Testimony of Neil J. Weidner

On Behalf of the Structured Finance Industry Group (SFIG)

Before the United States House of Representatives

Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing on

The Dodd-Frank Act's Impact on Asset-Backed Securities

February 26, 2014

Testimony of Neil J. Weidner

On Behalf of the Structured Finance Industry Group (SFIG)

Before the United States House of Representatives Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing on

The Dodd-Frank Act's Impact on Asset-Backed Securities

February 26, 2014

Introduction

Chairman Garrett, Ranking Member Maloney and members of the Subcommittee on Capital Markets and Government Sponsored Enterprises: I want to thank you for holding this afternoon's hearing entitled "The Dodd-Frank Act's Impact on Asset-Backed Securities."

My name is Neil J. Weidner and I am here to testify on behalf of the Structured Finance Industry Group (SFIG).

Founded in March 2013, SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. With approximately 240 institutional members, SFIG's membership represents all sectors of the securitization market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers and trustees.

SFIG membership believes that securitization is an essential source of funding for the real economy. It connects investors with desired investments and provides consumers and businesses with access to funding and capital. Securitization provides economic benefits that can increase the availability, and lower the cost, of credit to households and businesses.

Like any powerful tool, however, securitization must be used carefully, and thoughtful regulation is an important part of that. Yet if regulation is taken too far, it could render large portions of the securitization market either operationally or economically non-viable, leading to a reduction of available credit and/or increases in borrowing costs.

Ultimately, the level of regulation will determine the affordability of credit for Main Street, including commercial loans for manufacturers and other businesses, student loans for college and graduate students, and credit cards, mortgages and auto loans for consumers.

SFIG wants to ensure that all types of securitization transactions, irrespective of asset class, are both well-regulated and liquid. We continue to work with Congress and the federal agencies to address our concerns as they relate to Dodd-Frank rulemakings, including (but not limited to) risk retention, Regulation AB and the Volcker Rule.

While SFIG respectfully acknowledges that the goal of this hearing is to discuss Dodd-Frank's impact on asset-backed securities, we also highlight that the impact from regulation currently felt by the securitization market is by no means limited to Dodd-Frank. Other current rulemaking initiatives—such as shadow banking reform and proposals for implementing Basel III (including liquidity coverage and net stable funding ratios), also contribute to the high degree of uncertainty that exists in the securitization market today.

As we assess these regulatory initiatives, each of which has merit in its own right, we are concerned about the combined, long-term impact they could have on the ability of Main Street America—a primary beneficiary of securitization—to use the markets for affordable credit.

Our concern about this combined impact is also borne of the recognition that any single regulatory initiative, in isolation, can potentially have an outsized negative impact on the securitization market. One of the clearest examples of this is the effect of the Volcker Rule on collateralized loan obligations (or "CLOs") and, relatedly, the commercial loan market that relies on CLOs to provide affordable financing to U.S. borrowers. Another such example is the impact felt by the CLO marketplace from the proposed credit risk retention rules. My testimony today will focus on both examples and proposed solutions to counteract these negative effects.

If we do not foster a healthy and stable CLO market for all participants, then companies that create jobs, make capital investments to grow their businesses and provide goods and services will suffer. Companies such as:

- Berry Plastics of Evansville, Indiana, which manufactures packaging and bottles for food, soap, medicine and other consumer goods; or
- Pinnacle Food Group, LLC of Parsippany, New Jersey, which produces food products that reach more than 85 percent of U.S. households; or
- HCR ManorCare of Toledo, Ohio, which employs over 57,000 people in 32 states and provides post-hospital and long-term care; or
- SeaWorld Parks and Entertainment of Orlando, Florida, which operates 11 theme parks that hosted more than 24 million guests in 2012.

Importantly, CLO issuance in January, 2014, was down approximately $7.0 billion compared to January, 2013,[1] and some analysts have already reduced their full-year estimates for CLO issuance in 2014 by $10 billion or more.[2]

However, the CLO market has seen a slight upturn in February, and many in the market believe this positive result is due to the bi-partisan work of the Committee and the commitment by the federal agencies to resolve the unintended consequences of the Volcker Rule

Yet, SFIG is concerned that without an expedient resolution for CLOs, the market will quickly contract.

It is just as important to note that the long-term viability of the CLO market will not be solely determined by the implementation of the Volcker Rule. The pending credit-risk retention rulemaking is also of critical importance. If implemented as re-proposed, market forecasters

---

[1] http://research1.ml.com/C?q=wezDxGw7YSk.
[2] Id.

predict that CLO issuance and the amount of credit provided to businesses could be reduced by 75 percent or more.

We appreciate the bi-partisan work of the Committee and the federal agencies to work toward both a short-term solution for the Volcker Rule and a long-term solution for risk retention., Without significant changes to these regulatory initiatives, we are deeply concerned about the sustainability of the CLO industry.

Therefore, it is imperative that the momentum that this Committee has provided - on both sides of the aisle – is maintained. Thank you for your work on these important issues.

Overview of CLOs

What are CLOs?

CLOs are investment funds that invest in commercial loans—that is, senior secured loans (including middle market loans) made to U.S. companies. Companies may use these loans to finance expansion projects, such as building new utility plants and energy pipelines, to support working capital and general operations, such as paying employee salaries and supplier invoices, and for refinancing existing debt. Commercial loans are therefore a critical source of credit for U.S. businesses - credit that is necessary for job creation and economic growth. The credit provided by CLOs to the commercial loan market generally serves to stabilize and lower interest rates for businesses that might not otherwise have access to capital markets financing. In fact, CLOs represent the largest non-bank segment of the commercial loan market, having invested in approximately $280 billion of loans made to U.S. companies.

