Asset Securitization Report

The Premier Guide to Asset and Mortgage-Backed Securitization

January 11, 2016

OBSERVATION

The New Way CLO Managers are Financing 'Skin in the Game'

CLO managers are increasingly looking to non-traditional loan facilities to finance the economic interest in the credit risk that they must hold in their deals under the impending U.S. risk retention rules. Over the past year, insurance companies and other non-banking entities with extensive experience investing in collateralized loan obligations have shown considerable interest in providing these facilities. This is hardly surprising, given their numerous structural advantages.

BY GREG B. CIOFFI

The U.S. risk retention rules require CLO managers to retain an interest in the credit risk of each of their managed CLOs, either directly or through a majority-owned affiliate (commonly known as an "MOA"). The earliest U.S. compliant structural solutions for financing the purchase of the required retention interest proposed a capitalized manager vehicle or "CMV", the MOA vehicle, and the "hybrid" CMV vehicle (which seeks to synthesize the most desirable components of the CMV and MOA vehicles). All three options require an equity stake to be taken by the CLO manager and/or its affiliates, and a substantial portion of the funding for such financings is derived from third-party sources.

In recent months, much of this third-party funding has been provided by lenders under non-traditional loan facilities, a trend that seems likely to continue.

The "non-traditional" label is a reference to the non-traditional loan facility's numerous unique features. The facility interest rate, for example, is based upon the weighted average interest rate of the portion of the retention interest financed with the loan proceeds. 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. Depending on negotiated terms, CLO managers fully or partially guarantee the repayment of loans made to the related MOA. In any 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 on the outstanding loans will ultimately be full recourse to the borrower, irrespective of the credit performance of the related interest.

The required risk retention interest may be held in a number of ways, including, among others, as a "vertical interest" in each tranche of CLO securities equivalent to 5% of the face value of each such tranche, or as a "horizontal interest" in the CLO equity equivalent to at least 5% of the fair value of the CLO securities. 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.

Structural Advantages

Non-traditional loan facilities can be structured to benefit CLO managers in numerous respects. They can 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.

Non-traditional loan facilities can also afford CLO managers the flexibility to trade 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). These facilities can also be structured to comply with the European Union risk retention rules.

There are also advantages for lenders. For instance, loan interests can be freely transferrable, making them much more liquid than equity interests in other kinds of risk retention structures. In addition, the voting and consent rights in respect of the underlying risk retention interests given to lenders in non-traditional loan facilities can typically be significantly broader than those given to equity investors in many other risk retention structures.

To comply with U.S. risk retention rules, a loan facility must be full recourse to the borrower 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

U.S. risk retention rules, particularly when the non-traditional loan facility is being used 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 U.S. risk 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.

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.

Balancing Lender Rights with Borrower Compliance

Although the final U.S. 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.

In recognition of this, non-traditional loan facilities seek to balance a lender's right to foreclose on its collateral against the uncertainty regarding the CLO manager's continued compliance with the U.S. risk 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, 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 using a combination of both.

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 recog-nized 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 European Union risk retention rules may be better served utilizing a CLO manager borrower.

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.

Although 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 risk retention 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.

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