Innovative CLO retention solutions give small managers renewed hope

By Tom Davidson

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CLO arrangers, investors and managers are considering two possible solutions to CLO risk retention: issuing bonds from a majority owned affiliate or bringing in a third-party to provide vertical financing.

In its most simplistic form, risk retention requires a manager to retain 5% of its CLO through an equity position or a vertical strip comprising 5% of each tranche. Both approaches are considered too capital intensive for all but a handful of managers.


Shiloh Bates

One solution is for the manager to use full-recourse financing to fund their vertical strip. But according to Greg Cioffi, a partner at Seward & Kissel, traditional bank lending facilities of vertical strips may only be available to the largest managers. “Small and mid-sized managers may not have traditional loan facilities made available to them from banks,” he says.

Seward & Kissel has suggested using a non-traditional type of loan facility to fund risk retention, with the loan directly or indirectly supplied by CLO investors. The risk retention on a single deal would be funded by a loan that mirrors the returns the provider would get from investing directly in the CLO. The manager could then provide principal protection by a combination of recourse against its own assets and overcollateralisation.

An alternative concept is the use of a manager-owned affiliate to hold the horizontal risk retention piece. This would reduce a CLO manager’s 5% retention stake by at least half. But one of the problems with this approach is finding an investor willing to take on an illiquid exposure for the lifetime of a CLO.

Investors say that arrangers are looking for ways to introduce some liquidity into the investor's stake in a manager-owned affiliate.

"For us, one of the least attractive parts of being an investor in a majority-owned affiliate is the lack of liquidity in that investment," says Shiloh Bates, head of structured products at Business Development Corporation of America.

"But we've been approached by several different arrangers who are looking to structure that investment with a cusip to make it more liquid and give third-party investors a potential exit."

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