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House Subcommittee on Capital Markets and Government Sponsored Entities Hearing on

The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Market and Securitizations

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Good afternoon Chairman Garrett, Ranking Member Maloney and members of the Committee. My name is Meredith Coffey, and I am the Executive Vice President in charge of research and analysis at the Loan Syndications and Trading Association, or LSTA.[1] The LSTA is an association that represents the interests of all participants in the nearly $4 trillion corporate loan market. Importantly, the LSTA does not represent the securitization market or the market for Collateralized Loan Obligations (or "CLOs"). Instead, the LSTA represents the corporate loan market – and our concern is how certain regulations could severely diminish securitization (particularly CLOs) and how this could markedly reduce U.S. companies' access to the loans they need to expand, build factories, build cellular networks and engage in M&A as they grow and create jobs. We are grateful to be here today to testify on how important securitization is to lending and to U.S. companies, and how some regulations have the potential to decimate this important market.

My testimony will begin with an introduction to the U.S. corporate loan market, will then describe CLOs and address how the risk retention regulations under Dodd-Frank could very adversely affect this important source of financing for U.S. companies. Finally, I would like to discuss the "Qualified CLO," which is a commonsense solution that would both meet the letter and the spirit of the Dodd-Frank Act and would avoid a material disruption of the CLO and corporate loan markets.

[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.

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The U.S. Corporate Loan Market

According to the Shared National Credit ("SNC") Review, which is run jointly by the Office of the Comptroller of the Currency ("OCC"), the Federal Reserve and the Federal Deposit Insurance Corporation ("FDIC"), banks and non-bank lenders provide $3.9 trillion in syndicated loan and loan commitments to companies. The 2015 SNC Review indicated that, based on their survey results, U.S. banks held $1.49 trillion of these commitments, foreign banks held $1.14 trillion, while non-banks (like CLOs, finance companies, mutual funds and others) provided over $760 billion in credit.[2] Some of the companies that use syndicated loans are blue chip investment grade companies like IBM, UPS, McDonalds, Wal-Mart, John Deere and Microsoft. Banks are the largest providers of lines of credit to these large investment grade companies.

But most companies are not large investment grade companies like Wal-Mart or Microsoft. In fact, the vast majority of companies in America are "non-investment grade" or rated below BBB- by S&P or Baa3 by Moody's. In 2014, Moody's rated 2,000 large US companies; over 70% of them were "non-investment grade." And there is nothing wrong with being "non-investment grade." Indeed, many of these companies are very familiar and reliable names. For instance, non-investment grade borrowers include communications companies like Cablevision, Charter Communications and Univision, healthcare companies like Community Health and HCA, airlines like Delta and American, diverse food related companies such as Dole Foods, Albertsons and Aramark, many of America's fast food chains including Wendy's, Burger King and Dunkin' Donuts – as well as turnaround situations like Dell Corp. All told, it is estimated that such loans provide financing for more than 5,000 companies.[3] Without such loans, these businesses would have to turn to more expensive financiers like hedge funds or simply be unable to access credit at all.

These companies have been fortunate in recent years; accommodative monetary policy has made credit easily available, and this credit availability has supported what has been, admittedly, a

[2] *Shared National Credits Program, 2015 Review, available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090924a1.pdf.
[3] ThomsonReuters LPC DealScan database.

tepid recovery. However, the credit environment may be beginning to change. According to the Federal Reserve's Senior Loan Officer Survey, banks have tightened credit availability in two back-to-back quarters; this is first time that has happened since the Financial Crisis. Yet, while banks may be tightening credit, borrowers' needs for credit may be increasing. On February 16, 2016, Moody's published a report noting that U.S. non-investment grade companies will have a record amount of debt coming due through 2020; this debt will need to be refinanced or the companies could face a credit crunch.[4] This development has not gone unnoticed at the Federal Reserve. Last week, Bloomberg ran an article called "Fed Frets Corporate Credit Crunch Will Crimp Economic Growth"[5] that quoted the concerns of both Federal Reserve Chairwoman Janet Yellen and Boston Federal Reserve President Eric Rosengren in this regard.[6]

In such an environment, it is unwise to materially diminish a safe and proven source of financing to U.S. companies. Unfortunately, that is exactly what the risk retention rules will do.

