Good afternoon Chairman Garrett, Ranking Member Waters and members of the subcommittee. My name is Bram Smith and I am the Executive Director of the Loan Syndications and Trading Association, or LSTA. The LSTA has more than 300 member firms which consist of all types of participants in the syndicated commercial loan market, including large and regional U.S. banks, foreign banks, insurance companies, fund managers and other institutional lenders. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices in respect thereof, balancing the interests of all market participants.

Our testimony today will focus on one aspect of commercial loan financing – collateralized loan obligations, or CLOs. The LSTA appreciates the opportunity to appear here today to offer our views on how the recently proposed risk retention rules under the Dodd-Frank Act would impact the CLO market. Unfortunately, attempting to apply the risk retention rules to CLOs is like trying to fit a square peg into a round hole. **They simply don't fit**. The proposal, as currently drafted, would have a profoundly negative impact on CLOs – indeed, it could basically end CLO formation entirely. Since CLOs are a major lender to U.S. companies, this action could significantly reduce lending to American corporations and impact their ability to expand and create jobs. To be clear, the LSTA does not exclusively represent CLOs, though they number among our members. Rather, we are concerned about the impact that indiscriminate risk retention rules will have on lending itself.

In this testimony, I will discuss:

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- The importance of CLOs to U.S. corporate borrowers
- Why CLOs are different from "originate-to-distribute" asset backed securities ("ABS")
- Why the risk retention requirements recommended by the joint proposed rulemaking do not work for CLOs
- Why the approach taken in the joint proposed rulemaking is inconsistent with some of the mandates of the Dodd-Frank Act[1]
- Ways in which the joint proposed rulemaking does not follow the recommendations of the Federal Reserve's Risk Retention Study[2]
- Some alternative approaches to align interests in the CLO market – and keep this important source of corporate financing alive

The Importance of CLOs to U.S. Corporate Borrowers

The U.S. commercial loan market is critical to the success of American businesses. According to the Shared National Credit Review[3], which is run by the Federal Reserve, the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC"), in 2010 there were $1.2 trillion of funded syndicated commercial loans to U.S. companies. Lenders other than banks, such as insurance companies, finance companies, mutual funds and CLOs, provided more than $500 billion of these syndicated commercial and

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[1] The "Dodd-Frank Wall Street Reform and Consumer Protection Act," Pub.L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act").

[2] Report to the Congress on Risk Retention, The Board of Governors of the Federal Reserve (Oct. 19, 2010), available at http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf ("Risk Retention Study").

[3] Credit Quality of the Shared National Credit Portfolio Improved in 2010, Shared National Credit Review (Sept. 28, 2010), available at http://www.federalreserve.gov/newsevents/press/bcreg/20100928a.htm.

industrial loans. CLOs, alone, provided $250 billion. Thus, CLOs provide more than 20% of the funded syndicated commercial and industrial loans to U.S. companies. The terms of the joint proposed rulemaking are unworkable for CLOs, and CLO formation will be dramatically reduced if the proposed risk retention requirements are not adapted to this asset class. If the proposed rules are not adjusted, this source of liquidity will dry up for U.S. companies. This is particularly unfortunate because, first, CLOs are not the "originate-to-distribute" ABS that the Dodd-Frank Act attempted to remedy and, second, CLOs performed well in the Global Financial Crisis.

CLOs Are Not "Originate-to-Distribute" ABS

FDIC Chairperson Sheila Bair noted that "[f]undamentally this rule is about reforming the 'originate-to-distribute' model for securitization and realigning the interests in structured finance."[4] **However**, **CLOs are not "originate-to-distribute" securitizations.** CLOs are not a way for banks to remove assets from their balance sheet. Instead, CLOs are a way for SEC registered investment advisors – like Eaton Vance or Invesco – to create an investment pool of syndicated loans. These independent third party asset managers, which have a fiduciary responsibility to their investors, seek out and purchase pieces of individual loans they believe are good investments – just like they would for a mutual fund. In addition, CLOs invest in a discrete number – roughly 150-250 – of individual corporate loans rather than the thousands held by a typical originate-to-distribute ABS. These commercial syndicated loans are subject to a robust

[4] Press Release, FDIC, Chairman Bair's Statement on Credit Risk Retention Notice of Proposed Rulemaking (Mar. 29, 2011), available at http://www.fdic.gov/news/news/press/2011/statement03292011.html.