The companies that access the funding provided by CLOs can be found in every state of the Union and operate across all kinds of industries, including: restaurants, utilities, healthcare providers, rental car companies, communications and broadcasting companies, manufacturers, and supermarkets and food services companies. It is no exaggeration to say that the access to credit provided by CLOs affects nearly everyone in your Congressional districts who is working hard to create jobs and spur the U.S. economy.

As a technical matter, CLOs are structured as securitizations. They issue securities that are dependent upon repayment from portfolios of financial assets.[3] It is important to note that the CLO structure and associated markets have a proven track record, having demonstrated their stability and resiliency before, during and after the recent financial crisis. This strength is largely driven by five differentiating features:

1. Diversification. A CLO portfolio is primarily comprised of senior secured commercial loans, usually a minimum of 90 percent, and those loans are well-diversified across different industry sectors. Consequently, CLOs are not reliant on the performance of any particular company or industry.

2. Active Management. CLOs are actively managed by SEC-registered investment advisers who perform credit analysis on the commercial loans in which the CLO invests and, within certain limitations, buy and sell assets in response to changing market conditions. CLO managers are charged with managing the portfolios of CLOs with portfolio risk guidelines while minimizing realized losses. Their expertise significantly contributed to CLOs' strong credit performance during the financial crisis.

3. Alignment of Interests. The interests of CLO managers are strongly aligned with the interests of CLO investors. In other words, CLO managers have "skin in the game." They do not profit from the sale of assets to the CLOs they manage at the time of sale; they receive the bulk of their compensation only when and if the CLO performs well over time; and if they breach their legal duties as set out in the CLO transaction documents, they can be removed as manager by the investors.

---

[3] CLOs usually issue multiple classes of secured debt and a single class of unsecured equity, with the most senior class of secured debt (which bears the least risk of loss) at the top of the CLO capital structure and the most subordinated equity class (which bears the most risk of loss) at the bottom of the CLO capital structure. By issuing their securities in multiple classes or "tranches," CLOs are able to attract investors with varying risk/reward appetites.

4. Self-Correcting Mechanisms. CLOs are designed to "self-correct" for any material deterioration in the credit quality of the portfolio of commercial loans. These mechanisms include tests that, if not satisfied, require that investors in the CLO's senior debt securities be repaid before the CLO manager receives most of its fees or any investors in the CLO's junior equity securities receive further payment, until compliance with the tests is restored.

5. Transparency. CLOs purchase commercial loans from third-party sellers in an active, transparent secondary market. The loans are issued by companies that are audited by reputable accounting firms; report financial performance information to loan investors on a regular basis; frequently are required to file regular financial reports with the SEC; and typically have assigned, monitored ratings from one or more of the principal credit rating agencies.

State of the CLO Industry

Historical Performance

CLOs performed very well before, during and since the financial crisis. As a result of the strong historical performance of the underlying leveraged loans, 5 year cumulative impairments on investment grade CLO debt securities since 1993 have been less than 0.8%.[4] Consequently, no CLO debt security initially rated higher than "A" by one of the primary credit rating agencies has suffered a principal loss. For debt securities initially rated "BBB" or higher the 5-year cumulative principal loss rate for securities issued between 1993 and 2012 is just 0.2%.[5] These loss rates compare favorably with certain fixed income securities such as corporate bonds, which have seen principal loss rates of approximately 0.7% during the period from 1992 to 2012.[6]

CLOs have also provided strong returns to investors compared to other fixed income

---

[4] Moody's Investors Service, *Default & Loss Rates of Structured Finance Securities: 1993-2012*, November 27, 2013.

[5] Moody's Investors Service, *Default & Loss Rates of Structured Finance Securities: 1993-2012*, November 27, 2013.

[6] Id.

securities, as CLO debt securities with an average rating of "A" returned an average of 3.9% in 2013, compared to an average loss of 2.2% for all other fixed income securities during the same time period.[7]

Current State of the CLO Marketplace

Issuance Compared to Historical

While CLO issuance has rebounded considerably from financial crisis levels, the uncertainty surrounding interpretation of the Volcker Rule appears to have contributed to putting a damper on recent CLO issuance activity. CLO issuance in January 2014 was down approximately $7.0 billion compared to January 2013.[8] Based on this, some analysts have already reduced their full-year estimates for CLO issuance in 2014 by $10 billion or more.[9] It has been further estimated that if the risk retention rules proposed under the Dodd-Frank Act were enacted in their current form, CLO issuance and the amount of credit they provide to businesses could be reduced by 75 percent or more over the long term.

We note that issuance this month increased after seeing a 17-month low in January. This recent uptick has been attributed to the market's reaction to this Committee's bi-partisan support for a regulatory fix to the Volcker Rule.

Therefore, we appreciate the bi-partisan efforts of this Committee to address these issues, and we appreciate the continued momentum that this hearing has provided. Without the efforts of both Congress and the agencies, the market may quickly decline, and forecasters' downward predictions for both the near- and long-term CLO market will prove accurate.

