U.S. CREDIT RISK RETENTION RULES: Will CLOs Survive?

On 21 October and 22 October 2014, the Agencies[1] adopted a final rule (the Final Rule) implementing the Risk Retention Requirement.[2] The Final Rule retains the basic risk retention framework of the Re-Proposed Rule[3], with certain changes designed to address comments from market participants and to provide further clarity on certain points. Unfortunately, the Agencies rejected most of the comments submitted by market participants seeking relief for CLOs through structural exemptions and third-party options. In rejecting these comments, the Agencies concluded that risk retention is appropriately applied to CLO managers, and any structural exemption or third-party option would likely undermine the consistent application of the Final Rule. The Agencies noted that the recent increase in the level of activity in the leveraged loan market (comprising the primary assets purchased by most CLOs) has coincided with widespread loosening of underwriting standards, which could expose the financial system to risks. As such, the Agencies concluded that it is appropriate to apply the Risk Retention Requirement to open market CLOs as well as balance sheet CLOs with limited relief.

The Final Rule will become effective one year after the date of publication in the Federal Register with respect to residential mortgage-backed securities and two years from the date of publication in the Federal Register with respect to all other asset-backed securities (ABS).

OVERVIEW OF RISK RETENTION REQUIREMENT

The Final Rule permits a sponsor to satisfy the Risk Retention Requirement by retaining (i) an eligible vertical interest, (ii) an eligible horizontal residual interest or (iii) any combination thereof (an L-shaped interest); *provided* that in the event that a sponsor elects to satisfy the Risk Retention Requirement by retaining an L-shaped interest, the Risk Retention Requirement must be calculated proportionally based on the applicable percentage of eligible vertical interest and eligible horizontal residual interest comprising such L-shaped interest. The determination regarding the sponsor's satisfaction of the Risk Retention Requirement must be made as of the closing date of the securitisation transaction.

The Final Rule permits a sponsor to transfer its obligation to satisfy the Risk Retention Requirement to a "majority-owned affiliate" of the sponsor[4].

- *Eligible Vertical Interest*. The Final Rule permits a sponsor to satisfy the Risk Retention Requirement under the vertical option by retaining (i) at least 5% of the face value of each tranche of the ABS interests issued as part of the securitisation transaction or (ii) a single vertical security which represents an interest in each tranche of the ABS

[1] In April 2011, the Federal Deposit Insurance Corporation (the FDIC), the Federal Housing Finance Agency (the FHFA), the Office of the Comptroller of the Currency (the OCC), the Federal Reserve Board (the FRB), the Securities and Exchange Commission (the SEC) and the Department of Housing and Urban Development (the HUD and, together with the FDIC, the FHFA, the OCC, the FRB and the SEC, the Agencies) proposed a rule (the Proposed Rule) designed to implement the credit risk retention requirements (the Risk Retention Requirement) of Section 15G of the Securities Exchange Act of 1934 (15. U.S.C. 78o-11) (the Exchange Act), as added by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).

[2] See footnote 1 above.

[3] In August 2013, the Agencies issued a re-proposed rule (the Re-Proposed Rule) that amended the Proposed Rule in response to comments received from various market participants.)

[4] A majority-owned affiliate is defined as an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, the sponsor. For purposes of this definition, majority control means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.

interests issued in the securitisation equal to at least 5% of the cash flows paid on each class of ABS interests in the issuing entity (other than such single vertical security).