`credit approval process prior to origination. A potential borrower will usually engage a lead lender to arrange a syndicated loan for the borrower. The initial loan commitment is subject to a number of significant conditions precedent and each of the lenders will perform financial due diligence on the borrower. The final loan documentation is typically drafted by the lead lender's counsel, with input from the syndicate lenders. In addition, these loans are individually analyzed by the CLO manager and are very transparent, both for the manager and for investors. These loans are reported on in the press[5], they are priced daily by third party pricing services and more than $400 billion of these loans trade every year. Investors receive a monthly trustee report, which describes the performance of the CLO, highlights whether the CLO is passing all the tests found in its indenture, and details each loan asset. The manager actively buys and sells these loans when he believes there is an opportunity to avert losses on or improve the performance of the portfolio. Moreover, the manager *is hired and can be fired* by the CLO investors. **Crucially, the manager is only paid if the CLO performs**. As noted in the Federal Reserve's Risk Retention Study, the manager is not paid upfront, but is rather paid through a three-tier fee structure during the life of the CLO: A small amount of the fee (usually 10-20 basis points (bps)[6]) is paid prior to the note holders receiving their interest. This fee allows the manager to cover various costs such as rent and utilities. The bulk of the "running" fee (usually 30-40 bps) is paid only after the interest is paid on all of the CLO notes. Thus, if the CLO is not performing well and interest is not being paid on the notes, the CLO manager will not receive the bulk of his fees. Finally, the majority of CLOs also have an "incentive fee", which is paid toward the end of the life of the CLO.[7] This fee is paid only if all the CLO notes have received all their interest payments *and* the CLO equity has achieved a certain pre-negotiated rate of return. Thus, the vast

[5] See Thomson Reuters LPC, S&P/LCD and Credit Investment News.
[6] A basis point is 1/100th of one percent.
[7] Risk Retention Study, p. 46-47.

majority of the CLO manager's remuneration is tied to the performance of the CLO. This compensation structure ensures that the CLO manager's interests are aligned with the investors throughout the life of the CLO.

It is also important to note that CLOs performed very well in the worst financial crisis since the Great Depression. There are more than 630 cash flow CLOs outstanding today, and there have only been two payment defaults[8], neither of which caused losses for investors holding notes rated A or better. And, while there were ratings downgrades, they were relatively modest. For instance, 85% of the CLO notes originally rated Aaa by Moody's were still rated Aa or better following the downgrade sweep. Notably, a significant number of the downgrades were due to the rating agencies changing their criteria, making them considerably more stringent, rather than to a change in the quality of the CLOs. Moreover, recognizing that CLOs performed well, the rating agencies have been upgrading CLO notes since early 2010. There have been more than 430 CLO notes upgraded in the last three months alone. (See the appendix attached hereto for an example of the structure of a CLO.)

The Joint Proposed Rulemaking Will Not Work for CLOs

We appreciate the work the Agencies have done to prepare the proposed rules contained in the Notice of Proposed Rulemaking[9] ("Proposed Rules"). These Proposed Rules will cover many different "originate-to-distribute" products, whose outstandings total more than $10 trillion. With

[8] Moody's Investors Service.
[9] Notice of Proposed Rulemaking on Credit Risk Retention, the Agencies (Mar. 28, 2011), available at http://www.fdic.gov/news/board/29Marchno2.pdf.

such an overwhelming task, it is surely not surprising that the Agencies were not able to create a nuanced and workable regime for a $250 billion asset class – albeit one that is very important to U.S. companies. Indeed, CLOs appear not to have been given direct consideration in the Proposed Rulemaking. (The 376-page NPR's sole mention of CLOs outside of a volume table was footnote 42 designating the CLO manager as the "sponsor" even though the manager does not fit the literal definition of "securitizer" or "originator" as the Dodd-Frank Act envisioned for "originate-to-distribute" ABS.) Because CLOs are not "originate-to-distribute" ABS, the Proposed Rules' architecture simply does not work for them.

