April 7, 2017

Hon. Steven Mnuchin
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, D.C. 20220

Re: Credit Risk Retention Requirement for Managers of CLO Assets

Dear Secretary Mnuchin,

In support of your efforts to identify counterproductive or overbroad financial regulations, as directed by President Trump in his order of Feb. 3, 2017,[1] I write on behalf of the Loan Syndications and Trading Association ("LSTA") to suggest a significant financial regulation that should be eliminated to advance the interests of investors, borrowers, and consumers.

That regulation is the component of the credit risk retention rule that applies to independent managers of the assets of the issuers of collateralized loan obligations ("CLOs"). It was adopted in late 2014 as part of the implementation of a provision of the Dodd-Frank Act by four agencies (the Securities and Exchange Commission, the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Commission, and the Office of the Comptroller of the Currency) and became effective on December 24, 2016. As described below, the application of the rule to independent managers of CLO assets provides no benefits to investors or the public in light of the structure and operation of CLOs, and instead is quite harmful to the capital markets, investors, U.S. companies dependent upon loans supported by CLOs, and consumers. Readily available mechanisms exist to relieve these asset managers of the rule's requirements and to prevent these harmful consequences.

Background.

Syndicated leveraged loans in the United States comprise approximately $1.4 trillion of financing to U.S. companies. The companies receiving these loans are generally not eligible for investment grade loans, constitute more than 70 percent of U.S. companies, and include a variety of well-known companies and major employers in industrial and service sectors throughout the economy. Issuers of CLOs have for many years been the single largest source of capital that supports these loans and the extensive range of American companies that depend on them to expand operations, create jobs, improve their goods and services, and otherwise increase competition and economic growth. Issuers of CLOs perform this function by securitizing pools

[1] *Presidential Executive Order on Core Principles for Regulating the United States Financial System*, § 2 (Feb. 3, 2017).

of syndicated bank loans, thus selling notes with varying degrees of credit risk to investors with a broad range of risk appetites and investment objectives – including investors who would not directly purchase bank loans or lend to companies that receive them. According to S&P Global Market Intelligence, capital provided by CLO issuers has ranged from $50 billion to $125 billion annually as part of a syndicated loan market of approximately $130-550 billion annually. Hedge funds, mutual funds, insurance companies, and banks also provide capital to this sector.

The proposed regulatory relief concerns only the rule's application to independent managers of the assets of CLO issuers. Such managers are often small, thinly capitalized fund managers focused on and rewarded for delivering returns to investors and regulated by the SEC as investment managers. Issuers with this type of independent manager stand in contrast to "balance sheet" CLO issuers, which are used to securitize pools of loans provided by an originating bank rather than loans purchased on the open market by an independent manager. Independently managed CLO issuers provide the overwhelming amount of capital raised and deployed by CLOs.

Section 941 of the Dodd-Frank Act required the SEC, FDIC, OCC and Federal Reserve (and for housing-related securitizations, HUD and the Federal Housing Finance Agency) to promulgate rules requiring certain "securitizers" to retain at least five percent of the credit risk associated with the securitized assets.[2] In the rulemaking that followed, the two most contentious issues were whether and how risk retention requirements would be imposed on independent managers of CLO assets and which securitizations of residential mortgages would be exempted from the risk retention requirements. The independent asset managers argued that they were not "issuers" or otherwise "securitizers" subject to risk retention requirements, and pointed to the significant adverse consequences for investors, borrowers, and consumers if they were subjected to the risk retention requirements. They also argued that, even if technically subject to Section 941, they should receive a partial or complete exemption due to the risk retention required of them already by investors, the adverse consequences of subjecting them to expensive additional risk retention requirements, and the investor protections and alignment of interests inherent in the CLO business model – reflected in the remarkable performance of CLOs during the 2008 crisis. They further argued that any risk retention obligation should be based on credit risk as the statute required rather than fair value, as proposed by the agencies and which would require far greater capital commitments.

In their final rules, the agencies determined that securitizers would have to retain an interest in five percent of the fair value of the securitization, that most residential mortgage securitizations would not be subject to the requirement, but that independent managers of CLO assets would be deemed "securitizers" and fully subject to the fair-value based risk retention requirement.