- *Eligible Horizontal Residual Interest*. The Final Rule permits a sponsor to satisfy the Risk Retention Requirement under the horizontal option by retaining a first loss eligible horizontal residual interest in the issuing entity in an amount equal to no less than 5% of the fair value of all ABS interests in the issuing entity that are issued as part of the securitisation transaction, determined using a fair value measurement framework under General Accepted Accounting Principles (GAAP).
  - The eligible horizontal residual interest may consist of either a single class or multiple classes in the issuing entity; *provided* that each interest qualifies, individually or in the aggregate, as an eligible horizontal residual interest.
  - Eligible Horizontal Cash Reserve Account. In lieu of holding all or part of its risk retention in the form of an eligible horizontal residual interest, the Final Rule permits a sponsor to cause to be established and funded, at closing of the securitization transaction, in cash, an eligible horizontal cash reserve account in an amount equal to the fair value of such eligible horizontal residual interest or part thereof, *provided* that the account meets all of the following conditions:
    - the account is held by the trustee (or person performing similar functions) in the name and for the benefit of the issuing entity;
    - amounts in the account are invested only in cash and cash equivalents; and
    - until all ABS interests in the issuing entity are paid in full, or the issuing entity is dissolved, amounts in the account are released only to (i) satisfy payments on ABS interests in the issuing entity on any payment date on which the issuing entity has insufficient funds from any source to satisfy an amount due on any ABS interest or (ii) pay critical expenses of the trust unrelated to credit risk on any payment date on which the issuing entity has insufficient funds from any source to pay such expenses; *provided* that (a) such expenses, in the absence of available funds in the eligible horizontal cash reserve account, would be paid prior to any payments to holders of ABS interests and (b) such payments are made to parties that are not affiliated with the sponsor.

RISK RETENTION DISCLOSURE REQUIREMENTS

Eligible Horizontal Residual Interest

With respect to any eligible horizontal residual interest held under the Final Rule, a sponsor must disclose:

- within a reasonable period of time *prior to* the sale of an ABS –
  - the fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitisation transaction and dollar amount) of the eligible horizontal residual interest that the sponsor expects to retain;
    - if the specific prices, sizes, or rates of interest of each tranche of the securitisation are not available, the sponsor must disclose (i) a range of fair values (expressed as a percentage of the fair value of all

of the ABS interests issued in the securitisation transaction and dollar amount) of the eligible horizontal residual interest that the sponsor expects to retain based on a range of bona fide estimates or specified prices, sizes, or rates of interest of each tranche of the securitisation and (ii) the method by which the sponsor determined any range of prices, tranche sizes, or rates of interest;

- a description of the material terms of the eligible horizontal residual interest to be retained by the sponsor;
- a description of the valuation methodology used to calculate the fair values or range of fair values of all classes of ABS interests, including any portion of the eligible horizontal residual interest retained by the sponsor;
- all key inputs and assumptions or a comprehensive description of such key inputs and assumptions that were used in measuring the estimated total fair value or range of fair values of all classes of ABS interests, including the eligible horizontal residual interest to be retained by the sponsor;
- quantitative information about discount rates, loss given default (recovery), prepayment rates, default rates, lag time between default and recovery and the basis of forward interest rates used;
- descriptions of all inputs and assumptions that either could have a material impact on the fair value calculation or would be material to a prospective investor's ability to evaluate the sponsor's fair value calculations; and
- a summary description of the reference data set or other historical information used to develop the key inputs and assumptions referenced in the disclosure, including loss given default and default rates.

- Within a reasonable time *after* the closing of the securitisation transaction –
  - the fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitisation transaction and dollar amount) of the eligible horizontal residual interest the sponsor retained at the closing of the securitisation transaction, based on actual sale prices and finalised tranche sizes;
  - the fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitisation transaction and dollar amount) of the eligible horizontal residual interest that the sponsor is required to retain; and
  - to the extent the valuation methodology or any of the key inputs and assumptions that were used in calculating the fair value or range of fair values disclosed prior to sale materially differs from the methodology or key inputs and assumptions used to calculate the fair value at the time of closing, descriptions of those material differences.
- If the sponsor retains risk through the funding of an eligible horizontal cash reserve account –
  - the amount to be placed (or that is placed) by the sponsor in the eligible horizontal cash reserve account at closing, and the fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitisation transaction and dollar amount) of the eligible horizontal residual interest that the sponsor is required to fund through the eligible horizontal cash reserve account in order for such account, together with other retained interests, to satisfy the Risk Retention Requirement;
  - a description of the material terms of the eligible horizontal cash reserve account; and
  - each of the disclosures required above with respect to the eligible horizontal residual interest held by the sponsor.

