Skin in the game

Recent US rules were designed to tackle issues identified in some asset-backed security markets. But it's still uncertain whether keeping an interest in the securities issued will improve their quality

On December 24 2016, the rules adopted by six US federal agencies implementing the credit risk retention requirements of section 941 of the Dodd-Frank Act became effective with respect to collateralised loan obligation transactions (CLO transactions).

In a typical CLO transaction structure, a collateral manager selects and manages a portfolio of loans that is securitised in an offering and sale of securities by a special purpose vehicle (a CLO issuer) structured and sold with the help of an arranging bank. (See chart on the next page.)

The US risk retention rules generally require a sponsor or a majority-owned affiliate of the sponsor – as defined in the US risk retention rules – of a securitisation transaction to retain no less than five percent of the credit risk of the assets collateralising a CLO issuer's securities by retaining either an eligible vertical interest (EVI) or an eligible horizontal residual interest (EHRI) in the securities issued, or some combination thereof (the retention interest).

As the final US risk retention rules were published on December 24 2014, participants in CLO transactions have had ample time to anticipate and consider their implementation and the potential effect thereof on their businesses. However, only recently have industry participants begun to apply their structural solutions to actual transactions now subject to the rules.

Retention providers

Prior to the effective date of the rules, managers were focused on ensuring that their management entities and affiliates were structured in a way that would permit them to comply with the US risk retention rules and that they had sufficient capital (or access to capital through financing) to purchase the retention interest in each CLO transaction entered into after the rules' effective date. To address these needs, some managers have formed (or employed existing entities as) majority-owned affiliates to act as the retention holder for their CLO platforms, or have created new standalone capitalised management vehicles (CMVs) to act as manager and retention holder for their CLO platforms going forward. The primary advantages to using a majority-owned-affiliate (as opposed to a CMV) are

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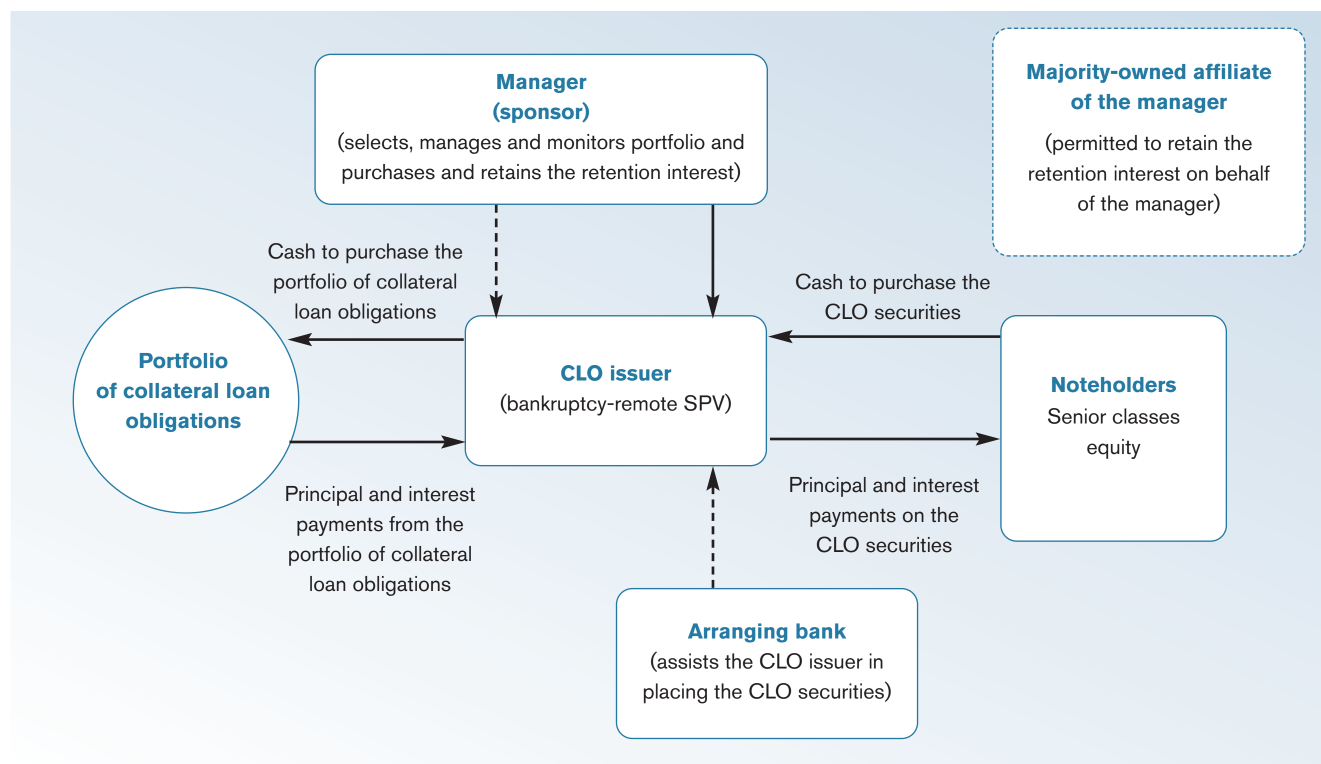
Risk retention rules were implemented in the US to address underlying issues in the asset-backed security (ABS) market, notably concerns surrounding the originate to distribute model, by aligning the interests of sponsors and investors of securitisations. They mandate that the sponsor of a securitisation transaction retain no less than five percent of the fair value of the ABS offered by the issuer.