<u>Public Benefits of Regulatory Relief.</u>

Applying the risk retention rules to independent managers of the assets of CLO issuers simply provides no benefits to the markets, investors, companies, or consumers. Doing so

[2] *See* 15 U.S.C. § 78o-11 (codifying the principal provisions of Section 941).

clearly harms all of them in significant respects. That application of the rule is ripe for elimination.

No Benefits From Current Rule.

The statutory risk retention requirement was designed to align the interests of investors with loan originators and to avoid market risks caused by "originate to distribute" securitizations. As the Financial Stability Oversight Council summarized, if "originators receive significant compensation upfront without retaining a material ongoing economic interest in the performance of the loan … [t]his reduces the economic incentive of originators and securitizers to evaluate the credit quality of the underlying loans carefully."[3] Section 941 was designed to ensure that securitizers retained "skin in the game" to "encourage sound lending practices, restore investor confidence, and permit securitization markets to resume their important role as sources of credit for households and businesses."[4]

None of these concerns applies to independent managers of CLO assets. They are not loan originators, and so have none of the disincentives the rules were designed to correct. Instead, they acquire loans on the open market on behalf of the CLO and are responsible for managing an active portfolio of loans through a substantial investment period. Like other fund managers, they are focused on delivering returns to their client investors. These investors, in turn, are extremely sophisticated and have developed an industry model that is carefully designed to align investor and manager incentives and to reward managers by ensuring that they do, in fact, have a financial interest in the performance of the underlying assets. The standard independent CLO securitization accomplishes this by providing that a principal form of the manager's compensation depends on the eventual returns received by holders of the CLO issuer's equity, ensuring that returns on those equity interests (and, thus, returns to the manager) occur after obligations to debt holders have been satisfied, and through other investor protections. The independent managers effectively hold a deeply subordinated interest in the performance of the CLO assets, which a Harvard Business School expert hired by the LSTA assessed at approximately five percent of the assets' credit risk.

The particular characteristics of CLOs also provide further protection for investors. Unlike many other types of securitizations, the securitized assets are remarkably transparent: the underlying syndicated loans trade on the secondary market, and CLO investors demand and receive detailed, regularly produced reports regarding individual loan performance, along with various aspects of the portfolio's overall performance. Investors also impose a range of constraints upon the trading and management practices of the manager, and the mandated collateralization and distribution structure of CLOs provide protections for investors in all the classes of CLO notes. Managers of CLO assets can limit risk related to underperforming assets by trading during the reinvestment period, and the loans themselves generally have first lien protections that ensure very substantial recovery in the event of borrower default.

---

[3] *See* Financial Stability Oversight Council, "Macroeconomic Effects of Risk Retention Requirements," at 11 (Jan. 2011).

[4] *See* S. Rep. No. 111-176, at 37 (2010).

As a result, CLOs performed remarkably well during the financial crisis. Out of more 6,141 CLO tranches rated by S&P between 1994 and 2013, just eight investment grade tranches defaulted and 17 high yield tranches defaulted. In that 20-year period, not a single AAA or AA CLO tranche defaulted. In contrast, the 10-year default rate on AAA and AA corporate bonds was 0.87% and 1.13%, respectively. The 1994–2013 default rate on A, BBB, BB and B rated CLO notes was 0.45%, 0.47%, 2.26% and 2.61%, respectively. The 10-year default rate on A, BBB, BB and B rated corporate bonds was 2.07%, 5.06%, 15.96% and 29%, respectively. In effect, the default rate on CLOs was *one-tenth to one-fifth* that of equivalently rated corporate bonds. Clearly, CLOs proved to be remarkably resilient and served investors extremely well, especially compared to most other types of investments, including in particular other types of securitizations.