The Proposed Rules recommend five forms of retention:

- a "vertical slice" option, wherein the securitizer retains at least 5% of each liability tranche;
- a "horizontal residual interest" option, wherein the securitizer retains a first-loss position in an amount equal to at least 5% of the par value of all the ABS notes;
- a cash reserve fund option, wherein the securitizer establishes and funds an account in an amount equal to at least 5 percent of the par value of all ABS notes. The account will absorb losses in the same manner as a horizontal first-loss interest;
- an "L-Shaped" option, which consists of risk retention in both a vertical slice and a horizontal residual interest; and
- a representative sample option, which requires the securitizer to retain a randomly-selected pool of assets that are materially similar to the assets collateralizing the ABS issuance, measured as 5.264 percent of the unpaid principal balance of the securitized assets.

None of these options work for CLOs. Through a series of surveys that culminated last November, the LSTA polled asset managers that, collectively, manage $100 billion in CLOs. According to our survey, just 13% of respondents have the capacity and the structure that might allow them to retain a vertical slice option. (However, several respondents that said that they could theoretically hold a vertical strip added that they might not be able to justify deploying scarce capital to do so.) The vertical slice is thus either not allowed or is uneconomic for CLOs. For similar reasons, the L-shaped option is also unfeasible. Likewise, while a representative sample option might theoretically be feasible, the Proposed Rules require the sample to be drawn from a pool of at least 1,000 separate assets. As most CLOs manage only 100-200 assets, they simply do not have 1,000 separate assets to draw from. This is another clear example of how, despite the Agencies' efforts, the Proposed Rules were written without fully considering products like CLOs.

In the LSTA's survey, the only option that CLO managers said was even marginally feasible was the horizontal first loss strip – but only if it was of a reasonable size. Unfortunately, the Agencies have substantially over-estimated the necessary size of the horizontal first loss strip, focusing on the par value of the ABS rather than on the credit risk of the assets, as required by the Dodd-Frank Act. As discussed more fully below, because the horizontal first-loss position imposes a 5% retention of the entire value of the ABS, it incorrectly assumes that the credit risk of every ABS is 100% (i.e., that the entire portfolio will default and suffer a 100% loss given default). As we explain below, the horizontal first-loss position as currently proposed would impose on the CLO manager a retention requirement far in excess of the 5% of the *credit risk* of the ABS contemplated by the Dodd-Frank Act. Thus, a first loss position of an amount equal to at least

5% of the par value of all the ABS notes *is a far larger risk position than all the other retention options.* Moreover, it is not consistent with the explicit language of Section 941(b) of the Dodd-Frank Act, which requires retention of a portion of the "credit risk" and not of the par value of the assets.