How Declines in CLO Issuance Affect Main Street

As noted earlier, CLOs are currently invested in approximately $280 billion of senior,

---

[7] http://research1.ml.com/C?q=BVkyYbIBgLg.
[8] http://research1.ml.com/C?q=wezDxGw7YSk.
[9] Id.

secured commercial and industrial loans made to U.S. companies. This $280 billion represents approximately 45 percent of the credit available to non-investment grade U.S. companies that borrow in the commercial loan market. These borrowers include companies in a wide variety of geographic areas and important sectors of the U.S. economy. They are growing, job-creating companies that affect the everyday lives of U.S. workers and consumers. On the whole, the businesses that use CLO financing are currently estimated to employ approximately 7.5 million people.[10]

As CLO issuance declines, the ability of these companies to obtain important financing at reasonable rates diminishes. And if CLO issuance declines by the 75 percent or more that is estimated, as a result of the proposed risk retention rule being implemented in its current form, then it is expected that a "refinancing wall" will occur between 2017 and 2020. Specifically, this means that there would be more loans that need to be refinanced than the commercial loan market, as currently composed, would be able to support.[11]

CLOs also allow global investors, who lack the access to directly lend to U.S. companies, a method of providing this credit with the assistance of a U.S.-based asset manager and at the risk level they are most comfortable. Without CLOs available as a means of funding commercial and industrial loans, there is no certainty that the other current participants in the commercial lending market, such as banks and mutual funds, would be able to provide all of the additional funding necessary to support the refinancing wall that would hit U.S. borrowers. At the very least, even if alternate funding sources become available, then they will be more expensive than CLOs and will increase the costs of borrowing for the companies, making it harder for companies to meet payroll or grow without sacrificing jobs.

---

[10] This figure is derived from SFIG's analysis of FY2012 data consisting of public company information, private company information and third-party research. At the request of the committee, SFIG will be pleased to share its methodology.

[11] See *The CLO Salmagundi: Risk Retention Consequences*, Wells Fargo Research (Dave Preston and Jason McNeilis), September 20, 2013. See also *CLO Weekly: Loan Performance Solid*, Bank of America Merrill Lynch Securitized Products Research (Chris Flanagan, Ryan Asato, Justin Borst and Collin Chan), October 18, 2013, p. 7.

Reasons for the Current State of the CLO Marketplace

Volcker Rule

Even though CLOs are "long-only" funds that invest primarily in loans to U.S. companies through a robust, transparent structure with a buy-and-hold strategy that does not contribute to mark-to-market volatility, most CLOs are effectively treated as hedge funds under the Final Rule[12]. The Final Rule defines "covered fund" in a way that includes securitization issuers, such as CLOs, that rely on the exemption provided by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. Although the Final Rule excludes from the definition of covered fund "loan securitizations," or securitization issuers that hold only loans and certain servicing assets, risk-mitigating assets and cash equivalents[13], most CLOs in existence today do not qualify for the loan securitization exclusion, even though typically 90 percent or more of their portfolios are devoted to commercial loans.[14]

One of the primary consequences of a CLO being treated as a covered fund under the Volcker Rule is that banks are not permitted to acquire or hold an "ownership interest" in that CLO, absent certain limited exceptions. The problem for the CLO market, and for the banks that invest in it, is that the Final Rule defines "ownership interest" in a way that includes not only the junior-most "equity" class of securities issued by a CLO (in other words, the class of securities that economically "owns" the CLO), but also the highly rated, senior secured classes of debt securities issued by a CLO and commonly purchased by banks of all sizes. As a result, over the next 17 months U.S. banks may have to divest up to $70–80 billion of senior CLO debt securities. In addition to disrupting the CLO market (and consequently, the market for commercial loans on which so many U.S. businesses depend for financing) and creating

---

[12] 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").

[13] Section __.10(c)(8)(i) of the Final Rule.

[14] CLOs that have already issued their securities and commenced operations are commonly referred to as "legacy CLOs." Legacy CLOs typically permit a small portion (usually in the 7.5% to 10% range) of their portfolios to consist of bonds, for the purposes of diversity and realizing extra income. Bonds and other securities, however, generally are not permitted under the loan securitization exclusion.

downward pressure on the market values of CLO debt securities generally, this forced selling could very well cause banks to unnecessarily incur substantial losses on otherwise well-performing, high quality assets.[15]

The Volcker Rule's Effect on Bank CLO Investments: A Case Study

The well-underwritten commercial loans held by CLOs, the various structural features of CLOs that provide significant protections to investors, the strong historical performance of CLOs (before, during and since the recent financial crisis) and the excellent risk-adjusted returns of CLOs, among other factors, have attracted a variety of institutional investors to CLOs.

In particular, a wide range of U.S. banks, including large, mid-size and community banks, have invested in CLOs—specifically, in the interest-bearing, secured note classes issued by CLOs that are rated "AAA" or "AA" by one or more rating agencies.[16] As mentioned, the amount of senior CLO debt securities currently held by U.S. banks is between $70 and $80 billion.

For example, First Federal Savings Bank, an over 90-year-old community bank in Elizabethtown, Kentucky, with approximately $850 million in assets, is one such U.S. bank that invests in CLOs. In a February 4th, 2014 letter to the federal agencies responsible for implementing the Volcker Rule[17], the Chief Financial Officer of First Federal Savings Bank describes CLO debt securities as "well structured, variable rate, diversified credit assets that

---

[15] In addition to the $70–80 billion held by U.S. banks, it is estimated that approximately $60 billion of senior CLO debt securities are currently held by non-U.S. banks. Non-U.S. banks that have branches or agency offices in the U.S. are subject to the Volcker Rule and are prohibited, in the same manner as U.S. banks, from holding an ownership interest in a covered fund that is open to U.S. investors. As a result, such non-U.S. banks face the same issue as U.S. banks regarding whether, in the absence of clarification or guidance from the agencies or action by Congress, they will need to sell their CLO debt securities or attempt a restructuring of the CLOs that issued those securities. The absence of such non-U.S. banks from participation in the CLO market would further diminish the funding capacity that CLOs provide to U.S. businesses.