For all these reasons, Section 941 was not designed to apply to independent managers of CLO assets. Such managers fall within neither of the two components of the definition of a "securitizer": they are neither issuers nor parties that organize securitizations by directly or indirectly transferring assets to the issuer.[5] That issue of statutory construction is currently the subject of litigation pending before the U.S. Court of Appeals for the D.C. Circuit. In any event, the independent asset management function of managers and the nature and performance characteristics of CLOs justify exempting those managers from any risk retention restrictions that may technically apply. Managers of bank loan mutual funds and other funds holding similar assets are not subject to risk retention requirements, and imposing risk retention requirements on managers of CLO assets is simply unnecessary to achieve the alignment of interests that Section 941 was designed to accomplish.

<u>Significant Harm Arising From Current Rule</u>.

Even as the rule as applied to independent managers achieves no benefits, it also will cause significant harm to the market, investors, borrowers, and consumers – as even the promulgating agencies' own analysis confirms.

This harm arises principally because the rule imposes costs upon independent asset managers that they cannot bear, forcing them to restructure or to retreat from the market or to pass those costs to third parties in the form of higher costs or reduced service. Like many other asset managers, many independent managers of CLO assets are thinly capitalized, and even those that are not generally pursue a business model predicated on asset management rather than direct investment. They are agents rather than principals and design their services to benefit investors. The credit risk retention rule, however, requires these asset managers to undertake large outlays as principal investors. This is so in part because the agencies determined that the economic interest in credit risk must be determined based on "fair value" rather than – as the statute directs – "credit risk."[6] So, for example, managers of assets for a $500 million CLO securitization must purchase and retain an interest of $25 million (five percent of fair value). In contrast, before the rule, those managers would have retained nearly five percent of credit risk through their deeply subordinated compensation, as generally required by investors, and even a relatively small equity

[5] *See* 15 U.S.C. § 78o-11(a)(3).

[6] *See id*. § 78o-11(b).

interest would embody approximately five percent of the assets' credit risk. And when managers must meet the regulation's risk retention requirements by holding an interest in the most subordinated tranche of notes, they bear a degree of credit risk that is many multiples of the 5 percent benchmark that regulators otherwise deemed adequate.

The resulting capital outlay requirements can be expected to strongly deter the formation of independent CLOs. LSTA surveys indicated that CLO formation may ultimately be reduced by half. The responsible agencies' own analysis conceded that the rule would significantly impair CLO formation and the resulting capital available from CLOs to support the loan syndication market, and they disagreed with LSTA's analysis only with respect to the particular degree of impairment.[7] CLOs that continue to be formed will be managed by a smaller group of competitors as smaller, less capitalized managers are acquired or squeezed out of the market, and those CLOs likely will be priced and structured somewhat less efficiently because the manager must depart from the market-based, asset management business model. The agencies' own analysis confirmed these points. That analysis acknowledged that that increased capital outlay requirements, or holding of excess credit risk, will inevitably reduce CLO formation, increase lending costs, and reduce the efficiency of the affected capital markets.[8]

Preliminary market performance since the release of the rules confirms these predictions. The rules became formally effective at the end of 2016. However, since the announcement in late 2014 of the risk retention requirements, it has been recognized that CLOs' ability to refinance after the rules' effective date may require CLO managers to satisfy the risk retention requirements at that time. The decline in CLO issuance has been significant: in 2014, before the rulemaking was completed, $124 billion of CLO notes were issued; in 2015 and 2016 the comparable figures were $98 billion and $74 billion. Thus, CLO formation declined 40 percent in just the run-up to the introduction of risk retention requirements. Similarly, the predicted consolidation and contraction among managers has already commenced. There has already been material consolidation in the market and lessened activity from smaller fund managers that had been active in the sector. And, although the agencies justified imposing the risk retention requirements on independent managers in part based on the availability of a "lead arranger" alternative designed to reduce the adverse effect on CLO issuance,[9] no CLO issuance has occurred using that option – precisely as industry commenters predicted.

These market effects will be directly borne by borrowers and investors and only slightly less directly by consumers. Recently increased investor interest in higher-yielding assets has partially masked these adverse effects, but as the risk retention rules are implemented the basic laws of supply and demand ensure that the price of capital will be higher and the availability of capital will be less than they otherwise would have been in this crucial economic sector. Compared to the market that would have existed in the absence of the risk retention rule, reduced CLO issuance and less efficient pricing mean reduced options or increased prices for investors. Those effects also will increase the relative costs of borrowing and decrease the scope of lending in the syndicated bank loan market. Those increased costs and reduced access to capital, in turn,

---

[7] *See, e.g.*, 79 Fed. Reg. 77602, 77729–730 (Dec. 24, 2014).