We appreciate the fact that the Agencies structured a number of retention options that fit many asset classes, and encourage them to continue to offer all the proposed options. However, we would like to use a numerical example to illustrate how, while the vertical pro rata strip option captures 5% of the credit risk of the portfolio, a first loss position of 5% of the par value of the ABS notes is far in excess of 5% of the credit risk of the assets. Suppose there is a hypothetical $400 million CLO with five note tranches rated from AAA (senior-most and least likely to suffer losses if there are losses in the portfolio of assets) to unrated equity (junior-most and most likely to suffer losses if there are losses in the portfolio of assets). The first four note tranches are each $95 million, and there is a $20 million equity/first loss tranche at the bottom of the CLO's capital structure. The Proposed Rules say that a sponsor can retain risk either in a vertical slice ($4.75 million of each of the first four notes and $1 million of the equity note) or in a horizontal slice ($20 million in the first loss, equity slice). If the portfolio suffers losses, the losses will accrue from the bottom (the equity) up. For instance, suppose the portfolio of loans suffers $20 million of losses. In this case, the equity note will absorb all the losses and will be completely wiped out. If the sponsor held a 5% vertical slice of each note tranche, he would lose $1 million (or, 5% of the credit losses – just as the Dodd-Frank Act intended). If the sponsor held his risk retention in a horizontal first loss position (the equity tranche), he would lose $20 million (or 100% of the

credit losses – far more than the Dodd-Frank Act intended)[10]. These are not the same outcomes, yet the Proposed Rules treat them as though they are. Consequently, we request that the final rules reflect a consistent approach to risk retention, i.e., first loss retention equal to 5% of the credit risk.

5% "First Loss" Retention is Far More Than 5% of Credit Risk

The reason these two are not the same is because the Proposed Rules assume that 5% of the par value of the ABS (in any form) and 5% of the credit risk are the same thing. As the above example illustrates, they are not the same because the credit losses are concentrated in the first loss position. Importantly, the Dodd-Frank Act requires the securitizer to retain "an economic interest in a portion of the ***credit risk*** for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells or conveys to a third party," [11] and the Agencies have generally determined that 5% is the appropriate "economic interest". However, a first loss position of at least 5% of the par value of the ABS is far more than 5% of the credit risk of the assets.

The annual mean expectation of credit risk is "expected loss". Expected loss is simply the amount of money a lender can expect to lose due to defaults in a portfolio of loans. Expected loss for a funded loan can be calculated as 1) probability a company will default multiplied by 2) how much of the loan value the lender will lose if the company defaults.

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[10] The Risk Retention Study provides an example of how the losses "flow up" on a tranched securitization. See Risk Retention Study, p. 12-14.

[11] Section 941(b) of the Dodd Frank Act (codified at 15 U.S.C. §78o-11(b)(1)).

A real world example may be useful. On average, approximately 3.15% of B1 rated commercial syndicated loans default every year[12]. Because commercial loans that are held in CLOs are the most senior debt in the borrower's capital structure and because they are typically secured by the majority of the borrower's assets, even when these loans default, the lender still recovers a substantial amount of its loan. In other words, the loan will have a high "recovery given default". Based on 1,800 observations since 1988, the average "recovery given default" of senior, secured commercial loans is 80 cents on the dollar[13] of the defaulted loan. Conversely, "loss given default" – the amount that is not recovered – is only 20 cents on the dollar of the defaulted loan.[14]

All told, the expected loss on a portfolio of single-B rated commercial loans that is held for 10 years is 5.4 cents on the dollar. For a $400 million CLO, this means the CLO's expected loss is $21.6 million after 10 years. *The entire expected loss is $21.6 million.* The Dodd-Frank Act generally requires the securitizer to hold 5% of the credit risk. In this case, 5% of the credit risk (defined as expected loss) would be $1.08 million. However the Proposed Rule would require the sponsor that is retaining through the horizontal slice to hold $20 million of a first loss piece – *more than 18 times what the Dodd-Frank Act mandates.*

The Commercial Loan Exemption is Unworkable

[12] Moody's Investors Service.
[13] Moody's Investors Service Report: Hard Data for Hard Times II: The Crisis That Wasn't, Moody's Global Credit Research (Feb. 23, 2011).
[14] Notably, this recovery rate was consistent even through the Global Financial Crisis.

