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CLO RISK RETENTION: THE EMERGENCE OF NON-TRADITIONAL LOAN FACILITIES

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In recent months, a considerable amount of energy has been dedicated to developing structures to enable CLO managers to raise the capital necessary to fund the acquisition of the economic interest in the credit risk of CLO assets (the "Retention Interest") prescribed by the final U.S. risk retention rules (the "Retention Rules")[1]. While these structures have taken a number of forms, this article will focus primarily on the structure that has recently emerged as the most prevalent risk retention financing solution in the CLO marketplace: the "Non-Traditional Loan Facility".

The Retention Interest

As the Agencies[2] have confirmed, the Retention Rules require CLO managers to retain the Retention Interest in each of their managed CLOs, either directly or through a majority-owned affiliate ("MOA")[3]. This Retention Interest may be held in the following menu of ways:

(a) as a "Vertical Interest" in each tranche of CLO securities equivalent to 5% of the face value of each such tranche;

(b) as a "Horizontal Interest" in the CLO equity (i.e., the most subordinated tranche or tranches in the CLO capital structure) equivalent to at least 5% of the fair value of the CLO securities, determined in accordance with U.S. GAAP;

(c) as any combination of the Vertical Interest or Horizontal Interest equivalent to 5% of the fair value of the CLO securities; or

(d) in a cash reserve account in lieu of the Horizontal Interest.

Risk Retention Structures

Prior to delving into Non-Traditional Loan Facilities, it would seem useful to provide a brief overview of the various CLO risk retention financing structures that have arisen in recent months. Importantly, these structures and Non-Traditional Loan Facilities are not mutually exclusive; in fact, they are frequently implemented in conjunction with one another, with Non-Traditional Loan Facilities serving as an important component of the whole.

The CMV Structure. The CMV structure generally consists of a newly-formed capitalized manager vehicle (the "CMV") with an independent board of directors, the majority of the equity of which is owned by one or more third-party equity investors. A minority equity stake in the CMV is typically taken by an established CLO manager and/or one or more of its affiliates, which manager in turn provides staffing and management services to the CMV pursuant to an employee and services agreement. The required Retention Interest for each CMV-managed CLO is purchased by the CMV,

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1 Credit Risk Retention, 79 Fed. Reg. 77,602 (December 21, 2014).

2 The Agencies are as follows: the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, U.S. Securities and Exchange Commission, Federal Housing Finance Agency, and Department of Housing and Urban Development.

3 A majority-owned affiliate is an entity that, directly or indirectly, majority controls, is majority controlled by, or is under common majority control with the sponsor. *See* Credit Risk Retention, 79 Fed. Reg. at 77741. "Majority controls" means owning 50% or more of the equity or maintaining a controlling financial interest (as determined under GAAP). *See id.*

using its equity commitments or a combination of equity and debt financing as the source of funding.

The Equity-MOA Structure. The Equity-MOA structure involves the establishment of an MOA vehicle for the sole purpose of purchasing the Retention Interest. A minority equity position in the MOA is typically held by the related CLO manager[4] or the parent of such CLO manager while the remainder is owned by third-party investors, with the MOA's purchase of the related Retention Interest being funded by contributions from the MOA's equity investors or an equity/debt combination.

The Hybrid CMV Structure. This structure essentially seeks to synthesize the most appealing characteristics of the CMV and MOA structures.

The Master-Feeder Structure. The master-feeder structure typically involves either the establishment of a new management entity or the restructuring of an established CLO manager. The manager funds the acquisition of the Retention Interest for each of its managed CLOs by drawing from the capital commitments of its equity investors, who, in the case of the master-feeder structure, would be comprised primarily of newly established investment funds that have adopted private equity-like master-feeder fund structures.

Non-Traditional Loan Facilities: An Overview

Given their compatibility with other risk retention financing structures, it is not surprising that Non-Traditional Loan Facilities have to date emerged as the most prevalent means for funding the acquisition of Retention Interests. The "Non-Traditional" label is in reference to the structure's many unique features, including the following:

- the lenders are predominantly comprised of insurance companies and other non-banking entities with extensive historical CLO investment experience;
- the loan interest rate is based upon the weighted average interest rate of the portion of the Retention Interest financed with the loan proceeds (with any unfinanced portion acting as additional loan collateral);
- the loan maturity and payment dates substantially mirror those of the CLO securities comprising the Retention Interest; and
- the lender's returns are enhanced by an entitlement to a specified portion of the CLO manager's management fees.

Non-Traditional Loan Facilities are structured as full recourse to either the CLO manager or its MOA and secured, in part, by the Retention Interest.[5] In certain limited cases, CLO managers will fully or partially guarantee the repayment of loans made to the related MOA. In either case, the CLO manager will generally pledge its related CLO management fees as additional loan security. Regardless of structure, payment of principal and accrued interest will ultimately be full recourse to the Non-Traditional Loan Facility borrower irrespective of the credit performance of the related Retention Interest.

Non-Traditional Loan Facilities may also be structured to allow multiple loans to be drawn down, on a committed or uncommitted basis, to acquire the Retention Interests for multiple CLOs over a designated multi-year period under a single set of loan documents. These multi-tranche facilities are particularly attractive to high-volume CLO managers, as they effectively spread formation costs over numerous CLO issuances.

The Retention Interests financed by Non-Traditional Loan Facilities have to date taken the form of Vertical Interests. Consequently, these facilities are often structured such that loan interest payments will be deferred correspondingly with any deferring CLO tranches.

[4] If a CLO manager chooses to hold a minority equity stake in the MOA, the MOA must be structured such that the CLO manager holds a controlling financial interest in such MOA consistent with GAAP.

[5] *See* Credit Risk Retention, 79 Fed. Reg. at 77732 (Subpart C, §__.12(e)).