[16] Such notes typically comprise the senior-most (commonly referred to as the "controlling class") or next senior-most classes of CLO debt securities and represent a majority of a CLO's capital structure.

[17] The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission.

provide banks of all sizes with an opportunity for an attractive risk-adjusted return." The CFO noted that First Federal Savings Bank has invested $36.5 million in senior CLO debt securities, an investment that represents 14 percent of a "carefully managed investment portfolio," which First Federal Savings Bank views as "a conservative and much less risky component of [its] balance sheet."[18]

However, if there is no clarification to the Volcker Rule, then First Federal Savings Bank would be forced to divest its CLO assets by July 21, 2015. At the same time, all other U.S. banks subject to the Volcker Rule would have to similarly divest their CLO debt securities, thus creating a buyer's market and depressing asset prices. As the bank stated in its letter to the agencies, "A 20% decline in market value of these CLOs as a result of forced liquidation would equate to a $7.4 million charge to earnings. A loss of this magnitude would erode tangible common equity by more than 30%." The bank further stated, "We should not be forced to divest and take losses on safe investments that were on our balance sheet prior to the finalization of the Final Rule."

We highlight First Federal Savings Bank as a text book example of a community bank's equity being needlessly eroded though impairing its ability to lend to local businesses. If taken on National scale, clearly the consequences for the U.S. economy would be significant.

The Rulemaking Issue

The Final Rule effectively transforms the senior CLO debt securities held by banks into the equivalent of equity securities. It does this by re-characterizing as "equity-like" certain common features of CLO debt securities that are designed solely to safeguard the rights of those security holders as secured creditors of the CLOs in which they have invested. The Final Rule essentially says to banks, "You may have thought you were ***lending*** to CLOs, but you really ***own*** those CLOs." This was news to both banks and the actual owners of the CLOs.

---

[18] First Federal Savings Bank Letter (Feb. 4, 2014), available at https://fdic.gov/regulations/laws/federal/2014/2014-collateralized-debt-obligations-ae11-c_03.pdf.

The definition of "ownership interest" in the Final Rule contains specific language that is intended to capture securities and other interests that, while in the form of debt, exhibit substantially the same characteristics as equity. Most of this language describes features relating to economic control of the issuing entity or the right to receive a share of the entity's profits and losses. However, the definition also treats as "ownership interests" those interests that, on a current, future or contingent basis, have "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)."[19]

As discussed in the Overview, there are a number of structural features that contribute to the robustness of CLOs. Among these are important creditors' rights given to holders of CLO debt securities that reflect their effective status as senior ***lenders*** to, rather than ***owners*** of, a CLO. Although most of these creditors' rights are vested in the senior-most outstanding or "controlling class" of debt securities, because CLO debt securities are paid in order of seniority, any class of CLO debt securities can become the controlling class after all classes senior to it have been paid in full.

One such important creditors' right is the ability to remove a CLO manager "for cause" and participate in the selection of its replacement. In typical CLO transaction documents, the events that could trigger the right to remove a CLO manager "for cause" include, among others, a willful breach by the CLO manager of its obligations under the transaction documents, the dissolution or insolvency of the CLO manager or fraud or criminal activity by the CLO manager in connection with its investment management business.[20] By their very nature, "for cause" events ultimately threaten the ability of a CLO to make promised payments of principal and interest to the holders of its debt securities.[21] Another important creditors' right is to vote on the

---

[19] See Section __.10(d)(6)(i)(A) of the Final Rule.

[20] In the event of a CLO manager's removal, the controlling class typically shares with the equity class of securities the right to propose a replacement. If specified percentages of the two classes are unable to agree on a replacement, a court can be petitioned to appoint a successor.

[21] In CLO transaction documents, the equity class of securities issued by a CLO receives no such promise of repayment in respect of amounts invested by its holders. Rather, CLO equity is entitled only to receive excess interest and principal collections that are not needed to pay amounts due to holders of CLO debt securities or certain

replacement for a CLO manager that resigns. The resignation of a CLO manager is effectively a change-of-control event for the CLO, a circumstance under which traditional bank lenders often receive consent rights or the right to be repaid.

In almost all CLOs, a specified percentage of the controlling class has the right to remove the CLO manager "for cause" and the right to nominate or approve the replacement of a CLO manager who has been so removed or has resigned. Consequently, CLO debt securities are, under a literal reading of the Final Rule, interests that have "the right to participate in the selection or removal" of an investment manager of a covered fund—in other words, "ownership interests" in which banks may not invest. Incongruously, because these rights are structured to help ***prevent*** an event of default under the CLO transaction documents, the carve-out in the Final Rule's language for "rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event" does not appear to apply.