The Proposed Rules theoretically offer a means by which loans with sufficient underwriting standards can be exempted from retention requirements. Unfortunately, the criteria are drawn so narrowly that virtually no commercial loan qualifies. For two years before and after the closing of the loan, the borrower must have i) a total liabilities ratio of 50% or less, ii) a leverage ratio of three or less, and iii) a debt service coverage ratio of 1.5 or greater. [15] In addition, the term must be five years or less, and repayment must come solely from business revenues (and not asset sales or refinancings) and be based on straight-line amortization.[16]

Here are some examples of companies whose commercial loans would not qualify for the exemption: General Electric Capital Corp., AT&T, Wal-Mart, Johnson & Johnson, Verizon Communications, Chevron Corp., Pfizer Inc., Time Warner Inc, Hewlett-Packard, Kraft Foods, PepsiCo, UPS and Deere & Co.

If these companies, which are some of the strongest in America, do not meet these narrow criteria, then it is clear that this exemption for underwriting standards is all but unworkable.

Moreover, even if more than a handful of loans qualified for the exemption, the Proposed Rules also introduce requirements that do not reflect CLO market practices. For instance, the Exemption under the Proposed Rules prohibits CLOs from reinvesting in new loans and does not

[15] Total liabilities ratio "equals the borrower's total liabilities, determined in accordance with GAAP divided by the sum of the borrower's total liabilities and equity, less the borrower's intangible assets, with each component determined in accordance with GAAP." NPR, n. 168.
Leverage ratio "equals the borrower's total debt divided by the borrower's annual income before expenses for interest, tax, depreciation, and amortization (EBITDA), as determined in accordance with GAAP." NPR, n. 169.
Debt service coverage ratio "equals the borrower's EBITDA, as of the most recently completed fiscal year divided by the sum of the borrower's annual payments for principal and interest on any debt obligation." NPR, n. 170.

[16] "Under the proposed rules, the loan payments under the commercial loan must be determined based on straight-line amortization of principal and interest that fully amortize the debt over a term that does not exceed five years from the closing date for the loan." NPR, p. 151.

allow managers to purchase loans more than six months after their closing date. Both of these criteria are counter to the active management that investors seek from CLO managers.

The Proposed Rulemaking Does Not Follow the Recommendations of the Risk Retention Study

The Dodd-Frank Act required the Federal Reserve to conduct a study ("Risk Retention Study") "of the combined impact on each individual class of asset backed security of the new credit risk retention requirements and make recommendations for eliminating any negative impacts on the continued viability of the asset backed securitization markets and on the availability of credit for new lending."[17]

In its Risk Retention Study, the Federal Reserve recommended that in writing rules, the Agencies should:

- Consider the specific incentive alignment problems to be addressed by each credit risk retention requirement established under the jointly prescribed rules.
- Consider the economics of asset classes and securitization structure in designing credit risk retention requirements.
- Consider the potential effect of credit risk retention requirements on the capacity of smaller market participants to comply and remain active in the securitization market.

[17] Section 941(c) of the Dodd-Frank Act.

- Consider the potential for other incentive alignment mechanisms to function as either an alternative or a complement to mandated credit risk retention.
- Consider the interaction of credit risk retention with both accounting treatment and regulatory capital requirements.
- Consider credit risk retention requirements in the context of all the rulemakings required under the Dodd–Frank Act, some of which might magnify the effect of, or influence, the optimal form of credit risk retention requirements.
- Consider that investors may appropriately demand that originators and securitizers hold alternate forms of risk retention beyond that required by the credit risk retention regulations.
- Consider that capital markets are, and should remain, dynamic, and thus periodic adjustments to any credit risk retention requirement may be necessary to ensure that the requirements remain effective over the longer term, and do not provide undue incentives to move intermediation into other venues where such requirements are less stringent or may not apply.[18]

In particular, the Risk Retention Study recommended that the Agencies consider "the economics of asset classes and securitization structure in designing risk retention requirements."[19] As none of the Proposed Rules' retention requirements could be utilized for most CLOs, it clearly does not address CLOs as a unique asset class.

