

Final US Risk Retention Regulations Will Affect CLOs: Preliminary Thoughts On The New Regime

Contrary to many industry comments the new rules will require managers of open-market CLOS to retain risk.

On October 21, 2014, six US federal regulators (the Agencies) began voting to adopt final rules implementing the risk retention requirements of Section 941 of the Dodd-Frank Act.¹ The rules require a “securitizer” to retain at least five percent of the credit risk of securitized assets, and prohibit the securitizer from transferring or hedging that retained risk. For these purposes, a “securitizer” is an issuer of an asset-backed security or a person who organizes and initiates a securitization transaction by selling or transferring assets — either directly or indirectly — including through an affiliate or issuer. Pursuant to the final regulations, the manager of a collateralized loan obligation transaction (CLO) is considered to be the securitizer for purposes of these rules. This Client Alert summarizes the key elements of the new rules that will apply to CLOs.

The Agencies specifically rejected numerous industry comments to the effect that open-market CLOs should be treated differently than other categories of securitizations because the sponsor of the transaction is an investment adviser and not in the chain of title on the assets. By contrast, in most other securitizations, the sponsor of the transaction transfers financial assets that it owns, directly or indirectly, to a special purpose entity that issues asset-backed securities (ABS). Although the collateral manager for open-market CLOs generally causes the issuing entity to purchase those assets in secondary market acquisitions, the rule expressly states that CLO managers will be subject to risk retention requirements. There are exceptions for CLOs that invest only in CLO-eligible loan tranches and for CLOs that meet the conditions of a safe harbor for foreign related transactions, each as discussed below. Unless relying on these exceptions, it appears likely that U.S.-based CLO managers, and CLO managers of transactions with a sufficient U.S. nexus, will need to retain risk (or have their majority-owned affiliates retain risk) in accordance with the standard requirements of the rule.

Standard Requirements for Risk Retention

The standard requirements set forth in the US rule require the retention of:

- (i) A five percent interest in a vertical slice of the securitization (either five percent of each tranche of securities or a single security representing five percent of the cash flows for each tranche)
- (ii) An “eligible horizontal residual interest” equal to five percent of the fair value of the securities issued by the CLO, which horizontal interest is required to absorb losses before all other interests in the securitization (the eligible horizontal residual interest can be in the form of a security or a cash reserve)

(iii) A combination of (i) and (ii) that collectively result in the retention of five percent risk.

A special option for CLOs would allow managers to forgo risk retention if they invest only in CLO-eligible loan tranches. The basic driver of the regulatory approach to CLOs appears to be regulatory concern about the underwriting criteria that are being used in the origination of leveraged loans (which are also the subject of separate regulatory guidance²).

CLO-eligible Loan Tranches and the Arranger Option

To be a CLO-eligible loan tranche, a loan tranche would have to be a term tranche of a syndicated loan facility. The lead arranger would have to make commitments to retain an interest of 5 percent of the CLO-eligible loan tranche until its maturity, repayment, acceleration, payment default or obligor bankruptcy. The lead arranger would have to initially commit to provide 20 percent of the overall syndicated facility and no other lender could provide a larger portion of the facility. There are other restrictions related to voting rights and the terms of a CLO-eligible loan tranche relative to the overall facility of which it is a part. Although the market expressed doubts about the viability of the arranger option when the Agencies proposed it last year, we expect this option to be explored with renewed interest now that it has become part of the final rules.

Foreign-related Securitization Safe Harbor

The Agencies recognize that there must be some extraterritorial limit on the reach of the risk retention rules, but have been quite restrictive in setting that limit. Some of the critical conditions of the safe harbor require that:

- The sponsor (*i.e.*, the collateral manager) not be a person chartered, incorporated or organized under US laws, or a US branch or office of an entity chartered, incorporated or organized elsewhere.
- For CLOs with a foreign sponsor, not more than 25 percent of the securitized assets come from or through a majority-owned affiliate of the sponsor organized under US law or an unincorporated US branch or office of the sponsor.
- Not more than 10 percent of the value of the ABS can be initially sold to US persons.
- The offering cannot be registered under US securities law (or required to be so registered).

