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House Committee on Financial Services Hearing on

The Impact of the Volcker Rule on Job Creators

January 15, 2014

Good morning, Chairman Hensarling, Ranking Member Waters and members of the Committee. My name is Elliot Ganz, and I am the Executive Vice President and General Counsel of the Loan Syndications and Trading Association, or LSTA. The LSTA is an association that represents the interests of all participants in the $3 trillion corporate loan market.[1] We thank you for the opportunity to testify regarding ***The Impact of the Volcker Rule on Job Creators***.

This hearing is very timely given the recent issuance of the final rules implementing the Volcker Rule[2]. The impact of this and other parts the Dodd-Frank Act will be felt not only by the financial sector, but also by American businesses and job creators that require affordable and efficient financing. Dodd-Frank, and the Volcker Rule in particular, will result in significant unintended consequences, some of which are already starting to hit home. Our member firms have been working with the agencies for more than three years in an effort to mitigate these consequences and will continue to do so going forward.

My testimony will focus on how the Volcker Rule's definition of "ownership interest" could negatively impact credit availability for American companies. The Final Rule would profoundly disrupt the market for open market Collateralized Loan Obligations, or CLOs. This disruption could lead to a significant reduction in the amount of credit available to the some of the most dynamic, job creating companies of America, and would result in material and arbitrary losses to American banks that hold almost $70 billion of safe, highly-performing CLO securities.

What Are CLOs?

Perhaps the best place to start is by describing what a CLO actually is. CLOs are straight-forward, "long-only" investment funds that invest in the ingenuity, creativity and health of

[1] The LSTA, founded in 1995, is the trade association for the syndicated corporate loan market and is dedicated to advancing the interests of the market as a whole. The LSTA engages in a wide variety of activities intended to foster the development of policies and market practices designed to promote a liquid and transparent marketplace. More information about the LSTA is available at www.lsta.org.
[2] Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Dec. 10, 2013) ("Final Rule").

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American companies. They support growth and most importantly, American jobs. CLOs are not complicated derivatives where some people bet for and some people bet against the very same securities in the portfolio. Nor are they "originate-to-distribute" structures that create loans for the sole purpose of selling and securitizing them.

At bottom, CLOs are securitization funds managed by independent investment advisers registered with the Securities and Exchange Commission that issue securities to different types of institutional investors in order to purchase senior, secured corporate loans. **More than 90% of the proceeds of those funds are invested in senior, secured commercial and industrial loans made to American Companies**. As of today, CLOs hold approximately $300 Billion of these loans. This represents almost half of all loans made by non-banks in the United States. These loans are made to some of the most dynamic companies in America, across all states in industries including cable, broadband, satellite, cellular telephony, health and hospitals, energy, airlines and retail. Often, these growing, job-creating companies have no other access to the capital markets other than through the loan market.

Companies that access the CLO market include such American staples as Sears (which employs 275,000 people), Aramark (250,000), SuperValue Stores (130,000), JC Penney (116,000), Community Health (96,000), Dollar General (90,000), Rite Aid (90,000), Goodyear Tire (69,000), Delta Airlines (74,000), and American Airlines (65,000). Scores of smaller companies also rely on CLO financing, including, Regal Cinemas (22,000), Armstrong World Industries (8,500), ABC Supply (7,500) and Quikrete (3,500). In all, we estimate that companies that access the CLO market for financing employ more than 5 million people.[3]

As an investment, CLOs have performed remarkably well over the years, including during the financial crisis. **Since 1996, the cumulative impairment to CLO debt securities has been less than 1.5%. There have been practically no realized losses on these securities during or after the financial crisis.** There are six primary reasons for the strong performance of CLOs mostly relating to the many protections built in to the CLO structure for the benefit of investors:

(i) **Underlying Assets**. CLOs typically hold at least 90% of their assets in senior, secured commercial and industrial loans. These loans have performed very well over the last three default cycles beginning in the late 1980s (and including the recent financial crisis), experiencing a modest annual default rate and an average recovery-given-default rate of about 80 cents on the dollar. As described above, these are real loans to real American companies. CLOs invest in portions of 100-150 individual loans to companies like these, and these loans trade in a transparent secondary market.,

(ii) **Diversification**. CLO portfolios are highly diversified and, unlike real estate securitizations, are not reliant on any particular industry. In fact, CLOs are

[3] While the companies speak for themselves, it may still be worth noting that the companies that have accessed CLO financing deliver vital products and services throughout the country. For instance much of the infrastructure for rural cellular phone coverage was financed through CLOs.

usually limited to investing no more than 3% of their portfolios in the loans of any single borrower and no more than 15% in any single industry sector.