The Risk Retention Study also recommended that the Agencies "consider potential effect of credit risk retention requirements on the capacity of smaller market participants to comply and

[18] Risk Retention Study, p. 3-4.
[19] Risk Retention Study, p. 83.

remain active in the securitization market."[20] Just 13% of the respondents to the LSTA's CLO manager survey could retain risk in a vertical slice; no smaller managers were able to hold retention in this fashion. Clearly this is counter to the Federal Reserve's recommendation.

The Risk Retention Study also explicitly recommended that the Agencies "consider the potential for other incentive alignment mechanisms to function as either an alternative or a complement to mandated credit risk retention."[21] In fact, in its Risk Retention Study, the Federal Reserve specifically noted that for CLOs "alignment is typically accomplished by compensating the CLO managers using a performance-based fee structure."[22] However, these potential alternative forms of alignment are absent from the Joint Proposed Rulemaking.

Recommendations

We appreciate the vast amount of work the Agencies have done in a remarkably short period of time, and we likewise appreciate the opportunity to provide input on how the Proposed Rules could be fine-tuned so as to be appropriate for CLOs.

As explained above, CLOs are not "originate to distribute" ABS. The CLO manager is an independent third party, with fiduciary responsibility to his investors, who actively seeks out and manages loan assets via a CLO. Therefore, CLOs do not fit within the spirit of the risk retention provisions of the Dodd-Frank Act. **And so, we believe it is appropriate and prudent to expressly exclude them.**

[20] Risk Retention Study, p. 83.
[21] Id.
[22] Risk Retention Study, p. 46.

However, if the Agencies see fit to include CLOs, we believe it is important to consider ways to optimize the alignment of interests without shuttering this important source of financing to U.S. companies, which are the engine of job growth. We have three specific recommendations.

First, as discussed in the Federal Reserve's Risk Retention Study, we believe the Agencies should further investigate and consider the three-tier fee structure in CLOs that already exists. Because CLO managers do not receive the vast majority of their remuneration unless i) all note tranches are receiving all their contractual payments and ii) the equity tranche has earned a pre-negotiated rate of return, we believe the fee structure would continue to work exceptionally well as a means to align incentives.

Second, if – counter to the Federal Reserve's recommendations – the Agencies determine that risk retention is the only acceptable form of alignment, we would ask that they consider several additional alternatives. First, we recommend that the Agencies consider a retention option that is similar to that offered to commercial mortgage backed securitizations ("CMBS"), i.e., risk "retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first loss position."[23] We think this approach is worth pursuing for CLOs recognizing that, first, the Proposed Rules, as written, have considerable challenges that must be resolved before they can be effective for CMBS and, second, the Proposed Rules would need to reflect the differences between CMBS and CLOs.

[23] Section 941(b) of the Dodd-Frank Act (codified at 15 U.S.C. §78o-11(c)(1)(E)).

This approach is also consistent with that of the Committee of European Bank Supervisors ("CEBS") which explicitly accepted the retention of the first-loss position by a third party investor for risk alignment in CLOs.[24] Although Europe's Risk Retention legislation also has significant drawbacks with respect to CLOs, in part because the European Regulators had no ability to apply nuanced rulemaking, we believe the fact that CEBS recognized that CLOs were not originate-to-distribute ABS and attempted to provide alternatives demonstrates that regulatory alternatives are necessary.

Finally, we ask that the Agencies, when finalizing the rules for a "horizontal residual interest" option, ensure that the option captures 5% of the *credit risk* of the portfolio, rather than being equivalent to 5% of the face value of the ABS notes. As we demonstrated above, a first loss position of 5% of the face value of the ABS notes is many multiples of 5% of the credit risk of the pool of assets.

We again appreciate the opportunity to testify before this august committee and we look forward to working constructively with the Agencies to help produce rules that both align the interests of securitizers and investors *and* ensure that this important source of financing to Corporate America is not shut off.