Eligible Vertical Interest

With respect to any eligible vertical interest held under the Final Rule, a sponsor must disclose:

- within a reasonable period of time *prior to* the sale of an ABS –
  - the form of the eligible vertical interest;
  - the percentage that the sponsor is required to retain as a vertical interest; and
  - a description of the material terms of the vertical interest and the amount that the sponsor expects to retain.

- Within a reasonable time *after* the closing of the securitisation transaction –
  - the amount of the vertical interest the sponsor retained at closing, if that amount is materially different from the amount disclosed above.

RECORD MAINTENANCE

A sponsor must retain the certifications and disclosures required in the Final Rule with respect to (i) the Risk Retention Requirement and (ii) the disclosure requirements set forth above in its records and must provide the disclosure upon request to the SEC and its appropriate Federal banking agency, if any, until three years after all ABS interests are no longer outstanding.

HEDGING, TRANSFER AND FINANCING RESTRICTIONS

Hedging and Transfers. The Final Rule prohibits a sponsor or any affiliate from hedging the credit risk the sponsor is required to retain under the Final Rule or from purchasing or selling a security or other financial instrument, or entering into an agreement (including an insurance contract), derivative or other position, with any other person (other than a majority-owned affiliate of the sponsor) if: (i) payments on the security or other financial instrument or under the agreement, derivative or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor is required to retain, or one or more of the particular securitised assets that collateralise the ABS and (ii) the security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the sponsor to the credit risk of one or more of the particular ABS interests or one or more of the particular securitised assets that collateralise the ABS.

Financings. The Final Rule also prohibits a sponsor or any of its affiliates from pledging as collateral for any obligation (including a loan, repurchase agreement, or other financing transaction) any ABS interest that the sponsor is required to retain with respect to a securitisation transaction pursuant to the Final Rule *unless* such obligation is with full recourse to the sponsor or its affiliate, respectively.

Sunset on Hedging and Transfer Restrictions

For all ABS interests (other than RMBS, which are subject to different sunset provisions), the transfer and hedging restrictions under the Final Rule will expire on or after the date that is the latest of –

- the date on which the total unpaid principal balance of the securitised assets that collateralise the securitisation is reduced to 33% of the original unpaid principal balance as of the date of the closing of the securitisation;
- the date on which the total unpaid principal obligations under the ABS interests issued in the securitisation is reduced to 33% of the original unpaid principal obligations at the closing of the securitisation transaction; or
- two years after the date of the closing of the securitisation transaction.

CLO MANAGERS ARE DEEMED TO BE "SPONSORS" SUBJECT TO THE RISK RETENTION REQUIREMENT

Section 15G of the Exchange Act generally requires the securitiser of ABS to retain not less than 5% of the credit risk of the assets collateralising any ABS issuance. A "securitiser" under Section 15G includes either (i) an issuer of an ABS

or (ii) a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate or issuer. The sponsor of a securitization transaction fits within clause (ii) of the definition of securitiser.

Numerous market participants submitted comments to the Agencies asserting that CLO managers are not securitisers subject to the Risk Retention Requirement because (among other things) they cannot sell or transfer the assets securitised through the CLO, as they do not own, possess, or control the CLO assets. The Agencies rejected this premise and made it clear in the Final Rule that CLO managers are indeed sponsors subject to the Risk Retention Requirement. The Agencies' reasoning for this determination is as follows:

- a CLO manager organises and initiates a securities transaction because it typically negotiates the primary deal terms of the transaction and the primary rights of the issuing entity, and it directs the issuing entity to acquire the loans that comprise its collateral pool;
- a CLO manager indirectly transfers the assets to the issuing entity because it has sole authority to select the loans to be purchased by the issuing entity for inclusion in the collateral pool, directs the issuing entity to purchase such assets in accordance with investment guidelines, and manages the securitised assets once deposited in the CLO structure; and
- an asset is not transferred to the CLO issuing entity unless the CLO manager has selected the asset for inclusion in the collateral pool and instructed the issuing entity to acquire it.

