Alternative Option"). The Alternative Option allows open market CLOs[9] to satisfy the Retention Requirement if "the firm serving as lead arranger[10] for each loan purchased by the CLO were to retain at the origination of the syndicated loan at least

5 percent of the face amount of the term loan tranche purchased by the CLO"[11]. In order to ensure that a lead arranger retaining risk has a meaningful level of influence on loan underwriting terms, the lead arranger would be required to have taken an initial allocation of at least 20 percent of the face amount of the syndicated credit facility, with no other member of the syndicate assuming a larger allocation or commitment. A retaining lead arranger also would be required to comply with the same sales and hedging restrictions as sponsors of other securitizations until the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of the loan tranche.[12]

The Alternative Option would be satisfied only if: "(1) the CLO does not hold or acquire any assets other than CLO-eligible loan tranches[13] and servicing assets[14]; (2) the CLO does not invest in ABS interests or credit derivatives (other than permitted hedges of interest rate or currency risk); and (3) all purchases of assets by the CLO issuing entity (directly or through a warehouse facility used to accumulate the loans prior to the issuance of the CLO's liabilities) are made in open market transactions. The Agencies explain that the purpose of the Alternative Option is "to allocate risk retention to the parties that originate the underlying loans and that likely exert the greatest influence on how the loans are underwritten" and to "align the incentives of the party most involved in the credit quality of these loans – the lead arranger – with the interest of the investors".[15]

To date, CLO market participants have not been optimistic about the viability of the Alternative Option, due in part to risk management and compliance concerns on the part of lead arrangers of most commercial loans eligible for acquisition by CLOs.

V. OPTIONS FOR MANAGING COMPLIANCE WITH BOTH THE EUROPEAN AND PROPOSED U.S. REGIMES FOR RISK RETENTION

The final U.S. risk retention requirements are scheduled to become effective for CLOs two years after they are adopted.[16] CLO managers that seek to design (or redesign) their management platforms to appeal to the broadest possible base of investors will need to take into account the European risk retention rules as well as anticipate compliance with the future U.S. risk retention requirements. As the chart below illustrates, there are very few points of intersection between the European regime and the U.S. regime as proposed. A CLO management platform that is not constructed to maximize efficiency in this regard could require retention by more than one CLO participant and in an aggregate of more than 5% of the fair value of the CLO notes in order to satisfy both regimes.

Putting aside the question of whether the U.S. and European regimes will comparably measure the 5% retention requirement, and other potential differences such as those among sunset and hedging provisions, the chart below examines whether there could be an overlap in the various entities capable of acting as retention provider under the Modified Proposals and the European risk retention requirements. As discussed above, for CLO transactions in the U.S., the Retention Requirement may be satisfied by a CLO manager (or a majority-owned affiliate) or by lead arrangers through the Alternative Option. Under the EU Capital Requirements Regulation (the "CRR"), only those entities that meet the

strict technical definitions of "original lender", "originator" or "sponsor" will be eligible to act as retention holder in a securitization, without any exception.[17]

Potential Retention Providers	Eligible in US?	Eligible in Europe? (from January 1, 2014)
CLO manager as sponsor	Yes	Only some European Union-regulated CLO managers that meet the definition of "sponsor"
Affiliate of CLO manager	Only "majority-owned affiliates"	No
original lender	Yes (lead arranger under the Alternative Option)	Yes, if the definition of "original lender" is satisfied
other sponsor	No	Yes, if the definition of "originator" or "sponsor" is satisfied

Milbank lawyers are leaders in structuring CLOs for clients that seek to comply with the European risk retention rules, and in helping them see around corners as they anticipate the advent of the U.S. risk retention rules. Contact us for more information.

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[1] For background on the EU risk retention rules as recently modified, see our client alert *Risk Retention Reinvention: Some Questions Answered,* *http://www.milbank.com/images/content/1/3/13326/AIP-Client-Alert-Risk-Retention-Reinvention.pdf.*

[2] "Securitizer" with respect to a securitization transaction means either (1) the depositor of the asset-backed securities (if the depositor is not the sponsor); or (2) the sponsor of the asset-backed securities. "Sponsor" means a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. (Modified Proposals, pages 400-401.)

[3] The Original Proposals proposed that sponsors would generally have to retain the credit risk for the life of the securitization transaction. A majority of commenters opposed risk retention lasting throughout the life of the securitization transaction as unnecessary because "credit losses on underlying assets due to poor underwriting tend to occur in the first few years of the securitization and that defaults occur less frequently as the assets are seasoned" (Modified Proposals, page 207). The Modified Proposals limit the duration of the retention requirement by providing that "the transfer and hedging restrictions under the rule would expire on or after the date that is 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 ABS 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" (Modified Proposals, pages 209-210).