Thank you.

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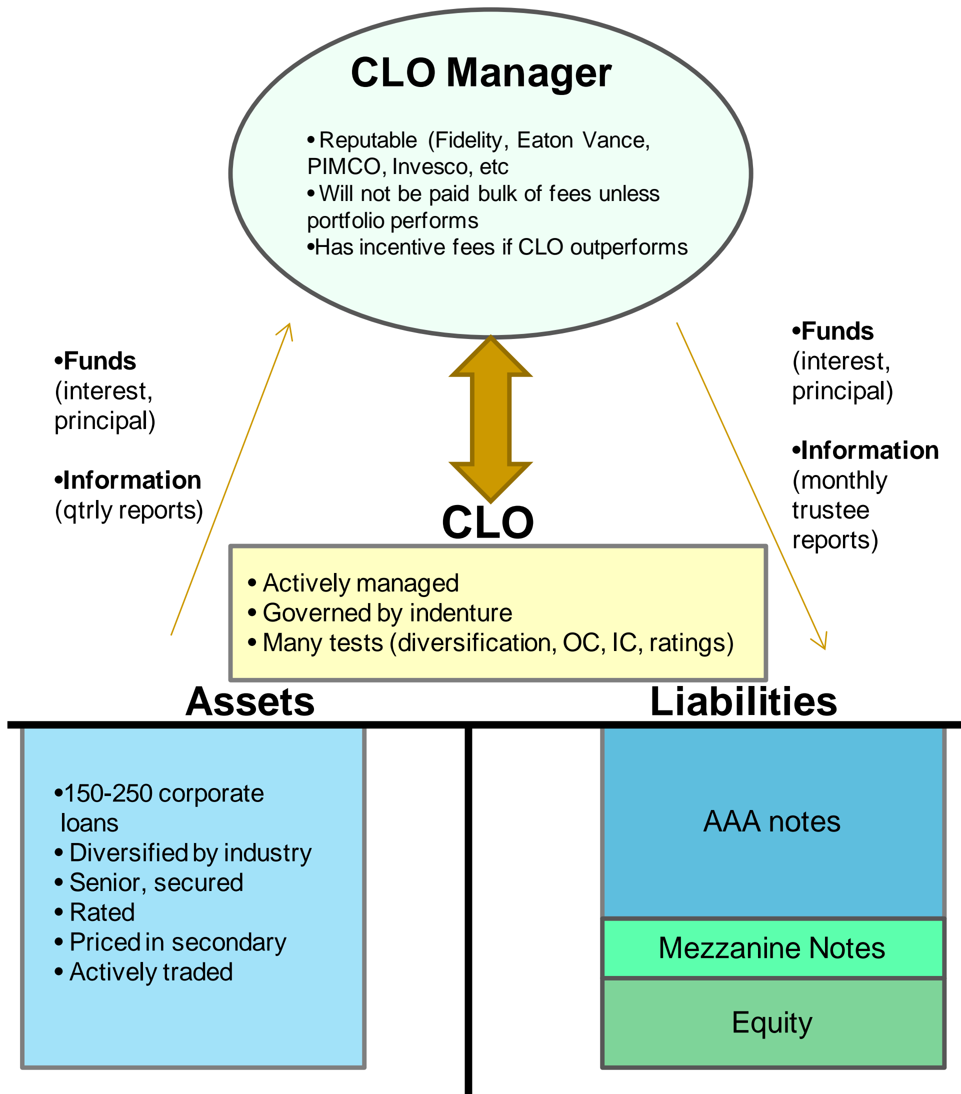
[24]Committee of European Banking Advisors, Feedback to the public consultation on Guidelines to Article 122a of the Capital Requirements Directive (Dec. 31, 2011), available at http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Feedback-document.pdf.