But questions have arisen among parties to a collateralised loan obligation, in part due to a recent surge in refinancing deals, and also because of concerns when implementation the rues in practice. These include disclosure requirements when retaining an interest in the form of an eligible horizontal residual interest, the resignation of a manager post-issuance as well as the status of warehouse financings.



efficiency and cost, as the existing manager remains the manager of future CLO transactions. The primary disadvantage is that there is a limit on the amount of outside capital that can be contributed to a majority-owned affiliate, as the sponsor has to maintain at all times a majority equity stake in the majority-owned affiliate or another controlling financial interest in such entity, as determined under generally accepted accounting principles (GAAP). According to accounting firms, such other controlling financial interest could be as low as 20%, depending on the specific facts. In contrast, the creation of a CMV is much more time and cost-intensive, as this involves the creation of a new management entity, with employees, a board of directors, Investment Advisers Act registration and other corporate formalities. But it has the advantage that it can be capitalised entirely by third-party capital.

Surge in refinancings

Due to favourable market conditions and in anticipation that a refinancing of an existing CLO transaction would be considered a new securitisation transaction under applicable securities law – and therefore require a manager to retain a retention interest in the securities issued in such refinancing – the last few months of 2016 saw in an increase in refinancing activity. Prior to the effective date of the rules, these refinancings not only re-priced the interest rates on the securities, but also were structured as resets of the original transaction, resulting in an extended reinvestment period and maturity date and potentially other material changes to the transaction. A reset transaction was preferable in this context of needing to close deals before the risk retention effective date due to the relative speed in which such transactions could be executed compared to new issue CLO transactions and the limited supply of collateral loans for new transactions.

In July 2015, the Securities and Exchange Commission (SEC) issued guidance in a no-action letter issued in response to a request submitted by a manager, Crescent Capital, which indicated that the SEC would not seek enforcement of the US risk retention rules in connection with a refinancing of a CLO transaction on the terms described in the letter. Thus far in 2017, many managers have relied on the Crescent no-action letter to refinance existing CLO transactions without retaining a retention interest. The terms of the letter require, among other things, that the original deal priced before the publication of the rules on December 24 2014, the refinancing be completed within four years after the closing date of the original CLO transaction, the interest rate applicable to the securities providing the refinancing be lower than the interest rate of the original securities and the legal and economic deal terms remain unchanged. As a result, these so-called Crescent refinancings have been relatively simple, with just the interest rate changing (by contrast to the reset refinancings done toward the end of 2016) as parties have been hesitant to change anything in their documents that would result in the transaction not satisfying the parameters of the Crescent no-action letter. As CLO spreads continue to tighten, it is anticipated that there will be more refinancings relying on the Crescent no-action letter in the coming months of 2017.

Interpretation of the rules and uncertainties

As the second quarter approaches, parties are negotiating and pricing new issue CLO transactions, and working to develop market standards that meet the regulatory requirements the rules require. The concerns related to risk retention are present throughout the life of CLO transactions, from the negotiation of engagement letters between the manager and the arranging bank to the post-closing disclosures that the sponsor is required to make to investors, to the requirement that the sponsor (or its majority-owned affiliate) hold the retention interest for the prescribed retention period.