[4] Modified Proposals, page 143.

[5] "Majority-owned affiliate" means an entity that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, the CLO manager. For purposes of this definition, "majority control" means ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP. (Modified Proposals, page 399.)

[6] "Eligible vertical interest" means, with respect to any securitization transaction, a single vertical security or an interest in each class of ABS interests in the issuing entity issued as part of the securitization transaction that constitutes the same portion of the fair value of each such class. (Modified Proposals, page 399.) "Single vertical security" means, with respect to any securitization transaction, an ABS interest entitling the sponsor to specified percentages of the principal and interest paid on each class of ABS interests in the issuing entity (other than such single vertical security), which specified percentages result in the fair value of each interest in each such class being identical. (Modified Proposals, page 401.)

[7] "Eligible horizontal residual interest" means, with respect to any securitization transaction, an ABS interest in the issuing entity: (1) that is an interest in a single class or multiple classes in the issuing entity, provided that each interest meets, individually or in the aggregate, all of the requirements of this definition; (2) with respect to which, on any payment date on which the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts paid to the eligible horizontal residual interest prior to any reduction in the amounts paid to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other governing contractual provision (until the amount of such ABS interest is reduced to zero); and (3) that has the most subordinated claim to payments of both principal and interest by the issuing entity. (Modified Proposals, pages 398-399.)

[8] Modified Proposals, page 43.

[9] "Open market CLO" means a CLO (1) whose assets consist of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in open market transactions and of servicing assets, (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. (Modified Proposals, pages 432-433.)

[10] "Lead arranger" means, with respect to a CLO-eligible loan tranche, an institution that: (1) is active in the origination, structuring and syndication of commercial loan transactions and has played a primary role in the structuring, underwriting and distribution on the primary market of the CLO-eligible loan tranche; (2) has 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) is 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 this section; and covenants therein to such holders that such lead arranger will fulfill the requirements of clause (1) of the definition of CLO-eligible loan tranche. (Modified Proposals, page 432.)

[11] Modified Proposals, pages 145-146.

[12] Modified Proposals, page 147.

[13] To qualify as a "CLO-eligible loan tranche", a term loan of a syndicated credit facility to a commercial borrower must have the following features: (1) a minimum of 5 percent of the face amount of the CLO-eligible loan tranche is retained by the lead arranger thereof until the earliest of the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of such CLO-eligible loan tranche, provided that such lead arranger complies with limitations on hedging, transferring and pledging with respect to the interest retained by the lead arranger; (2) lender voting rights within the credit agreement and any intercreditor or other applicable agreements governing such CLO-eligible loan tranche are defined so as to give holders of the CLO-eligible loan tranche consent rights with respect to, at minimum, any material waivers and amendments of such applicable documents, including but not limited to, adverse changes to money terms, alterations to *pro rata* provisions, changes to voting provisions, and waivers of

conditions precedent; and (3) the *pro rata* provisions, voting provisions, and similar provisions applicable to the security associated with such CLO-eligible loan tranches under the CLO credit agreement and any intercreditor or other applicable agreements governing [. . .] such CLO-eligible loan tranches are not materially less advantageous to the obligor than the terms of other tranches of comparable seniority in the broader syndicated credit facility. (Modified Proposals, pages 435-436.)

[14] "Servicing assets" means rights or other assets designed to assure the timely distribution of proceeds to ABS interest holders and assets that are related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets. Servicing assets include amounts received by the issuing entity as proceeds of rights or other assets, whether as remittances by obligors or as other recoveries. (Modified Proposals, page 401.)

[15] Modified Proposals, page 149.

[16] The Modified Proposals also suggest that most existing CLO transactions will be grandfathered and not subject to the risk retention requirements.

[17] Under the CRR, "originator" means either of the following: (a) an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; (b) an entity which purchases a third party's exposures for its own account and then securitises them (CRR, Article 4(1)(13)); and "sponsor" means an institution other than an originator institution that establishes and manages ... [a] securitisation scheme that purchases exposures from third party entities (CRR, Article 4(1)(14)). The definition of "original lender" appears to constitute a slightly narrowed sub-set of paragraph (a) of the "originator" definition set out in Article 4(1)(13) of the CRR.

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