APPENDIX: Example of a CLO structure



United States House of Representatives
Committee on Financial Services

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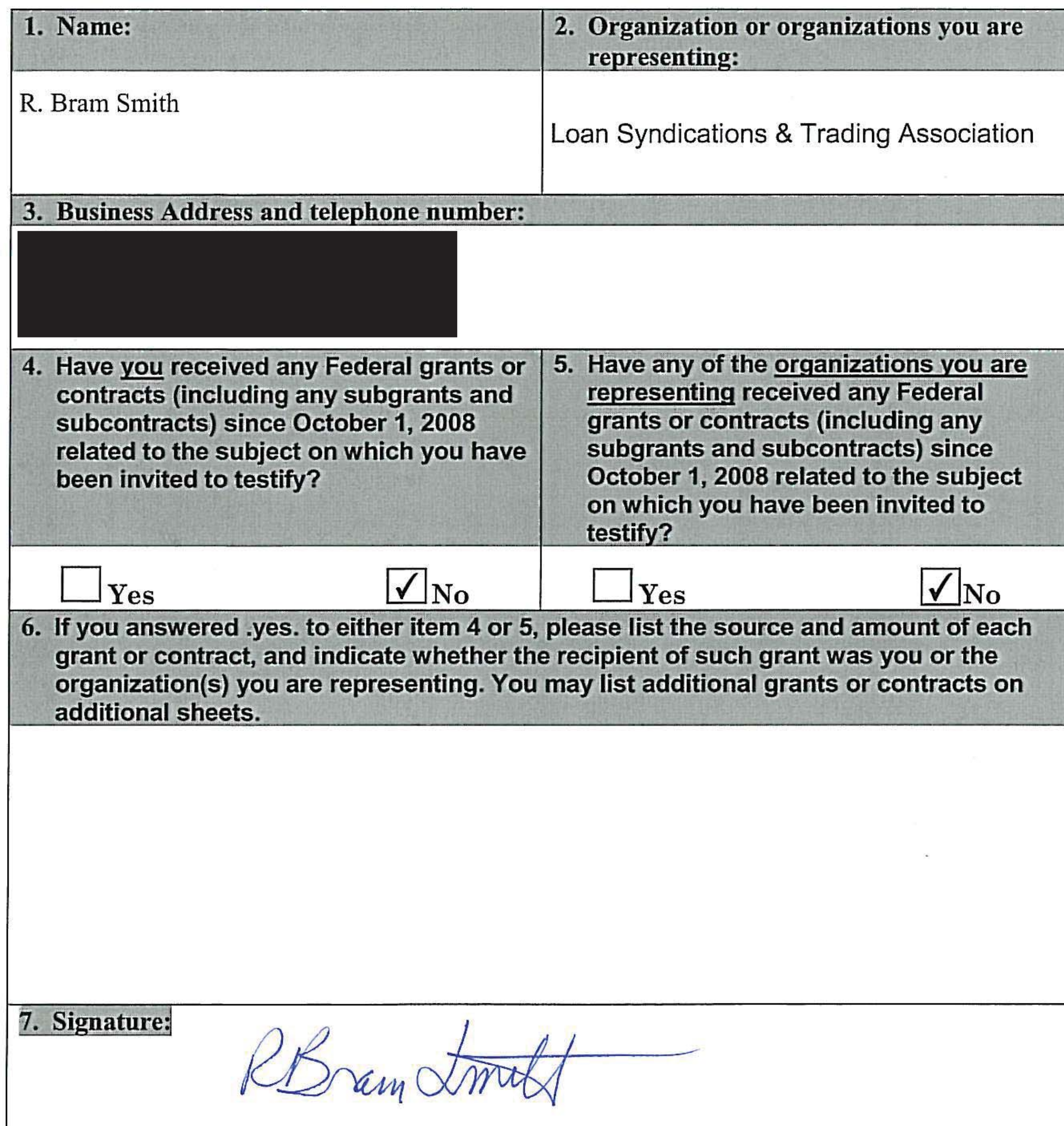

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