Restructuring as an Alternative to Bank Divestiture

As an alternative to divesting their CLO debt securities, banks theoretically could attempt to orchestrate the restructuring of the legacy CLOs that issued those securities so that the CLOs qualify for the loan securitization exclusion from the definition of "covered fund". For at least two reasons, however, restructurings of legacy CLOs on a widespread basis is unrealistic. *First*, CLO managers would need to sell existing holdings of bonds and other securities that are not permitted under the loan securitization exclusion. They may not be willing to do so, however, if the CLO would incur a loss. Moreover, CLO managers have fiduciary responsibilities to ***all*** of the investors in the CLOs that they manage. Sales of non-loan assets, while beneficial for banks as a means of qualifying for the loan securitization exclusion, might be economically disadvantageous to other, non-bank CLO investors. *Second*, even after such sales, CLO managers would need to promise not to make any new purchases of impermissible securities. Banks that have invested in CLOs likely would not be comfortable with any such promise unless it was formally memorialized in an amendment to the CLO's transaction documents. However,

---

service providers to the CLO, such as the CLO manager and trustee.

it can be very difficult to amend CLOs transaction documents because amendments frequently require the consent of a majority of each class of securities issued by the CLO and the cooperation of security holders whose interests are not always aligned.

One Immediate Effect of the Rulemaking Issue

Although banks have until at least July 21, 2015 to bring any existing activities and investments into compliance with the Volcker Rule, they may face a problem ***today*** under current accounting rules. If the CLO debt securities held by banks are impermissible "ownership interests" in covered funds, then those banks no longer will be able to treat their senior CLO debt securities as long-term investments. Consequently, if the current market values of those securities are lower than the prices paid by banks to acquire them, banks may need to recognize immediate charges against earnings. The irony is that banks face the prospect of reduced capital levels as the result of holding secure and performing investments, solely because the Final Rule re-characterizes as "equity-like" certain features of those investments that are designed to protect banks in the first place.

Risk Retention

Pursuant to Section 941 of the Dodd-Frank Act, six governmental agencies were tasked with developing rules to require securitizers to retain a portion of the risk of the assets they securitize. The agencies have released proposed rules which, if enacted "as-is," would permit a CLO to satisfy the agencies' risk retention requirements either by retaining a specific type of interest in the CLO by the CLO investment manager or by structuring CLOs to consist solely of "CLO-eligible loan tranches" and related servicing assets. In either case, these options for risk retention are unworkable for most of the current participants in the CLO market and, if they are the only options available, are expected to significantly decrease the number of participants in the CLO market, the amount of CLO issuance and, consequently, the availability of financing to U.S. companies. I will address the problems with each of these options in turn.

CLO Manager Retention

The current risk retention proposal will require CLO investment managers to retain an

interest equal to 5 percent of the fair value of all CLO securities issued in each new CLO it manages unless the transaction is structured to consist solely of "CLO-eligible loan tranches" and related servicing assets. In addition, to the extent that the retained interest represents a horizontal interest in the CLO, the interest is required to be structured in way to prevent the retention holder from receiving cash at a faster rate than that at which principal is paid to investors in all other CLO securities, as based on projected cash flows.

CLO managers are similar to (and in fact, often also are) mutual fund managers and generally do not profit from selling assets to an investment vehicle, but instead rely on fees received for active management in connection with the performance of the vehicle. As a result, many of the managers in the CLO market are not capitalized in a manner that would permit them to hold interests in CLOs that they manage at the level that the agencies are proposing. The agencies expressed understanding in their re-proposal that requiring collateral managers to be the sole sponsors of CLOs and to satisfy risk retention would reduce the number of CLO issuances and competition among CLO managers.

Also, the requirement to restrict payments received by the holder of a retention interest is unnecessary as CLO equity tranches are already fully subordinated to payments to CLO debt securities. Since CLOs distribute interest and principal received on the underlying loans separately, principal proceeds on the underlying loans are never paid to a CLO equity tranche before all of the CLO debt securities have been paid in full. Furthermore, CLOs typically provide that interest payments will be diverted to pay principal of CLO debt securities when certain overcollateralization or interest coverage tests are not met. As a result of these features, losses fall on CLO equity tranches before affecting any CLO debt security.

Perhaps even more importantly, restricting cash flows paid to the holders of CLO equity tranches will make them less attractive to investors. As almost of all of the credit risk of a CLO is found in the bottom 20 percent of the capital structure and CLO equity tranches represent roughly half of that bottom 20 percent, investors expect to receive a higher return in exchange for taking on the risk of potential losses. All of that higher return comes in the form of excess interest generated by the underlying loans. If interest cash flows are withheld, investors in CLO equity tranches may not be appropriately compensated for bearing the credit risk of the

transaction and may be unwilling to invest in CLOs going forward. A reduction in the number of CLO equity investors in the market would further reduce CLO issuance and shrink the availability of credit available to U.S. companies.

CLO-eligible Loan Tranches

Alternatively, the agencies proposed that a CLO manager would not have to retain an interest in a CLO it manages if the CLO consisted solely of "CLO-eligible loan tranches" acquired in the open market and related servicing assets. "CLO-eligible loan tranches" were defined by the agencies as loans where the lead arranger for the loan agrees to hold 5 percent of the loan purchased by the CLO for the life of the loan without the ability to hedge its exposure. Unfortunately, 10 banks are the lead arrangers for nearly 85 percent of all syndications of broadly syndicated loans, with 3 banks acting as lead arranger for nearly 49 percent of all syndications.[22] With such a small universe of lead arrangers, requiring the lead arrangers to retain 5 percent of every tranche of a loan syndication that a CLO wanted to have qualified as a "CLO-eligible loan tranche" would potentially require an enormous increase in those banks' risk-based capital. In addition, retaining these loan tranches would require the banks holding them to pay a higher premium for depository insurance. These additional costs, if not prohibitive to the banks, would be passed along to borrowers, further increasing the costs of borrowing and negatively affecting the ability of U.S. companies to finance growth. Additionally, the requirement that the banks hold a portion of these loan tranches until maturity without being permitted to hedge is a credit strategy opposed by both bank regulators and common prudential risk management practices. Given all of these concerns, banks have indicated that they are unlikely to originate a substantial amount of loans that would satisfy the proposed requirements of a "CLO-eligible loan tranche".