Qualifying Commercial Loans or Seasoned Loans

Although there are several suggestions in the preamble to the final rules that CLO managers could invest only in qualifying commercial loans or only in seasoned loans to avoid risk retention requirements, the definitions of these loans are very narrow. A qualifying commercial loan must amortize on a straight-line basis, rather than having a bullet maturity. Seasoned loans cannot have been modified since origination and must have been outstanding for at least two years or have had their principal balance reduced to one-third of the original principal balance.

New Required Disclosures

For CLOs in which the manager retains risk in the form of an eligible horizontal residual interest, disclosures will be required about the fair value calculations used to determine the required size of the retained interest. For CLOs in which the manager retains risk in the form of a vertical interest, the disclosures will need to address the form, terms and amount of the vertical interest retained. For CLOs that invest only in CLO-eligible loan tranches, additional disclosures will be required relating to the

specific loan tranches in which the CLO has invested and relating to the arranger that has committed to retain the risk with respect to each tranche. Sponsors will be subject to recordkeeping requirements with respect to these disclosures.

Effective Date for CLOs

CLO managers will become subject to the risk retention rules two years after publication of the rules in the Federal Register. The rules will apply to any CLO manager managing a CLO that issues securities after this effective date of the rules. Thus, the acquisition of new assets in currently existing CLOs does not appear impacted. However, certain actions contemplated in the documentation for many existing CLOs — such as issuing additional securities or refinancing existing securities — could trigger the application of these rules if those actions occur after the effective date of the rules (which will be in late 2016).

Ownership by Majority-owned Affiliate of CLO Manager

The risk retention rules will allow CLO managers to satisfy the requirements, if the risk is retained in a majority-owned affiliate. Under the rules, a majority-owned affiliate of the manager is an entity majority controlling, majority controlled by or under majority common control with the manager. Majority control is determined based on the ownership of more than 50 percent of the equity in an entity or another controlling financial interest as determined under US generally accepted accounting principles.

Restrictions on Transfers and Hedging

Retained interests cannot be transferred or hedged for a significant period after the transaction issuance. The hedging restriction is drafted broadly, and prohibits a retaining sponsor and its affiliates from purchasing or selling a security or other financial instrument, or entering into an agreement, derivative or other position, that has payments related to the credit risk of the retained interest and that in any way reduces or limits the exposure that the sponsor and its majority-owned affiliates will be required to retain. Significantly, the retained interests may be pledged on a full recourse basis. Although the restrictions on transfers and hedges will sunset, the requirements will not sunset for any CLO until a significant portion of its interests and assets have paid down. The test looks to the **latest** to occur of (i) the reduction of the pool of assets to one-third of the original principal amount, (ii) the reduction of the outstanding securities to one-third of the total unpaid principal obligations of ABS interests issued at closing or (iii) two years after the closing date of the securitization.

Conclusion

The final US risk retention rules differ from the risk retention rules that have been implemented in Europe. For example, the US rules impose the obligation on the sponsor of the transaction, *e.g.*, the CLO manager, rather than on the investor as in the European rules. The US rules also require that all risk retention be funded rather than permitting certain unfunded alternatives that may qualify under European rules.

We expect to work with market participants to begin quickly evaluating potential risk retention structures, including those that will satisfy both the US and the European rules, as well as financing, capital raising and M&A options that will allow CLO managers with limited capital to continue as active participants in the important CLO space.

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Endnotes

¹ Credit Risk Retention: Final Rule, Department of the Treasury, Office of the Comptroller of the Currency; Federal Reserve System; Federal Deposit Insurance Corporation; Federal Housing Finance Agency; Securities and Exchange Commission; Department of Housing and Urban Development, available at https://www.fdic.gov/news/board/2014/2014-10-21_notice_dis_a_fr.pdf?source=govdelivery&utm_medium=email&utm_source=govdelivery.

² Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766 (Mar. 22, 2013) available at <http://www.gpo.gov/fdsys/pkg/FR-2013-03-22/pdf/2013-06567.pdf>