CLOs and the Loan Market

To understand the impact of risk retention across America, it is important to understand what CLOs are – and how important they are to US companies. Open market CLOs are a steady and proven source of financing to many industries and in many states. According to ThomsonReuters, the three top industry holdings in CLOs are Technology (10%), Healthcare (9.2%) and Retail & Supermarkets (8.1%). Of note, Oil & Gas is the 17th largest industry in CLOs, comprising just 2.4% of the overall CLO universe's industry position.

So who are these companies? As of January 2016, CLOs provided more than $420 billion in financing[7] to U.S. non-investment grade companies like Del Monte, Chrysler and United

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[5] Available at http://www.bloomberg.com/news/articles/2016-02-17/fed-frets-corporate-credit-crunch-will-crimp-economic-growth.

[7] *Thomson Reuters LPC Leveraged Loan Monthly*, January 2016, at slide 36.

Continental Airlines. All told, according to ThomsonReuters and loansmeanbusiness.com, more than 1,200 companies – employing more than six million people –receive financing from CLOs.[8]

But what exactly are CLOs and – and are they something to be worried about? Despite their unfortunate acryonym, the reality is that CLOs are straight-forward, "long-only" investment funds that invest in bank loans to U.S. companies. They are similar to mutual funds where an investment manager selects pieces of individual corporate loans to purchase and actively manages that portfolio of loans.[9] However, CLOs are match-funded, which means they issue long-term liabilities (bonds) and use the proceeds to invest in loans to US companies. Because they are match-funded, there is *not* a possibility of a run on a CLO[10] – and thus they actually act to stabilize the markets they invest in. In other words, when other investors have to sell, CLOs often stand ready to buy.

In addition, being long-only investments, CLOs are not complicated derivatives where some people have a stake in a portfolio's success while others have a stake in its failure. Nor are they "originate-to-distribute" structures that make loans simply to collect a fee, then sell them off and forget about them. At bottom, a CLO is simply an actively-managed investment fund that uses securitization technology to provide its investors exactly the risk and return they are looking for.[11]

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[8] www.loansmeanbusiness.com/positiveimpact

[9] These corporate loans are usually quite large – $20 million to more than $1 billion – and pieces of these loans are syndicated to many different investors, including CLOs. A CLO would typically purchase a $1-10 million piece of a loan.

[10] In a speech in February 2013, Federal Reserve Board Governor Jeremy Stein noted that "CLO equity does not represent a form of demandable short-term financing and hence does not have the potential to contribute to fire-sale dynamics in the same way as, say, repo financing." *Overheating in Credit: Origins, Measurement and Policy Responses*. February 7, 2013.

[11] The terms "CLO" and "open market CLO" are used interchangeably in this testimony. Both terms include CLOs that are actively managed, as described above, but do not include synthetic CLOs or "balance sheet CLOs." A "balance sheet CLO" means a CLO whose assets consist predominantly of loans originated and transferred to the CLO by one or more of its affiliates other than in (i) open market transactions or (ii) from another open market CLO, and the assets and liabilities of such CLO are, immediately after issuance of its asset-backed securities in a securitization transaction, included under generally accepted accounting principles in the consolidated balance sheet of one or more of its affiliates.