SFIG's Recommendations

SFIG believes there are simple, straightforward solutions for restoring regulatory clarity

[22] Dealogic (October 25, 2013)

to the participants in the CLO marketplace and keeping affordable credit flowing to U.S. businesses of all kinds. SFIG further believes that these solutions can be achieved expediently and in ways that are consistent with the intent of Congress when it passed the Dodd-Frank Act.

Solutions for the Volcker Rule

SFIG has requested that the agencies confirm, in a FAQ or other appropriate interpretive guidance, that the term "ownership interest" as defined in Section__.10(d)(6) of the Final Rule does not include the debt securities of CLO issuers that are covered funds, where those CLO debt securities give holders only a contingent right to remove a CLO manager "for cause," or to nominate or vote on a nominated replacement for a CLO manager following its removal for cause or resignation, but do not contain any of the other indicia of ownership listed in the Final Rule. SFIG believes that such confirmation would clarify for banks that their holdings of senior CLO debt securities are not impermissible holdings of "ownership interests" of covered funds under the Volcker Rule, thus protecting both CLO market participants and the U.S. companies that rely on the commercial loan market for financing from the adverse consequences of divestiture described previously.

In the event that the agencies decline to provide this guidance, SFIG has asked that, alternatively, the agencies provide guidance that debt securities of CLOs in existence as of a certain date of determination (to be identified by the agencies), which afford their holders the creditor's right to remove a CLO manager "for cause" or to participate in the selection of its replacement upon removal or resignation, but which do not have any of the other indicia of ownership listed in the Final Rule, not be deemed to be "ownership interests" under the Final Rule. In light of the significant difficulties involved in restructuring legacy CLOs, SFIG believes that the grandfathering of existing CLO debt securities is a practical solution for mitigating the Volcker Rule's disruptive effect on the commercial loan market.

SFIG further notes that some banks that hold senior CLO debt securities have considered the effect of unilaterally waiving their creditor's right to remove a CLO manager "for cause" or to participate in the selection of its replacement upon removal or resignation. There is, however, no existing guidance from regulators as to whether such action by banks would be effective to

cause their investments in CLO debt securities to not be deemed to be "ownership interests" under the Final Rule. SFIG believes that banks would welcome, in the absence of other regulatory clarification or guidance and as an alternative to widespread divestiture of bank holdings of CLO debt securities, interpretive guidance from the agencies that any such unilateral waiver would be so effective.

Solutions for Risk Retention

As demonstrated earlier, the currently proposed options for asset-backed securities risk retention are unworkable for CLOs and are expected to greatly reduce CLO issuance and its beneficial effect on the commercial loan market. In its comment letter to the agencies, SFIG has proposed certain additional solutions to make risk retention more workable for the CLO market while also satisfying the policy concerns that led to the adoption of the Dodd-Frank Act.

Moreover, in a second comment letter developed with the LSTA and SIFMA, SFIG has explored alternative solutions, suggesting that the agencies consider adopting the concept of a "Qualified CLO" as a means of satisfying the purposes of Section 941 of the Dodd-Frank Act.[23] Below are detailed descriptions of these suggested solutions for CLO risk retention:

Third Party Retention

SFIG's members believe that the agencies should adopt a third-party retention holder option as a way for broadly syndicated CLOs to meet their risk retention obligation. We note that the agencies have indicated that, in some cases, an entity that is a third party to a transaction may be an appropriate entity to satisfy a securitization's risk retention, such as the proposed lead arranger for a CLO-eligible loan tranche. In CLOs, investors actively negotiate the quality and parameters of the securitization's asset pool through negotiation of the portfolio constraints of the managed CLO asset pools. As a result, we believe that CLOs would be an appropriate asset class for a third-party retention holder option. We further propose that a third-party retention

[23] See LSTA, SFIG and SIFMA Letter Comment, Jan. 10, 2014.

option for CLOs contain the following characteristics:

1. Third Party Retention Holders and Eligible Retention Interests. SFIG has proposed that the CLO third-party purchaser retention option permit up to two third-party purchasers to jointly satisfy some or all of a CLO's risk retention requirements. We think that it is appropriate to permit multiple parties to be able to jointly satisfy such CLO's risk retention requirements due to the nature of the market for CLO securities and the active involvement of investors in the structuring of such CLOs.