U.S. Retention Rules

While the Retention Rules do not prohibit a CLO manager or its MOA from financing the acquisition of the Retention Interest through a loan facility, they do require such loan facility to be full recourse to the borrower[6] when such Retention Interest is pledged to secure the borrower's obligations.

In instances where recourse is limited to an MOA borrower and its assets, careful attention must be paid to ensure compliance by the CLO manager with both the letter and spirit of the Retention Rules, particularly when the Non-Traditional Loan Facility is being utilized to finance the very first Retention Interest to be acquired by an MOA. In these cases, the analysis will rely on a number of factors, including the economic substance and level of capitalization of the MOA by the related CLO manager and/or its affiliates. Notably, a pledge of the CLO manager's management fees as security for the MOA's obligations is considered to be a very helpful factor.

The Retention Rules prohibit sponsors and their affiliates from purchasing or selling a security or financial instrument or entering into an agreement or position if (i) the payments on the security or financial instrument are materially related to the credit risk of the Retention Interest and (ii) the security, financial instrument, agreement or position reduces or limits the financial exposure of the sponsor or the MOA borrower to the credit risk of the Retention Interest.[7] Thus, it is important to draw the distinction that even though the interest rate, payment date, maturity date, and certain other terms of the Non-Traditional Loan Facility may substantially mirror the corresponding terms of the financed Retention Interest, the obligation to pay principal and interest on the loan in full when due is not related to the credit risk or performance of the Retention Interest.

Although the final Risk Retention Rules are silent on the implications of a lender foreclosing upon the Retention Interest following an event of default, the commentary to both the first and second proposals of the rules indicated that if a counterparty to a recourse financing were to take the Retention Interest (whether by consent, exercise of remedies or otherwise), the related CLO manager would be deemed to have violated the mandated prohibition on the transfer of such Retention Interest.[8] In recognition of this, Non-Traditional Loan Facilities seek to balance a lender's right to foreclose on its collateral with the CLO manager's need to remain in compliance with the Retention Rules, typically by providing for agreed-upon foreclosure grace periods (which would afford the CLO manager the opportunity to cure the related event of default or refinance or otherwise prepay the loan prior to the lender's exercise of its foreclosure rights), limiting the types of events of default giving rise to foreclosure, or utilizing a combination of both.

Structural Advantages

There are numerous structural advantages to utilizing a Non-Traditional Loan Facility to finance Retention Interests. These advantages include:

- the ability to fund the Retention Interest for multiple CLOs over a number of years under a single set of loan documents;
- flexibility for CLO managers to trade-off principal protection in the form of guarantees and overcollateralization in return for reducing the lender's entitlement to enhanced returns (i.e. portions of CLO management fees);
- the voting and consent rights given to risk retention lenders are typically broader than those given to risk retention equity investors in many other risk retention structures;

6 *See id.*

7 *See id.* at 77753 (Subpart C, §__.12(b)).

8 *See* Proposed Rule: Credit Risk Retention, at 96, available at <https://www.fdic.gov/news/board/29Marchno2.pdf>; Reproposed Rule: Credit Risk Retention, at 175, available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20130828a1.pdf>.

- free assignability of a lender's loan interest, and thus higher liquidity than many other risk retention investment strategies; and

- the ability to comply with the capital requirements regulations of the European Union and the accompanying directives (the "EU Retention Rules").[9]

Rated Facilities

A facility rating can be critical for lenders grappling with regulatory or internal constraints or seeking to achieve more favorable capital treatment. Fortunately, a well-structured Non-Traditional Loan Facility has proven capable of being rated by a nationally recognized statistical rating organization.

While the use of a newly-established, bankruptcy-remote MOA borrower simplifies the Non-Traditional Loan Facility rating process, facilities seeking to comply with the EU Retention Rules may be better served utilizing a CLO manager borrower for a variety of reasons that are beyond the scope of this article.

Looking Ahead

Going forward, we would expect the enhanced returns, liquidity and other inherent structural advantages of Non-Traditional Loan Facilities to attract an increasing number of lenders, the majority of whom will likely possess significant prior CLO investing experience.

While the Retention Interests financed by Non-Traditional Loan Facilities have thus far taken the form of Vertical Interests, we would anticipate a potential appetite on the part of private investment funds and other investors attracted by higher yields to offer loans secured by Horizontal Interests. Indeed, in spite of the challenges posed by the "residual" and front-ended nature of payments on the underlying CLO equity, loan financing of Horizontal Interests seems logically poised to gain traction among CLO investors in the near future. In fact, Seward & Kissel has already dedicated substantial time toward developing legal and structural solutions to address the many nuances of this developing product, including features to enable lenders to capture the full economic benefits of a Horizontal Interest.

For the numerous reasons cited in this article, we believe that Non-Traditional Loan Facilities will play an increasingly important role in the CLO industry in the coming years.

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9 The EU Risk Retention Rules are comprised of (i) Articles 404-410 of the EU Capital Requirements Regulation (Regulation (EU) 575/2013) of June 26, 2013 as published on June 27, 2013, as supplemented by Commission Delegated Regulation (EU) No 625/2014 of 13 March 2014; (ii) Chapter 3 Section 5 of the EU Commission Delegated Regulation (EU) 231/2013 implementing Article 17 of EU Directive 2011/61/EU on Alternative Investment Fund Managers (the "AIFMD"); and (iii) Articles 254-257 of Delegated Regulation (EU) No 2015/35 of 10 October 2014 supplementing the Solvency II Directive (2009/138/EC).

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If you have any questions or comments about this legal update, please feel free to contact Greg B. Cioffi at **(212) 574-1439** or e-mail **cioffi@sewkis.com**

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