As a result of this determination, CLO managers are sponsors under the Final Rule and must therefore comply with the Risk Retention Requirement unless they can avail themselves of the Arranger Option set forth below.

ARRANGER OPTION

The Final Rule provides for a lead arranger option (the Arranger Option) for open market CLOs, under which an open market CLO could satisfy the Risk Retention Requirement if, among other requirements:

- the CLO does not hold or acquire any assets other than CLO-eligible loan tranches and servicing assets;
  - 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:
    - a minimum of 5% of the face amount of the CLO-eligible loan tranche must be retained by the lead arranger from the time of origination of the syndicated loan 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 must also comply with the limitations on hedging, transferring and pledging set forth in the Final Rule with respect to the interest retained by the lead arranger;

- lender voting rights within the credit agreement and any inter-creditor or other applicable agreements governing such CLO-eligible loan tranche must be 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 the calculation or payments of amounts due to the holders of the CLO-eligible tranche, alterations to pro rata provisions, changes to voting provisions, and waivers of conditions precedent; and
- 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 inter-creditor or other applicable agreements governing such CLO-eligible loan tranches cannot be materially less advantageous to the holder(s) of such a CLO-eligible tranche than the terms of other tranches of comparable seniority in the broader syndicated credit facility.

- the lead arranger takes on an initial allocation of at least 20% of the face amount of the broader syndicated loan or credit facility, with no other member of the syndicate assuming a larger allocation or commitment;
- the open market CLO does not invest in ABS interests or in credit derivatives other than hedging transactions that are servicing assets to hedge risks of the open market CLO;
- all purchases of CLO-eligible loan tranches and other assets by the open market CLO issuing entity or through a warehouse facility used to accumulate the loans prior to the issuance of the CLO's ABS interests are made in open market transactions on an arms-length basis;
- the CLO manager of the open market CLO is not entitled to receive any management fee or gain on sale at the time the open market CLO issues its ABS interests;
- the CLO manager discloses a complete list of every asset held by an open market CLO (or before the CLO's closing, in a warehouse facility in anticipation of transfer into the CLO at closing) containing the following information:
  - the full legal name, Standard Industrial Classification (SIC)[5] category code and legal entity identifier (LEI)[6] issued by a utility endorsed or otherwise governed by the Global LEI Regulatory Oversight Committee or the Global LEI Foundation (if an LEI has been obtained by the obligor) of the obligor of the loan or asset;
  - the full name of the specific CLO-eligible loan tranche held by the CLO;
  - the face amount of the CLO-eligible loan tranche held by the CLO;
  - the price at which the CLO-eligible loan tranche was acquired by the CLO;
  - for each loan tranche, the full legal name of the lead arranger subject to the sales and hedging restrictions; and
  - the full legal name and form of organisation of the CLO manager.

[5] The Standard Industrial Classification (SIC) is a system used by government agencies (e.g., the SEC) for classifying industries by a four-digit code.

[6] The legal entity identifier (LEI) is a 20-digit, alpha-numeric code that connects to key reference information that enables clear and unique identification of companies participating in global financial markets.

- The CLO manager is required to provide this disclosure list within a reasonable period of time prior to the sale of the ABS in the securitisation transaction (and at least annually with respect to information regarding the assets held by the CLO) and, upon request, to the SEC and the sponsor's appropriate Federal banking agency, if any.
- The CLO manager is also required to certify or represent as to the adequacy of the collateral and certain attributes of the borrowers of the senior, secured syndicated loans acquired by the CLO and certain other matters.