(iii) **Alignment of Interest**. The majority of a CLO manager's compensation is paid only after the note holders are paid. The manager does not get paid most of its fees unless the CLO portfolio performs as expected.

(iv) **Regulatory Oversight**. Virtually all CLO managers are registered under the Investment Advisers Act which entails a range of fiduciary obligations that protect investors and subjects CLO managers to supervision by the SEC. All purchases and sales of the CLO's assets must be conducted on an arm's-length basis in compliance with the Investment Advisers Act.

(v) **Structural Protections**. CLOs have overcollateralization restrictions and interest coverage tests that protect senior note holders. If, for some reason, the CLO does not perform well, instead of the equity and the manager being paid, funds are used to pay off the senior notes

(vi) **Transparency and Disclosure.** CLO investors receive monthly reports that include a list of CLO assets - and for each asset - its interest rate, maturity date, and the type of asset. Investors receive a report on the aggregate principal balance of the portfolio and a breakdown of how much each asset comprises of the portfolio. They also receive a summary of the overcollateralization test and interest coverage test. Finally, they receive a report on all purchases, repayments, and sales during that period as well as the identity of any defaulted loans. CLO investors have a substantial amount of relevant information available to them.

How Have CLO Debt Securities Performed?

Not surprisingly, CLO debt securities have performed very well historically. In 2013, U.S. debt securities rated A, AA and AAA returned an average of 3.9% to investors[4]. During that same time period all other fixed income securities lost 2.5%[5]. Moreover, cumulative impairments (not losses) on CLO debt securities since 1996 are less than 1.5%. Practically no CLO debt investor has lost any money through and after the recent financial crisis.

Why Do Banks Invest in CLO Notes?

Attracted by the safety and soundness of CLOs, their historical performance and their excellent risk-adjusted returns, a wide range of U.S. banks currently invest almost $70 billion in these

[4] Bank of America Merrill Lynch CLO Weekly, January 10, 2014, available at http://rcr.ml.com/Archive/11347776.pdf?w=eganz%40lsta.org&q=aOVjPABRxo-5YpytkUrEsw&__gda__=1389538989_00d84a51fd7f108ce232833a74d5f17f.
[5] Merrill Lynch US Broad Market Index.

securities.[6] While a significant amount of CLO debt securities are held by large banks, CLO debt securities are also held by 21 U.S. banks with assets of less than $25 billion, including a number of community banks.[7]

How Does the Final Rule Disrupt the CLO Market?

The Final Rule arbitrarily and artificially "converts" highly rated CLO debt securities into the equivalent of equity securities thereby making them ineligible to be held by banks[8]. As a result, over the 18 months banks will have to divest, or attempt to orchestrate the restructuring of up to $70 billion of CLO Notes.

The Final Rule contains seven "indicia of ownership" that are intended to insure that debt securities that have certain equity-like features are treated under the Volcker Rule as ownership interests rather than debt. Any of these indicia, standing alone, is enough to constitute an ownership interest under the Final Rule. The last six of these provisions properly relate more to the economic control of the entity and the potential for securities holders to receive an "upside" if the fund performs well. These six provisions are generally not applicable to CLOs, but if they were, we would agree that they would be indicative of an ownership interest rather than debt. The first provision,[9] however, includes **"the right to participate in the selection or removal" of an investment manager of a covered fund, "(excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event)."** Unlike the first six, this provision protects creditors from unexpected circumstances *and is not related in any way to the economics of the transaction.*

CLOs provide the holders of their debt securities with a number of creditor rights designed to protect their debt interests. Most of these rights are vested in the "controlling class," typically the most senior class of debt securities then outstanding.[10] Most existing controlling class CLO debt security holders have the contingent right to participate in the removal and replacement of the CLO manager, but only "for cause," as such term is defined in the transaction documents. The definition of "cause" that would trigger the right of removal includes, for example:

- a willful breach by the manager of its obligations under the CLO transaction documents;

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[6] Based on a review of Call Reports as of September 30, 2013.
[7] Id.
[8] Banks invest almost exclusively in the AAA and AA rated notes of CLOs. These notes typically yield a fixed annual return above LIBOR, usually in the range of LIBOR + 1.15-1.45% for AAA rated notes and approximately LIBOR + 2% for AA rated notes. In contrast, CLO equity tranches yield more than 10% per annum. The difference in the yields reflects the fact that equity holders, the true owners of the CLO, are taking the most risk and therefore reaping the most reward. In contrast, the AAA and AA notes are simply a debt investment. If the banks "owned" the CLO – as the Volcker Rule indicates they do – they would earn far more on their investment.
[9] Section __.10(d)(6)(i)(A) of the Final Rule defines "ownership interest" to include "the right to participate in the selection or removal" of an investment manager of a covered fund, "(excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event)."
[10] Since CLO debt securities are paid serially, any class of these debt securities can become the controlling class after the more senior classes have been paid in full.

- the dissolution or insolvency of the manager;
- a material failure of a representation or warranty that is not timely cured; or
- fraud or criminal activity by the manager in connection with its investment management business.[11]

Most existing controlling class CLO debt security holders also have the right to participate in the replacement of a manager after the manager's resignation. The resignation of the manager is tantamount to a change of control of the issuer — a circumstance under which traditional bank lenders often receive consent rights or the right to be repaid.

These "for cause" and resignation events pose clear and direct threats to the interests of holders of debt securities as creditors of a CLO, and their ability to respond to and remediate these threats is properly viewed as an essential creditor's right, and not as an ownership interest.[12] *Oddly, the Final Rule carves out from the definition of ownership interest a security whose rights to remove or replace a manager stem from the occurrence of an event of default but do not carve out such rights when they are* ***triggered by provisions that are meant to prevent an event of default****.*

In the absence of interpretive guidance from the agencies or action from Congress, this provision threatens to seriously disrupt the CLO market. The provision arbitrarily converts CLO debt securities into the equivalent of equity securities even though they have none of the indicia of ownership that markets expect from equity securities. Since banks are prohibited from holding ownership interests in "covered funds"[13], including CLOs that hold any securities, that artificial conversion of debt securities into ownership interests makes CLO debt securities prohibited for banks to hold.

What Will Happen if the Final Rule is Not Clarified?

While the date on which banks must fully conform with the Final Rule is still months away, existing accounting standards make the implications of the Final Rule troublesome almost immediately. Institutions holding CLO debt securities where the current market value is lower than the security's cost will be forced to recognize that difference as a loss because they can no

[11] *See, e.g.,* Offering Circular for "Finn Square CLO LTD", available at http://www.centralbank.ie/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/14788/Prospectus%20-%20Standalone%20302052.PDF. Transaction contains, at pp. 128-130, typical "for cause" manager removal and replacement provisions.

[12] It is worth noting that holders of CLO debt securities affirmatively choose to invest in a particular CLO specifically because of the track record and reputation of the CLO manager. The last thing they want or expect to do is remove and replace the very manager they have chosen. It is only in extremely rare and unexpected circumstances that one would expect to invoke these rights.

[13] Covered funds are defined in a way that includes securitization vehicles, such as CLOs, that rely on the 3c-1 or 3c-7 exemptions to the Investment Company Act of 1940.

longer represent that such CLO debt securities can be held until the market price recovers (since the Final Rule requires their divestment). These losses will reduce bank capital levels unnecessarily and arbitrarily. Indeed, even the risk of being in a situation where such losses would need to be recognized will immediately reduce the attractiveness of these securities. If banks are unwilling to participate in CLOs, this will immediately increase the cost of capital for those borrowers that typically rely on CLOs. These risks will put downward pressure on prices for CLO debt securities, thereby triggering further selling pressures, leading to a cascade of falling prices triggering further sales *despite no fundamental changes in the projected cash flows of the underlying CLO debt security*. To put this in perspective, while banks holding CDOs of TruPs may have to recognize, on an accounting basis, cumulative losses (that have already occurred) of up to $600 million, if the price of CLO debt securities were to drop by only 10%, banks holding CLO debt securities would face potential cumulative losses of up to $7 billion, **which losses would be driven solely by imposition of the Final Rule.** The Final Rule as written would cause banks to recognize significant losses on otherwise safe, high quality assets, which furthers no regulatory objective.