While CLOs are proven investment products that have historically performed very well, they often are mistaken for collateralized debt obligations, or CDOs. In fact, they are quite different. Critically, the collateral underlying a CLO is very different. CLOs invest in senior secured syndicated loans to U.S. companies, both large and iconic and small and growing. The characteristics, credit risk and performance of each of these loans are very transparent to the CLO manager and its investors. There is an active syndication and trading market for loans – in fact, more than $590 billion of U.S. syndicated loans traded in the secondary market in 2015.[12] Each loan is typically individually rated by a third party rating agency and there are two major pricing services that provide daily prices on these loans. Moreover, the typical CLO portfolio has only 100-150 companies in it; thus the manager tracks these individual loans easily – and can decide to sell a loan if it is underperforming. In addition, CLOs are diversified by industry, with no industry typically accounting for more than 15% of the portfolio. Finally, CLO investors receive a wealth of information regarding the CLO and the underlying assets on a regular basis. Every month, investors receive a trustee report that details the CLO's loan assets and, for each asset, reports its interest rate and maturity date. In addition, investors receive a report on the portfolio itself, how much each asset comprises of the portfolio and how the CLO is performing relative to its overcollateralization and interest coverage tests. Finally, the CLO investors receive a report on all purchases, repayments and sales during the month, as well as the identity of any defaulted loans.

Another critical difference between CLOs and CDOs is performance. In a report released in June 2015, Moody's Investors Service calculated the 10-year cumulative impairment rates from 1993-2014 for many securitization classes, including global CLOs and CDOs. The 10-year cumulative impairment rate for global CLOs was **1.52%,** while the same figure for CDOs was **44.47%.**[13] Importantly, no Aaa or Aa rated CLO tranches had *any* impairments. In contrast the Aaa impairment rate on CDOs was 35.89%; it was 45.35% of Aa rated CDO notes.[14]

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[12] LSTA *Week in Review* (Jan. 22, 2016).
[13] It is important to differentiate between Mark-to-Market price declines on CLO notes and actual losses. As an example, in early 2009, CLO Aa-rated note prices had dropped to less than 20 cents on the dollar on average.

Why did CLO notes perform so well? This performance was due to the unique characteristics described above (asset performance, diversification and disclosure) as well as structural protections in CLOs and an alignment of interest that already exists between the CLO manager and its investors.

But regardless of the critical role CLOs play in the provision of credit to U.S. companies and notwithstanding their stellar performance, CLOs are currently set to be swept up in – and materially harmed by – the risk retention rules. Risk retention will be particularly harmful because CLOs do not fit the profile of securitizations that fit easily into those rules. CLO managers are investment advisors who are in the business of managing investments for others. Like many investment advisors, firms that manage CLOs are not heavily capitalized like banks, nor do most managers have access to capital necessary to purchase 5% of the face value of the CLOs they manage as fiduciaries to their investors.

Risk Retention

In December 2014, the agencies released their risk retention rules for all types of securitizations. These rules go effective for CLOs in December 2016. The truth is, the way the rules are written, they would significantly damage the CLO market – and, by extension, make credit more expensive, or unavailable, to the borrowers that rely upon them. In fact, even though the risk retention rules are not yet effective for CLOs, they already have impacted both the volume of CLOs being done and the types of managers that can issue CLOs.

In 2014, U.S. CLO formation totaled $124 billion, and CLOs were not being structured to be risk retention compliant as the rule was not finalized and the implementation date would still be two years in the future. In contrast, by mid-2015, investors were asking managers to either make their new CLOs risk retention compliant or show investors that the managers had a detailed and viable plan to become risk retention compliant. Due both to this shift in investor requirements and a

However, an investor that did not sell would have been repaid in full. As noted above, not one Aa rated note ever suffered any impairment.

[14] Moody's Investors Service, Special Comment: Default and Loss Rates of Structured Finance Securities: 1993-2014. June 1, 2015, pp. 52-53.

softening market,[15] CLO issuance declined markedly. CLO issuance dropped 20% from 2014 levels, totaling $98 billion for full-year 2015. Moreover, CLO formation was $38 billion in the second half of 2015 (when investors began requiring risk retention or, at least, detailed risk retention plans), down 37% from first half of the year. Bear in mind that this drop in CLO formation also means that U.S. companies began to struggle when they looked to receive new or replacement financing.

However, the decline in total volume of CLOs being formed (and loans to companies being financed) is not the only impact of risk retention. Another unintended consequence of the risk retention rule is that it is effectively picking winners and losers among CLO managers. Large managers that have the capital to retain risk can continue in the market while smaller firms that do not have the capital cushion are struggling to meet the rule.