To date, market participants have been doubtful about the feasibility of the Arranger Option. It remains to be seen whether the CLO market will ultimately adopt the Arranger Option with respect to future CLO issuances.

ORIGINATOR OPTION

The Final Rule permits a sponsor to allocate a portion of the Risk Retention Requirement to any originator of the underlying assets if –

- such originator originated at least 20% of the underlying assets in the pool;
- the amount of the retention interest held by such originator allocated credit risk is at least 20%, but is not in excess of the percentage of the securitised assets it originates;
- the originator holds its allocated share of the Risk Retention Requirement in the same manner as is required of the sponsor (i.e., in the form of an eligible vertical interest, eligible horizontal residual interest or L-Shaped interest);
- the originator is subject to the same restrictions on transferring, hedging and financing as the sponsor;
- the sponsor provides, or causes to be provided, to potential investors (and the appropriate regulators upon request) the name and form of organisation of any such originator that will acquire and retain (or has acquired and retained) an interest in the transaction, including a description of the form, amount, and nature of the interest (e.g., senior or subordinated), as well as the method of payment for such interest;
- the sponsor agrees to be responsible for any failure of an originator to abide by the transfer, hedging and financing restrictions set forth in the Final Rule.

By limiting this option to originators that originate at least 20% of the asset pool, the Agencies sought to ensure that the originator retains risk in an amount significant enough to function as an actual incentive for the originator to monitor the quality of all the securitised assets (and to which it would retain some credit risk exposure).

15 U.S.C. 78o-11(a)(4) defines the term originator as a person who, through the extension of credit or otherwise, *creates* a financial asset that collateralises an asset-backed security; and who sells an asset directly or indirectly to a securitiser (i.e., a sponsor or depositor). The Final Rule incorporates this definition without modification, and expressly excludes any person that *acquires* loans and transfers them to a sponsor, as such person would not be the *creator* of such asset.

There is a consensus among market participants that the Originator Option is not applicable to CLOs backed by broadly syndicated loans. However, the Originator Option may be a feasible alternative in the middle market space.

QUALIFYING COMMERCIAL LOAN EXEMPTION

The Final Rule includes stringent underwriting standards for qualifying commercial loans (QCLs) that, when securitised, would be exempt from the Risk Retention Requirement. The underwriting standards impose limitations on debt service coverage ratios, leverage ratios, liability ratios, amortisation periods and other loan terms. In addition, (i) a QCL must base loan payments on a straight-line amortisation schedule over no more than a 5-year term (rather than a bullet amortisation typical in most CLOs), (ii) all QCLs must be funded prior to the securitisation, (iii) the securitisation cannot allow for any reinvestment

periods and (iv) if a loan is subsequently found not to have met the QCL criteria, the sponsor is required to effect a cure or buyback of the loan.

Clearly, most loans acquired by CLOs would not meet the stringent QCL criteria. Therefore, the Qualifying Commercial Loan Exemption is not a plausible option for CLOs.

ELIMINATION OF RESTRICTION ON PROJECTED CASH FLOWS TO ELIGIBLE HORIZONTAL RESIDUAL INTEREST

One of the few positive changes included in the Final Rule that actually benefits CLOs is the Agencies' decision to eliminate the proposed cash flow restriction set forth in the Re-Proposed Rule, which would have restricted the amount and timing of projected cash flows to be paid to the eligible horizontal residual interest. Under the proposed cash flow restriction, the sponsor would have been prohibited from receiving any cash flows at a faster rate than the rate at which principal was projected to be paid to investors on all ABS interests in the securitisation. The proposed cash flow restriction would have been problematic for CLOs and other structures that use principal proceeds to reinvest in additional assets, but continue to pay interest, for significant reinvestment periods. In addition, the calculations, disclosures, and certifications required by the proposed cash flow restriction would have created a costly administrative burden for CLO participants.