2. Asset Pool Composition and Third Party Review. In order for an open market CLO to be eligible to utilize the third-party purchaser retention option, such CLO's asset pool would be required to be comprised primarily of commercial loans and servicing assets. The agencies have asserted that risk retention should be held by collateral managers when no other party is the sponsor of the CLO as the agencies consider the collateral managers to be the parties that determine the credit risk profile of the securitized assets in a CLO. Although CLO managers do select the specific assets to be included in a CLO asset pool, they do so in accordance with set parameters laid out in the transaction documents for each CLO. Due to the revolving nature of a CLO asset pool and the number assets in the typical CLO asset pool, it is not practical, nor commercially desirable by other CLO investors, for a third-party retention holder to approve each asset selected by the CLO manager before it is acquired by a CLO issuer. However, we believe that it is possible for a third-party retention holder to materially influence the selection of the assets in an open market CLO in a manner that will satisfy the agencies' goal of improving the quality of the assets in securitization asset pools without reviewing and approving each asset. As a proxy for reviewing each asset, each third-party retention holder would be required to conduct a review of, and approve certain key terms (the "Transaction Portfolio Terms") governing the quality of the assets the CLO will be permitted to purchase and the composition of the CLO's portfolio. Once the Transaction Portfolio Terms have been approved, the CLO manager will be permitted to trade portfolio assets without additional

approvals from the third-party retention providers so long as trades are made in accordance with the Transaction Portfolio Terms. After the third-party retention holders have approved the initial Transaction Portfolio Terms, no material change to any of the Transaction Portfolio Terms may be effected without the prior written consent of each third-party retention provider. Additionally, to satisfy our proposed third-party retention holder option, the CLO issuer will be required to have acquired or entered into binding commitments to acquire by the CLO's closing date at least 50 percent of the initial target par amount CLO portfolio assets. This will help ensure that the third-party retention holders are able to gauge the CLO manager's ability to comply with the Transaction Portfolio Terms prior to the closing of the CLO.

3. <u>CLO Managers</u>. SFIG proposes that any broadly syndicated CLO relying on the third-party retention holder option be required to be managed by a CLO manager that is a registered investment adviser under the Investment Advisers Act of 1940.

4. <u>Retention Period</u>. SFIG believes that a shorter holding period than proposed by the agencies would be appropriate for third-party retention holders, after which the eligible horizontal residual interest (or "EHRI") or eligible vertical interest (or "EVI") would be freely transferable. Additionally, we also propose that during such holding period third-party retention holders be subject to the restrictions on hedging and transfer applicable to a sponsor holding an EHRI or EVI in order to ensure that such third-party retention holder is fully exposed to the credit risk of such broadly syndicated CLO.

Expand the Definition for Qualified Commercial Loans

SFIG's members believe that a viable definition of a "qualified commercial loan" would contribute significantly to the workability of subjecting CLOs to required risk retention. SFIG members find the re-proposal's definition unduly restrictive and believe that it effectively excludes other well-underwritten commercial loans that should be included. Unfortunately, due to the truncated period for comments on the re-proposal, SFIG's members have not had sufficient opportunity to formulate and propose an alternative, but are interested in a discussion

with the agencies regarding such an alternative.

SFIG's members also believe that CLOs of qualified commercial loans should not be static pools, but afforded the same active management as other CLOs.

"Qualified CLOs"

As was laid out in our joint letter with the LSTA and SIFMA to the agencies on January 10, 2014, for a CLO to be a "Qualified CLO," it would be required to be structured to meet certain minimum requirements for asset quality, portfolio composition, structural features, alignment of interests of CLO managers and investors, regulatory oversight and transparency and disclosure.[24] Among other things, these include:

1. Asset Quality Protections. In order to ensure the quality of the collateral in a "Qualified CLO", each "Qualified CLO" would be required to, among other things, hold at least 90 percent of its assets in senior secured loans and cash equivalents, not own ABS interests or derivatives (other than for hedging purposes), not purchase defaulted assets, margin stock or equity convertible securities, acquire loans held or acquired by at least three other investors or lenders not affiliated with the CLO manager and own loans whose borrowers are subject to an annual audit from an independent accredited accounting firm.[25].

2. Portfolio Protections. In order to ensure that CLO investors are not unduly exposed to loan pools that are concentrated in riskier areas of the global economy or certain specific borrowers, each "Qualified CLO" would be required to limit its investments such that no more than 3.5 percent of its assets relate to a single borrower, no more than 15 percent of its assets relate to a single industry and no more than 20 percent of its assets may relate to non-U.S. borrowers (and no more

[24] Id. at 6.
[25] Id. at 6-7.

than 10% may relate to borrowers outside the U.S. and Canada).[26]

3. Structural Features. In order to ensure that the CLO debt securities are adequately protected by means of structural features, a "Qualified CLO" would be required to have an equity tranche equal to at least 8 percent of the CLO's assets, as well as overcollateralization and interest coverage tests that, if failed, will require interest and principal proceeds to be used to repay CLO debt securities.[27]

4. Alignment of Interests of CLO managers and Investors. A "Qualified CLO" would be required to be structured to acquire assets in the open market rather than from the balance sheet of the CLO manager or an affiliate, make a majority of the CLO manager's fees be subordinated to payments due on rated CLO debt securities, limit the ability of the CLO manager to sell assets on a discretionary basis, require the CLO manager and/or certain of its affiliates and/or employees to hold a 5% unhedged interest in the CLO's equity tranche and to limit distributions on the retention interest for the first two years of the CLO.[28]

5. Regulatory Oversight. A "Qualified CLO" must have a manager that is a registered investment adviser under the Investment Adviser Act of 1940.[29]

6. Transparency and Disclosure. Each "Qualified CLO" will be required to provide certain monthly reporting to all CLO security holders.[30]

We believe that our proposal for a "Qualified CLO" could be an alternative solution for the problems described earlier. Perhaps most notably, this proposed retention interest would appropriately align the interests of the CLO manager with those of investors and more correctly size the risk retention interest to more closely correspond with 5 percent of the credit risk of the

---

[26] Id. at 7.
[27] Id. at 7-8.
[28] Id. at 8.
[29] Id. at 9.
[30] Id. at 9.