[8] *See id.*; *id.* at 77657.

[9] *See id*. at 77658.

mean that borrowers will be less able to maintain or expand their businesses, hire employees, or invest to improve their services. Consumers and the economy are ultimately harmed.

The agencies' rules also undermine market stability. The agencies claimed that the acknowledged costs of the rules were justified largely by the purported market benefits of reducing capital available to support the syndicated loan market. This rationale was in some tension with the statutory direction to increase access to capital and failed to recognize the public benefits associated with making capital more widely available to businesses. In any event, the agencies' own analysis undermined its rationale. The agencies reasoned that hedge and mutual funds would partially fill the gap in capital previously provided by CLOs.[10] However, CLOs served the markets and investors so well during the 2008 financial crisis in part because they are closed end funds, with capital available to purchase loan assets in sharp market downturns. Mutual and hedge funds, of course, are subject to investor redemptions and lack these characteristics. As applied to independent managers of CLO assets, the rule impeded rather than advanced interests in market stability.

Achieving Regulatory Reform.

Fortunately, straightforward methods exist to reform the rule and to end the adverse effects outlined above. Relief can directly relieve independent managers of CLO assets from credit risk requirements without requiring ancillary or related regulatory revisions.

There are three paths available to provide the requisite regulatory relief. First, legislative relief for this particular point has been discussed with the relevant committees in the House and Senate, and brief and effective proposals have been developed. We would be pleased to share those legislative proposals with you if the Administration and Congressional leaders choose a legislative path to financial regulatory reform.

Second, the agencies that promulgated the rule have rulemaking power to make further revisions, including specifically exemptions of particular groups or classes of persons from the broader credit risk retention requirements. This path has the disadvantage of delay to the extent the agencies pursue a further rulemaking and of having to align agencies with potentially divergent policy views.

Third, the SEC has independent authority to provide regulatory relief for the vast majority of independent managers of CLO assets. Section 941 provides that "[t]he regulations issued under this section shall be enforced by— … the Commission, with respect to any securitizer that is not an insured depository institution."[11] Section 941 further provides that this enforcement power supplements and "shall be *in addition to* the authority of the Commission to otherwise enforce the securities laws."[12] That additional administrative authority includes the rulemaking and related enforcement, exemption, and implementation authorities of 15 U.S.C.

---

[10] *See id.* at 77657, 77729–730.

[11] 15 U.S.C. § 78o-11(f)(2); *id.* § 78o-11(f)(1) (appropriate banking regulatory agency to enforce regulations with respect to insured depository institutions).

[12] *Id.* § 78o-11(g) (emphasis added).

§ 78w(a)(1) and 15 U.S.C. § 78mm. That latter provision in particular provides the Commission with power by "rule … or order" to "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."[13]

The Commission could readily use these exemption powers to relieve independent managers of CLO assets within its jurisdiction from the risk retention requirements, in whole or part. Relief would be justified as furthering the public interest, including protecting investors, by avoiding the harms identified above. It could take the form of a wholesale exemption of that class of asset managers. Or, relief could be predicated on those managers' satisfying certain structural or asset selection criteria, or based on the managers' holding a minimal amount of the most highly subordinated securities (comprising, for example, five percent of credit risk). In the course of the rulemaking, commenters proposed various alternatives designed to ensure that the independent managers of CLO assets would retain five percent credit risk without having to make the much larger capital outlay necessary to acquire five percent of the fair value of the securitization. Although wholesale regulatory relief would be more appropriate, the Commission might also predicate relief on compliance with the terms of any of those proposals or close variants upon them.

* * * *

We would be pleased to elaborate any of these points and would welcome the opportunity to work with you and your colleagues to achieve regulatory reform that will benefit investors, U.S. companies and other market participants, and consumers.

Respectfully,

R. Bram Smith
Executor Director

[13] 15 U.S.C. § 78mm.