



Risk Retention: A Chorus from the Aria

February 28, 2018 - As reported by Thomson Reuters LPC, the thousands of CLO-centric attendees at SFIG Vegas this week were buzzing about the U.S. Court of Appeals ruling that said risk retention did not apply to Open Market CLO managers. Conveniently, the LSTA's Meredith Coffey hosted a panel that asked - and (kind of) answered - "Does Everything Change After the US Court of Appeals Ruling?"

The panel represented a diverse group of members and viewpoints, including a manager, a rater, a researcher and three investors. As noted by Asset Securitization Report and Thomson Reuters LPC, while one of the panel's investors was not a fan of risk retention, the other two liked it either philosophically or because it provided economic opportunity. (That said, even one of those investors acknowledged that the court decision made sense.) Perhaps not shockingly, the manager did not think risk retention was appropriate for Open Market CLOs, while the rater and the analyst had mixed views. From the LSTA vantage point, we offered a CLO Risk Retention timeline - and explained why we spent the last eight years laboring on this. First, philosophically, we read the statute and did not see managers organizing and initiating CLOs by selling or transferring assets. Second, ethically, we felt that the regulation as proposed would put a number of law-abiding entrepreneurs out of business for no compelling reason. (And, indeed, it did. That's what the bloodless term "consolidation" means.) Third, practically, the cycle will turn some day and the LSTA wants a diverse investor base and a good share of loans in strong, match funded, long-term hands like CLOs.

We also explained why we couldn't answer exactly when the risk retention rule may be gone for CLO managers. As demonstrated in this memo and "circuit board diagram" of appeals options, the government has a number of ways (and days) in which to appeal. While the market has assumed that risk retention for CLO managers is numbered in days, we warned the audience not to get over their skis.

But the meat of the panel was a discussion of the impact of the risk retention ruling on i) managers, ii) investors, iii) CLO liabilities, iv) the loan market and v) other forms of securitization. The panelists did not see a slew of new managers rushing into the CLO market if risk retention were gone. They pointed out that those newer managers likely would have to price their liabilities wider - and the arb just might not work for them. The investors added that the end of risk retention probably wouldn't change the managers with whom they invest. One panelist noted that \$10 billion had been raised to invest in risk retention vehicles; even without risk retention, this money was likely to stay in the CLO market because the asset class was attractive - especially as "retention" investments become more liquid if they didn't have to be held for the life of the CLO.

Turning to the liabilities, the CLO analyst noted that his post-retention new issue estimate had risen modestly, climbing by \$10 billion. Refis and resets, which would no longer compete for risk retention capital, would increase more, jumping from \$90 billion to \$140 billion. Managers are not expected to sell their previous retention holdings en masse, which theoretically could bring supply into market. However, the liability curve likely will flatten as more refis and resets are done. As for loans, panelists did think that the end of risk retention could accelerate tightening spreads (and possibly loosening structures). If more CLOs reset, they can tolerate lower spreads on loans, which in turn allows loan spreads to compress further. However, we (the LSTA) also warned about looking at policy from a "point in time" perspective. The cycle will turn, and at that point capital will not be plentiful and having more long-term, stable holders will be critical.

Of course, a major discussion has been the applicability of the risk retention ruling to other asset classes.

Though they mentioned the possibility of re-remics fitting the definition, the panelists did not necessarily see a wide application of the ruling to either other types of CLOs (European or middle market) or other securitization asset classes.

The presentation slides are available here; please contact mcoffey@lsta.org or eganz@lsta.org if you have additional questions.