One aspect of the implementation of the US risk retention rules that parties have struggled with is the disclosure requirements in connection with acquiring a retention interest in the form of an EHRI. If the manager chooses to hold its retention interest in the form of an EHRI, the manager must retain an amount

equal to five percent of the fair value of all asset-backed securities' (ABS) interests in the issuing entity issued as part of the securitisation transaction, determined using a fair value measurement framework under GAAP. The manager must also provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the CLO securities (which is usually interpreted as the CLO pricing date), among other things, disclosure regarding the fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the transaction) and dollar amount of the EHRI that the sponsor expects to retain at the closing of the CLO. Within a reasonable period of time after the closing of the CLO transaction, the manager must also provide certain disclosure regarding the actual fair value of the retention interest that it acquired. In order to have comfort that their calculations are correct and as it is a GAAP analysis, some managers have looked to third-party providers such as accounting firms or other valuation specialists to assist in this determination or to tie out calculations. This results in additional transaction expenses, in the form of fees payable to such third-party providers and additional legal fees.

As a result of these requirements, there has been friction among certain CLO parties as to the allocation of responsibility for the accuracy of the disclosure relating to the US risk retention rules in CLO offering documents. Managers would argue that the CLO issuer should take responsibility for this disclosure, whereas arranging banks would prefer that the managers take responsibility. An early resolution that such parties have arrived at is the manager agreeing to indemnify the arranging bank (but no other transaction party) for any material misstatements or omissions in the risk retention disclosure provided by the manager. Because the standard is developing and remains in flux, parties have been reluctant to agree to such terms, which slowed the new issue CLO market at the beginning of 2017.

An additional uncertainty arising from the rules is the question of how to satisfy the rules in the event a manager resigns or is replaced post-issuance. In a typical CLO transaction, the manager can resign on its own volition or may be removed and replaced with a successor manager for cause by a certain percentage of the holders of the CLO securities. In such a scenario, it is unclear (i) whether a successor manager would have any obligation to hold a retention interest, (ii) if there any consequences to the successor manager if the original manager does not comply with its original obligations to retain the retention interest after it is replaced and (iii) what type of documentation would need to be in place between the original manager and successor manager to ensure compliance.

As CLO spreads continue to tighten, it is anticipated that there will be more refinancings relying on the Crescent no-action letter in 2017

An issue that is somewhat unique to CLO transactions is the status of warehouse financings under the rules. Prior to the offering and issuance of a CLO transaction, many arranging banks finance the CLO issuer's acquisition of the underlying loans through various warehousing or bridge financing structures. Both managers and arranging banks have been evaluating their structures and removing any features of those agreements, which are primarily in the form of loans, that could lead to the conclusion that such transactions may constitute an issuance of ABS under the Securities Exchange Act of 1934 and thus subject to the US risk retention rules.

Dual-compliant EU-US CLO transactions

Many participants in CLO transactions are familiar with risk retention from experience in the European context, which has imposed a five percent retention requirement on securitisation transactions since January 2011. Many managers are, and will be, aiming to structure transactions that are dual-compliant with both regulatory regimes. In most cases, such dual compliance will be accomplished by having the manager (or its majority-owned affiliate, as applicable) act as originator for purposes of the European retention rules (due to the fact that manager/sponsor compliance is only available in Europe for European-regulated managers). An originator is defined broadly under the European rules and includes an entity which either originates obligations in the primary market or acquires obligations in the secondary market for its own account and then securitises them (after holding for a specified seasoning period that must expose the originator to the credit risks associated with ownership of the obligations). However, in Europe currently the originator structure is subject to scrutiny and there is discussion regarding potentially increasing the required retention percentage for vertical strip retention from five percent to 10 or 20%. In contrast with US rules, which place the legal requirement to comply on the manager as sponsor, the EU risk retention framework places the burden of compliance on investors to ensure that they are investing in compliant deals. As such, different documentation is required; in particular, in the EU context, there is typically a retention letter between the retention holder, the CLO issuer and the trustee, wherein the retention holder issues covenants to retain the requisite five percent interest and to take (or not take) certain other prescribed actions in connection therewith. In the US context, as the rules are a requirement imposed on the manager by law (no different from any other legal requirement that the manager is subject to), contractually binding the manager to such undertakings is not necessary.

Looking to the future

Notwithstanding the complexities, uncertainties and questions outstanding regarding implementation of the US risk retention rules, the CLO market has been resilient and adaptive, and issuance appears poised to grow in 2017.

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