It is worth noting that there were 30 CLO managers that issued CLOs in 2014 that *did not* do so in 2015. As expected, the "drop outs" were disproportionately smaller managers. The managers that withdrew from the market last year had an average of $1.2 billion of CLOs under management in fewer than three CLOs. This is significant because these managers were *less than one-quarter the size* of 2015's leading CLO managers.[16] So, not only is risk retention already reducing CLO formation, but it also is squeezing out smaller managers.[17]

[15] The credit markets also were softening in part as the Federal Reserve looked to begin raising interest rates.
[16] The top 25 managers last year's ThomsonReuters LPC league CLO tables had, on average, more than $7 billion of CLOs under management in more than 12 CLOs.
[17] As a starting point to understand why risk retention is particularly challenging for these open market CLO managers, it is helpful to review the language of Section 941 of the Dodd-Frank Act. Section 941 of Dodd-Frank sought to use risk retention to align the incentives of "securitizers" with those of their investors. The very language of Section 941 suggests that it was intended to mitigate moral hazard in "originate-to-distribute" securitizations. Section 941 says that the securitizer – that entity that "initiates or originates an ABS by ***selling or transferring assets***, directly or indirectly, to the Issuer" – must ***retain 5% of the credit risk*** of the assets. The concept here is that a securitizer has a portfolio of assets on its balance sheet and, instead of selling 100% of the credit risk of the assets, it can only sell 95% - and must retain 5%.
While requiring the alignment of the interest of a "securitizer" in an originate-to-distribute securitization with its investors is understandable, the application of risk retention to open market CLOs as proposed is very challenging. Actively-managed CLOs do not have a securitizer as defined in Dodd-Frank. There is no entity that initiates or originates a securitization by selling or transferring assets. Instead, a CLO is an investment fund; a CLO manager is hired to *purchase assets* from a number of banks or in the secondary market on an arm's length basis and actively

Unlike banks, most CLO managers are thinly capitalized asset managers. As currently structured, few have the balance sheet or the funds to purchase $25 million of CLO notes for every new $500 million CLO they do. CLO management firms typically earn around 0.35%- 0.4% management fee on the CLOs they manage. This means that a CLO management firm would earn approximately $1.5-2 million per $500 million CLO per year. (Bear in mind this is *revenue*, not profit. A very substantial amount of this goes to paying the firm's expenses and would not be available for purchasing and retaining notes.) That $1.5-2 million in annual revenue (again, not profit) is less than one-tenth the amount of money that CLO managers would need to find simply in order to be allowed to run their business[18] – a business that they have been running successfully with infinitesimal losses to note holders for over 20 years.[19]

In a nutshell, the risk retention rules are already impacting – and reducing – the CLO market. This is particularly unfortunate because CLOs have a strong, proven track record, they currently provide almost one-half trillion dollars to US companies – and their curtailment would come

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manage the portfolio during a multi-year reinvestment period. Thus, the Dodd-Frank definition of securitizer simply does not correspond to open market CLOs. Ultimately, with no "securitizer" that matches the statute, the agencies decided to classify the CLO manager as the "sponsor" as it is the entity that ***selects assets for purchase***, and then manages the portfolio going forward. Because the agencies tagged the manager, the manager would need to purchase and hold 5% of the notional value – or $25 million of notes of any new $500 million CLO that is done. This is true whether the manager would retain in a vertical pro rata strip (in other words, 5% of each of the CLO's liabilities), a horizontal first loss strip (in other words, equity equivalent to 5% of the full CLO value) and some combination of vertical and horizontal retention.
There are three problems with the Agencies' proposed solution: First, it simply doesn't fit the plain language definition of securitizer in Section 941 of Dodd-Frank to tag the *buyer* of assets as the securitizer, rather than the *originating seller*. Second, instead of conforming to the language of the Dodd-Frank Act, which required the securitizer to retain 5% of the *credit risk*, the agencies instead required the securitizers to retain 5% of the *full amount* of any securitization. The reality is that the credit risk is concentrated in the first loss position – indeed, that is why it is called the first loss position – so holding equity equivalent to 5% of the full securitization is far more than 5% of the credit risk. Third, as a practical economic matter, it is challenging for open market CLO managers to purchase and retain 5% of the notes of the CLOs they manage. It is simply too much money. While the LSTA and CLO market participants worked diligently to come to a consensual solution with the agencies, the final rule is so destructive to smaller managers that the LSTA was, regretfully, required to bring a case on behalf of CLO managers.

