INSIGHT

VIEWPOINT

Risk Retention: CMOA, CMV, MOA, RR……B – Y – E – B – Y - E

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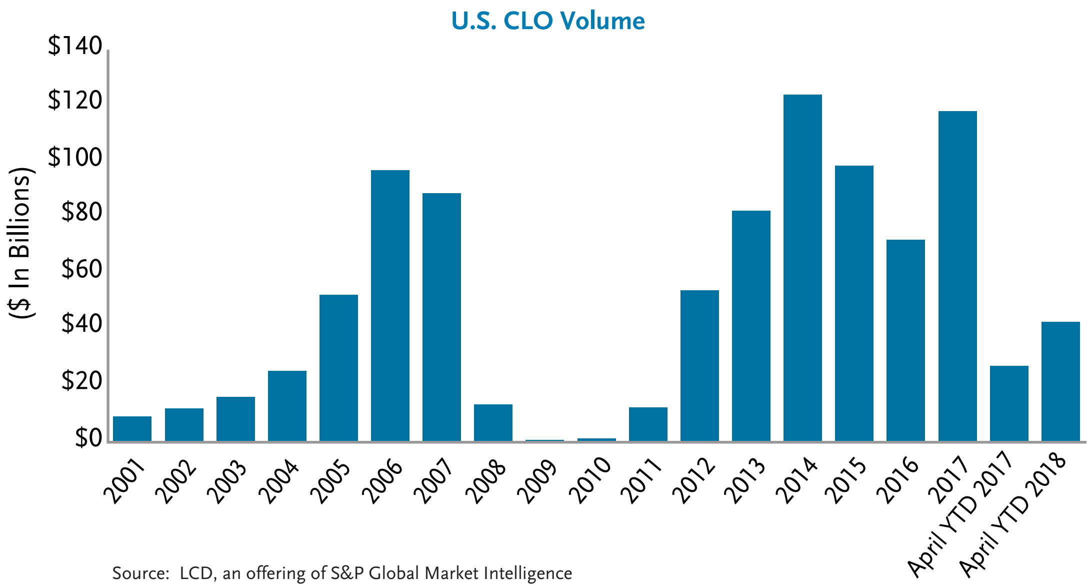
Mr. Sweeney is a Senior Vice President in the Fixed Income group where he trades leveraged loans. Mr. Sweeney joined TCW in 2015 from Bradford & Marzec, LLC where he managed loan strategies for both total return and CLO accounts as well as serving on the investment committee where he helped direct the firm's overall investment strategy. Prior to Bradford & Marzec, Mr. Sweeney worked for Macquarie Group (fka Four Corners Capital Management) in Los Angeles, where he managed both bank loan and high yield bond investments. Prior to Four Corners, he evaluated leverage loan and bond opportunities for Columbia Management (Ameriprise Financial, Inc.). He also worked as an Analyst with ING Capital Advisors and as a member of the investment banking team at First Union Securities where he gained additional experience in underwriting, structuring and syndicating leveraged transactions. Drew holds an MBA from the University of North Carolina Kenan-Flagler Business School and a BS from Rutgers University.

Back in the good 'ole days of 2014 when the cycle was young(er) and the capital markets were robust, regulators determined that CLO managers would need to comply with risk retention rules. Under the newly passed Dodd-Frank Act of 2010, the 'securitizer' or sponsor of a securitization would be required to hold 5% of the credit risk associated with a transaction. The market would have two years to prepare but, make no mistake about it, in December of 2016 all new issue CLOs would need to comply with the risk retention rules. Loan market participants were immediately concerned that CLO issuance would significantly slow if not stop altogether. How in the world would CLO managers come up with all this capital and would the economics make sense? The regulators were implementing a rule that was going to increase the cost of debt for most every company in the loan market. Or so the story was told. If the cost of capital increased to small and medium sized borrowers due to the lack of CLO issuance, growth in this segment of the market would slow and jobs would be lost. And if the leveraged loan market had a problem well then it might wreak havoc on the capital markets as a whole!

Risk retention existed for roughly 16 months before it was vacated. In 2017, the first year operating under the rules, U.S. CLO issuance increased. And it didn't increase a little bit. In the first year operating under the new rules, U.S. CLO issuance was near $120 billion. 2017 represented the second largest year for issuance in history and thus far in 2018 issuance has been greater than for the same period last year. Every deal issued in Q1 2018 needed to comply with risk retention as well.



Source: LCD, an offering of S&P Global Market Intelligence

$120 billion sounds like a very large number until you begin to drill down in a more granular way; then it sounds like a massive number. Actual CLO issuance was **$268.4** billion in 2017. That is the number of deals that were refinanced, reset or newly issued. Both resets and new issue deals needed to meet risk retention requirements. The manager had to meet the capital requirements required under the act. The managers had to put up 5% of the capital in each and every new issue or reset CLO. How in the world did that happen? What about the CLO market coming to a screeching halt?

Introducing the Invasion of the Acronyms

At first blush, the creation of risk retention shocked the loan market. It appeared to mandate a significant increase in capital from managers. Common sense suggested that small managers would disappear from the CLO landscape and larger managers would issue fewer transactions per year. However, as so often happens in free markets, solutions began to emerge.

Risk retention (RR) solutions began to emerge. Managers began to set up vehicles to comply with RR. Some managers set up Majority Owned Affiliates (MOAs). Others set up Capitalized Majority Owned Affiliates (C-MOAs). Others still were setting up Capitalized Manager Vehicles (CMVs). Law firms were busy figuring out the optimal structure that would allow managers to comply with both the spirit and letter of the law. To comply, managers formed new entities and raised dedicated equity capital. Managers would provide a co-investment of $2-$5mm into these new vehicles; not too dissimilar to what most managers were investing into their deal pre-risk retention.

What Now?

The easy conclusion would be to think that if risk retention was going to lead to less issuance, then the removal of RR would lead to more issuance. The removal of RR requirements will allow more deals to be reset without being RR compliant and on the margin that might extend the investment period of some subset of existing CLOs but the reality is that there will be little impact on the broader CLO market. The rule had little impact on CLO issuance and arguably the removal of the rule will have an equally muted impact.

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One interesting question to ask is whether risk retention actually created MORE issuance? How could that be the case? One could argue that risk retention created a need for managers to find a capital solution. In order to meet increased capital requirements managers raised dedicated equity capital in various structures. That dedicated money was raised and marketed with a 12-15% return expectation. One can certainly surmise that the managers may have felt pressure to deploy that capital fairly quickly. It is possible that warehouses were opened and deals were accelerated because of this new found buyer of CLO equity. Is it possible that the regulation actually created more issuance?

Conclusion

Was risk retention effective? To answer that question we must understand the goals of the regulation. It appears the regulators were attempting to have managers increase their commitment per investment vehicle, or "skin-in-the-game". One might also conclude that another goal of regulation was to attempt to improve underlying loan quality by reducing CLO issuance. If in fact these were the main objectives of the regulation it is clear that the regulation was not successful. ■

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