Can the Debt Securities be Restructured to Comply with the Volcker Rule?

For a number of reasons, it is not realistic to expect that $70 billion of CLO debt securities can be restructured to comply with the Final Rule over the next few months. First, in order to amend these securities, majorities of *all* classes of securities holders, not just the holders of the senior debt securities, must consent and the interests of these classes are not always aligned. In addition, because many of these securities are held at depositaries in nominee name, it may not even be possible to identify all the holders of the other securities.

Some banks have considered simply waiving their rights, but there is no consensus in the legal community that a bank could effectively waive its rights to exercise its removal and replacement rights unilaterally. Finally, while managers could theoretically agree to sell their securities and not purchase new securities (thus making the CLO exempt from the Volcker Rule as a non-covered fund), this, too, is unlikely on a large scale because managers (who are not impacted by the Final Rule) have fiduciary duties to all its securities holders and would be unwilling to sell securities at a loss. The bottom line: Banks, especially the smaller ones, will be under immense pressure to divest quickly.

Because the prospects for restructuring are so remote, every bank that holds CLO debt securities faces a prisoner's dilemma; i.e., when to run for the exit. The smaller banks that have fewer resources and less market power are especially vulnerable. Regardless of when they sell, they will be facing a buyer's market, and will have to sell sound, performing assets at a loss. This will result in a hit to their capital, solely due to regulatory overreach. This, in turn, means that these banks will have less money to lend into their local economies in the case of community banks, or to small and medium sized job-creating businesses in the case of mid-size banks. At the same time, the disruptive effect of this selling on the overall CLO market will make it more difficult for U.S. companies that rely on this market to borrow at affordable rates.

How Can the Agencies Fix This Problem?

The LSTA has requested confirmation from the Agencies in a FAQ or other appropriate interpretive guidance that the term "ownership interest" as defined in §__.10(d)(6) of the Final Rule does not include debt securities of CLO issuers that are covered funds, where these CLO debt securities give holders only a contingent right to remove a manager "for cause" or to nominate or vote on or consent to a nominated replacement upon a manager's removal for cause or resignation, but contain none of the other indicia of ownership interests listed in the definition. We believe that adoption by the Agencies of this proposal would allay the concerns of banking entities as to whether their debt securities represent ownership interests solely because of the removal and replacement rights described herein.

We note that some members of the Senate have introduced legislation[14] that would allow banks to continue to hold debt securities issued by CLOs that were issued before December 10, 2013. We support this legislation and are grateful to the members who support it. The grandfathering of existing CLO loans would mitigate the Volcker Rule's disruptive effect on the corporate loan market, and would permit both banks and CLOs to continue to finance economic expansion and job growth. Nevertheless, we understand that the legislative process is always fraught with uncertainty. It is our hope that the regulators will take their cue from Congress and issue the regulatory guidance described above.

Conclusion

As enacted, the Volcker Rule was intended to prohibit banks from owning hedge funds, private equity funds and the like. This is a point on which the law's proponents and detractors agree. Nothing in the law's legislative history indicates an intention to prohibit banks from owning CLO debt – the debt of funds that invest, almost exclusively, in corporate loans. Nevertheless, that is what the Final Rule will do. Not only is the result inconsistent with the law, but it will significantly deplete bank capital, reduce CLO liquidity, and drive up the cost of financing for American job creators. In the absence of a countervailing policy goal, this cannot be the result that Congress envisioned, or one that it should embrace. Should the Final Rule be implemented as is, it will likely increase the cost of financing for American businesses and force companies to curtail expansion plans, forego new hiring and cut dividends - all of which are avoidable and will hurt ordinary Americans who are still recovering from financial crisis.

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[14] S.1907, 113th Cong. (2014) (introduced by Senator Kirk (R. Ill.) and cosponsored by Senators Crapo (R. Id.), Toomey (R. Pa.), Barrasso (R. Wy.), Enzi (R. Wy.), Moran (R. Ks.) and Wicker (R. Mi.) on January 9, 2014).