CLO.

We also note that the proposed asset quality protections will help ensure the quality of CLO collateral and the safety of CLO debt securities as an investment for banks and help protect the soundness of our banking system.

Congressional Request

Given the importance of the CLO market in financing U.S. businesses and the need to ensure that CLO issuance does not meaningfully decline as a result of the agencies' rule making under Section 941 of Dodd-Frank, we respectfully request that the Financial Services Committee review our recommended solutions to the problems presented by the currently proposed rules.

Comments on Proposed Legislative Fix

SFIG appreciates the bi-partisan efforts this Subcommittee has shown to find solutions for the CLO marketplace it relates to the Volcker Rule. Chairman Garrett, today's hearing along with the two previously held hearings in the full Committee have helped elevate the prioritization of a solution for CLOs. Ranking Member Maloney, the letter that you and Ms. Waters wrote to the agencies—along with signatures by 15 other Democrats—has been instrumental in helping both the agencies and the industry work towards a solution.

As such, SFIG believes the discussion draft the Committee has offered is a natural extension of the bi-partisan work you all have continued to pursue. We believe it not only encapsulates the intent of lawmakers through the Dodd-Frank Act itself, but also the intent recently expressed by lawmakers of both parties on this Committee.

SFIG will continue to work with the agencies through the rulemaking process to find expedient solutions. And this discussion draft is yet another helpful tool for all of us to work together to create a well-regulated and liquid CLO marketplace.

As such, we have attached in Appendix A a list technical issues that will need to be addressed by the agencies in order for a CLO solution to Volcker to become operational. At the same time, we would not recommend that they become part of any legislative fix, as they are

technical in nature.

Conclusion

Securitization continues to be an essential source of funding for the economy, and SFIG believes in both a well-regulated and liquid securitization marketplace for all asset classes.

The financial crisis taught us that securitization must be carefully structured, and thoughtful regulation through Dodd-Frank Act implementation is an important part of that structuring process.

However, if regulation is taken too far, it will render large portions of the securitization market either operationally or economically unworkable.

Our regulatory concerns focus on the combined effects of current regulatory proposals, which encompass much more than Dodd-Frank, such as shadow banking reform and proposals for implementing Basel III (including liquidity coverage and net stable funding ratios).

At the same time, any single regulatory initiative, while having merits in its own right, can also have a severe and negative impact on the securitization market if not crafted appropriately. The most immediate example of such a negative impact is the effect felt throughout the CLO marketplace by the Volcker Rule and proposed risk retention rules. Without changes to the proposed regulatory framework, companies providing up to 7.5 million jobs could be negatively affected, as CLO issuance is expected to decline by 75 percent or more.

We thank the Chairman, Ranking Member, Congressman Barr and the Members of this Committee for the bi-partisan work with the agencies to resolve the unintended consequences of the Volcker Rule. The CLO market has seen a slight upturn in February. However, SFIG is concerned that without an expedient resolution for CLOs, the market will quickly contract.

If we do not find solutions that work for both the regulators and the marketplace, then companies who create jobs, make capital investments to grow their businesses and provide goods and services will suffer—businesses such as Berry Plastics, Pinnacle Foods, HCR ManorCare and SeaWorld.

As such, SFIG will continue to work with both the federal agencies and this Committee to find bi-partisan solutions to create both a well-regulated and liquid CLO marketplace.

Thank you, and I look forward to your questions.

Appendix

SFIG appreciates the substantial effort and consideration that both Congress and the federal agencies have put into understanding the implications of the Volcker Rule on the CLO market and searching for solutions that would ensure both a well regulated and liquid industry.

As legislators and regulators continue to move forward on this path, SFIG would like to raise the following points that should be addressed if a grandfathering framework for legacy CLOs is either considered or developed:

1. Since legacy CLOs are not all exclusively backed by loans, grandfathering must account for diverse types of portfolios, such as those with bond buckets, structured finance buckets and non-senior-secured loan buckets.

2. Bucket sizes used within the definition of a CLO should be measured relative to the original portfolio size, rather than current portfolio balances. As a CLO de-levers, its portfolio composition changes as the bucket sizes of remaining collateral tend to increase. This natural amortization should not make a CLO fall out of the definition used for grandfathering.

3. Several factors need to be considered regarding the cutoff date, including:

    a. Would a grandfathering date apply only to a bank's holdings purchased prior to the cutoff date, or would it apply to any deals issued prior to the cutoff date? This distinction would affect whether or not a bank is allowed to make new purchases of old, seasoned CLOs, or if they would merely be able to retain their existing holdings. It could also significantly affect market liquidity for pre-Volcker CLOs.

    b. A cut-off date should specify the date by which a CLO should be "traded," not "issued." Otherwise, if a CLO was traded prior to the cutoff date (which could include the pricing of new issue CLOs), but the trade settled (or the new transaction closed) after the cutoff date, it

would not benefit from the grandfathering.

c. There may also be some ambiguity as to whether the grandfathering date applies to the entire CLO transaction or to a specific tranche issued by the CLO. CLOs often allow for "additional issuances" of notes from the existing structure, effectively allowing the CLO to upsize later in life. Separately, CLOs typically allow existing tranches to be refinanced or re-priced after the end of a prescribed "non-call period." Any grandfathering rule should consider whether additional issuances or refinanced or re-priced tranches from grandfathered CLOs would likewise benefit from grandfathered status.