Fact Sheet: CLOs and Risk Retention

What is a CLO?

A Collateralized Loan Obligation (CLO) is a vehicle that invests in commercial loans to companies. Investors receive scheduled debt payments from the underlying loans. Typically investors buy various tranches, or segments, that reflect different levels of risk and reward profiles.

What role do CLOs play in the U.S. economy?

CLOs are an important source of financing for American companies and allow businesses to innovate, grow the economy and create jobs.

As of December 2015, CLOs provided more than $420 billion in financing to more than 1,000 American companies. These include large, well-known companies like Chrysler, Rite-Aid, Hilton and Clear Channel as well as smaller innovative companies like NetSmart Technologies and Rocket Software.

CLOs hold more than one quarter of all funded term loans made to U.S. companies and offer funding at more affordable rates than many other lenders.

Why do companies like borrowing from CLOs?

Due primarily to regulation, commercial banks are finding it harder and harder to lend to non-investment grade U.S. companies. But CLOs are increasingly filling this void and providing long-term financing to companies in this class.

Importantly, CLOs are long-term, buy and hold investors. They lock in investment money for approximately 10 years, so they can continue to provide funding for companies even during economic downturns or times when other investors are being forced to redeem their investments. For this reason, CLOs stabilize markets and are available for borrowers when other investors are not.

Who are the participants in the CLO market?

CLO managers are just like mutual fund managers (indeed, they often are mutual fund managers!). Managers range from large companies like Invesco and Eaton Vance to boutique companies like Kramer Van Kirk and Feingold O'Keefe.

How do CLOs perform?

Over the last 20 years, including through the financial crisis, CLOs have suffered *total* credit losses of just 0.81%. Cumulatively! Moreover, not one AAA or AA investor has ***ever*** suffered a credit loss. This is a better performance history than most investment grade corporate bonds and nearly any other asset class.

Due to the similarities of their names and basic structure, some people confuse "CLOs" with "CDOs" – or Collateralized Debt Obligations. However, these two products are very distinct in both what they do and how they have performed. The underlying assets in CLOs are bank loans, not structured products as with CDOs, which means that CLOs are much more transparent.

What happens if CLOs go away?

There are a number of new regulations that could dramatically shrink the CLO market, in particular, risk retention. If the CLO market contracts, the government has acknowledged that there will be less financing – or less stable financing – for U.S. non-investment grade companies. This would reduce credit availability and increase credit costs for these U.S. companies. And, in fact, CLO issuance declined from

more than $120 billion in 2014 to less than $100 billion in 2015, and is forecast to drop by as much as 50% again in 2016. Risk retention, though not the only reason for falling issuance, is a significant contributing factor.

What changes would risk retention impose?

The final risk retention rule requires a CLO manager to purchase and retain 5% of the value of any new CLO. This is akin to requiring a mutual fund manager to buy $5 of Apple stock for every $100 of Apple stock it buys, as a fiduciary, for the benefit of its investors. The mutual fund manager would quickly run out of money and would no longer be able to offer mutual funds to its investors. The same is true with CLO managers.

Even the agencies that wrote the rule acknowledged that risk retention would shrink the amount of credit available to American businesses from CLOs. Further, the application of this rule to CLOs is unnecessary because the CLO manager does not aim to move assets off of its balance sheet by organizing a CLO, which was the problem with subprime mortgages and the behavior this rule was designed to prevent.

Is there a solution?

A "Qualified CLO" would meet the policy objectives of the risk retention rule while not decimating the CLO market. A Qualified CLO would be required to meet six strict criteria around i) asset quality, ii) portfolio diversification, iii) capital structure, iv) alignment of interests of the manager and investor, v) regulation of the manager, and vi) transparency and disclosure. Only if the CLO meets all these criteria can it satisfy its risk retention obligations by purchasing and retaining 5% of the CLO equity tranche, rather than 5% of the face amount of the entire CLO.

This proposal meets a number of policy objectives, including supporting high quality underwriting (because the manager is not paid unless the CLO performs therefore has "skin in the game"), alignment of interest of the manager and the investor, and transparency and disclosure.

Importantly, the Qualified CLO concept received bipartisan support in a letter dated July 31, 2014 and signed by 17 members of Congress.

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About LSTA

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