[18] Requiring a CLO manager to purchase and retain 5% of every new CLO 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.
[19] There are investors who are developing "risk retention" funds, but there are considerable logistical, regulatory and tax hurdles to setting up many of these funds.

exactly when the regulators are beginning to be concerned about credit availability. Indeed, as Moody's observes, new CLO formation will be "shrinking as corporate refunding needs increase through 2020."[20]

Moreover, there is no need for the CLO market to be so diminished. There is a solution that matches the policy objectives of the Section 941 of the Dodd-Frank Act. This solution has received bipartisan support in Congress[21] and the Federal Reserve Board indeed acknowledged that the solution had features that could align interests of managers and investors. This solution would require managers to hold 5% of the *credit risk* of the assets (rather than their fair value) *and* it would require CLOs to meet a series of best practices. This is, of course, the "Qualified CLO."

Proposed Solution for Risk Retention and CLOs

The LSTA strongly supports H.R. 4166, the Expanding Proven Financing for American Employers Act of 2015, that was co-sponsored by Representatives Barr and Scott, which would ensure that CLOs could continue to provide essential financing for American businesses while at the same time requiring that CLOs are structured in a manner to minimize risk. The bill would do this by creating a "Qualified CLO" that would be subject to special risk retention requirements. The Qualified CLO is structured to meet both the words and policy objectives of the Dodd-Frank Act. First, the CLO manager would purchase equity and would retain more than 5% of the credit risk of the assets[22] - as Section 941 requires the securitizer to do.[23] Second, ***in addition to*** retaining 5% of the credit risk, the Qualified CLO would ***also*** require the CLO

[20] Moody's Investors Service, "Companies Face Record Maturities; New Issuance Wave Likely in 2017"; February 16, 2016, pp 5-8.
[21] July 31, 2014 letter to the Honorable Janet Yellen, the Honorable Martin J. Gruenberg, the Honorable Mary Jo White and the Honorable Thomas J Curry, signed by 17 members of the House of Representatives.
[22] *See* Letter from Professor Christine Ivashina to Directors, Commissioners, and Staff Members of Financial Regulator Agencies re: Notice of Proposed Rulemaking, Credit Risk Retention (Apr. 1, 2013), at Appendix A to LSTA Comment Letter on Risk Retention (Apr. 1, 2013) ("April Risk Retention Letter"), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=16434. The manager would retain 5% of the credit risk both by buying 5% of the equity – where the vast majority of the risk resides – as well as retaining credit risk through a deeply subordinated and deferred compensation structure.
[23] The LSTA does not concede that the CLO manager is the securitizer; rather we have simply attempted to work with regulators and lawmakers toward a solution that works both for them and for the CLO market.

manager to meet or exceed best practices in six specific areas. (In contrast, Section 941 does not require securitizers to meet any standards in addition to retaining risk.)

Essentially, the Qualified CLO creates six overlapping restrictions that meet a number of the agencies' objectives: It supports strong underwriting, it facilitates a continuity of credit, it ensures the alignment of interests of the managers and investors, it limits disruption in the market, and it protects investors. In effect, for a CLO to become a Qualified CLO, its governing documents would have to include requirements and restrictions around (1) asset quality; (2) portfolio composition; (3) structural features; (4) alignment of the interests of the CLO manager and investors in the CLO's securities; (5) transparency and disclosure; and (6) regulatory oversight. If the CLO meets all these criteria, which are detailed below, it may meet the risk retention rules by purchasing and retaining 5% of the equity.