REFINANCINGS, RE-PRICINGS AND AMENDMENTS: ARE LEGACY CLOS REALLY GRANDFATHERED?

CLO managers will become subject to the Final Rule in connection with any new CLO issuance occurring on or after the effective date of the Final Rule in late 2016. CLOs issued prior to the effective date of the Final Rule are exempt from the Final Rule. However, to the extent that any legacy CLOs otherwise grandfathered under the Final Rule issue new securities on or after such effective date in connection with a refinancing, a re-pricing or another additional securities issuance, it appears that such legacy CLOs would be subject to the Final Rule by virtue of such new securities issuance. Moreover, it is unclear whether the Agencies would take the view that certain other amendments to legacy CLOs not involving the issuance of new securities could also potentially trigger the Risk Retention Requirement. These and other issues will be the subject of further discussion and analysis by market participants.

Market participants may want to consider seeking further clarity on these points and other issues that will emerge as the market adjusts to the Final Rule. Although the Agencies are comprised of six different regulators, the SEC has primary jurisdiction over the CLO industry. Therefore, market participants may want to seek certain relief and further clarification on specific points from the SEC through the issuance of no-action letters or interpretive letters. With respect to grandfathered CLOs that permit refinancings, re-pricings and other types of additional issuances, it may be worth exploring whether the SEC would be sympathetic to the view that such transactions should not be subject to the Final Rule because there is no real sponsor or "transfer of assets" in connection with such new issuances.

OTHER ISSUES FOR CLO MARKET PARTICIPANTS TO CONSIDER

The Final Rule is silent with respect to the termination or resignation of a CLO manager subject to the Risk Retention Requirement. Presumably the successor CLO manager will be required to assume the predecessor CLO manager's risk retention obligations but the requirement is not clear under the Final Rule. Some market participants expect that CLO issuances will significantly decrease when the Final Rule becomes effective because smaller CLO managers will not have the ability to fund the Risk Retention Requirement and will therefore be subsumed by larger CLO managers with significant capital. If a CLO manager decides to finance the required retention amount with full recourse and such

CLO manager subsequently defaults on the loan, a lender's foreclosure during the retention period could result in non-compliance with the Final Rule. Therefore, CLO managers may attempt to negotiate financing terms with lenders that are willing to forebear the right to foreclose upon a default until the end of the retention period. However, such financing may be on less favorable terms than standard financing terms.

In addition, the Final Rule provides a safe harbor for foreign CLO issuances; *provided* that (among other things) with respect to a particular CLO issuance, US noteholders cannot represent more than 10% of all noteholders relating to such issuance. Although this 10% threshold excludes secondary sales, large volumes of contemporaneous secondary sales to US investors may be deemed to have exceeded the scope of this safe harbor. Assuming that a refinancing triggers the Final Rule, if less than all of the related notes are refinanced, it is unclear under the Final Rule whether the required retention amount would be 5% of the fair value of the entire CLO transaction, or only 5% of the face value of the refinanced notes (and if the latter, it is equally unclear what form of retention would be permissible under the Final Rule). CLO managers may want to consider the inclusion of new provisions in CLO Indentures that would grant the manager consent rights with respect to refinancings and other actions that could potentially trigger the manager's Retention Requirement under the Final Rule.

CONCLUSION

The Final Rule retains the basic risk retention framework of the Re-Proposed Rule, with very limited changes. CLO managers are deemed to be sponsors under the Final Rule. Therefore, CLO managers (or their majority-owned affiliates) must comply with the Risk Retention Requirement unless they can avail themselves of the Arranger Option or obtain subsequent relief from the Agencies. Although the Final Rule will not become effective for CLOs until late 2016, market participants currently involved in new issuances of CLOs otherwise grandfathered under the Final Rule must consider the impact that CLO structures with refinancings, re-pricings or the ability to effect other securities issuances will have on the CLO manager's obligation to meet the Retention Requirement when the Final Rule becomes effective in late 2016.

Authored by: Steven Lozner