Asset Quality: To ensure appropriate asset quality, at least 90% of the Qualified CLO's assets must be cash and senior secured loans to companies; it cannot purchase ABS interests, derivatives, loans in default, margin stock, or equity convertible notes; loans must be held by three or more investors or lenders unaffiliated with the CLO manager; and no more than 60% can be loans that rely on incurrence covenants (as opposed to maintenance covenants). In effect, the asset quality tests require the CLO to purchase higher quality assets[24] (loans) that have a lower expected loss.

Portfolio composition: The next layer of protection comes from the composition of the portfolio. Not only must the CLO purchase higher quality non-investment grade loans, but it must do so in a diversified manner. To ensure this objective, no more than 3.5% of its assets can be invested in loans to any single company and no more than 15% can be invested in loans to any one industry. With robust diversification, the whole portfolio should be stronger than the sum of its assets.

[24] The LSTA working group considered using a ratings criteria in determining "higher quality assets." However, the Dodd-Frank Act prohibits the agencies from using NRSRO ratings in their regulations, and thus we were unable to utilize a ratings based criteria.

Structural protections: The next layer of protection comes from the CLO structure itself. In order to differentiate Qualified CLOs from CDOs and to provide additional protection for the debt tranches, the Qualified CLO must have equity of at least 8% of the face value of the CLO assets. To add further creditor protections for the debt tranches, the Qualified CLO must be subject to interest coverage and overcollateralization tests that divert cash to pay down the notes if the portfolio underperforms.

Alignment of interests: Next, the Qualified CLO ensures the alignment of interests between the manager and its investors. First, it must be an open market CLO, not a balance sheet CLO. Next, the equity investors must have the ability to remove the manager for cause. In addition, the majority of the managers' fees must be subordinated to the rated CLO notes. Moreover, the manager must purchase and retain 5% of the CLO equity. These protections – the ability to fire the manager, subordinating most of the income of the manager, requiring funded retention that is not paid out upon closing – align the interests of the manager and investor.

Transparency and disclosure: The next protection in the Qualified CLO ensures that the investor has enough information to make an informed judgment about the CLO. To be a Qualified CLO, the manager must provide a monthly report that provides significant information on the assets (obligor name, CUSIP, interest rate, maturity date, type of asset and market price where available) and on the portfolio (the aggregate balance, the adjusted collateral principal amount, and the percentage of adjusted collateral represented by each name). In addition, the report must detail each Overcollateralization and Interest Coverage test and their status, all purchases, repayments and sales, as well as the identity of each defaulted asset. With all this information, the QCLO is extraordinarily transparent, unlike some of the securitizations that played a material role in the financial crisis.

Regulation: The final protection is built around regulation: The Qualified CLO manager must be a registered investment advisor, regulated by the SEC, with all the responsibilities – not least the fiduciary responsibilities – that go along with this.

With these six overlapping protections, a Qualified CLO will have a sound structure, will invest in higher quality non-investment grade loans in a diversified manner, will ensure alignment of interests between the CLO manager and investor, will ensure that the investors are sophisticated and further ensure that these sophisticated investors receive all the information they need to make informed judgments. Furthermore, it will offer all these benefits while limiting the disruption that the current risk retention rule would impose on the CLO and financing markets. Thus, the Qualified CLO approach would accomplish precisely the objectives of Section 941, related to ensuring prudent asset selection and underwriting, protecting investors, ensuring access to and competition in the provision of capital, and achieving related public interest benefits.

It is, in effect, Dodd-Frank *plus* best practices.

Conclusion

Despite an unfortunate acronym, CLOs have been a stable, safe and proven source of financing for U.S. companies for 20 years. CLOs survived the worst financial crisis since the Great Depression with extremely low default and loss rates. Moreover, they continue to provide over $400 billion in financing to U.S. companies. Unfortunately, risk retention has the potential to decimate this important market. This diminution of the CLO market will either reduce financing for companies or raise their financing costs. Fortunately, the Qualified CLO is a commonsense solution that would allow risk retention to meet the letter and spirit of the Dodd-Frank Act, while still permitting CLOs to function and provide financing to the 1,200 American companies that rely upon them.