

---

# Risk Retention for CLOs

---

## LSTA Contacts

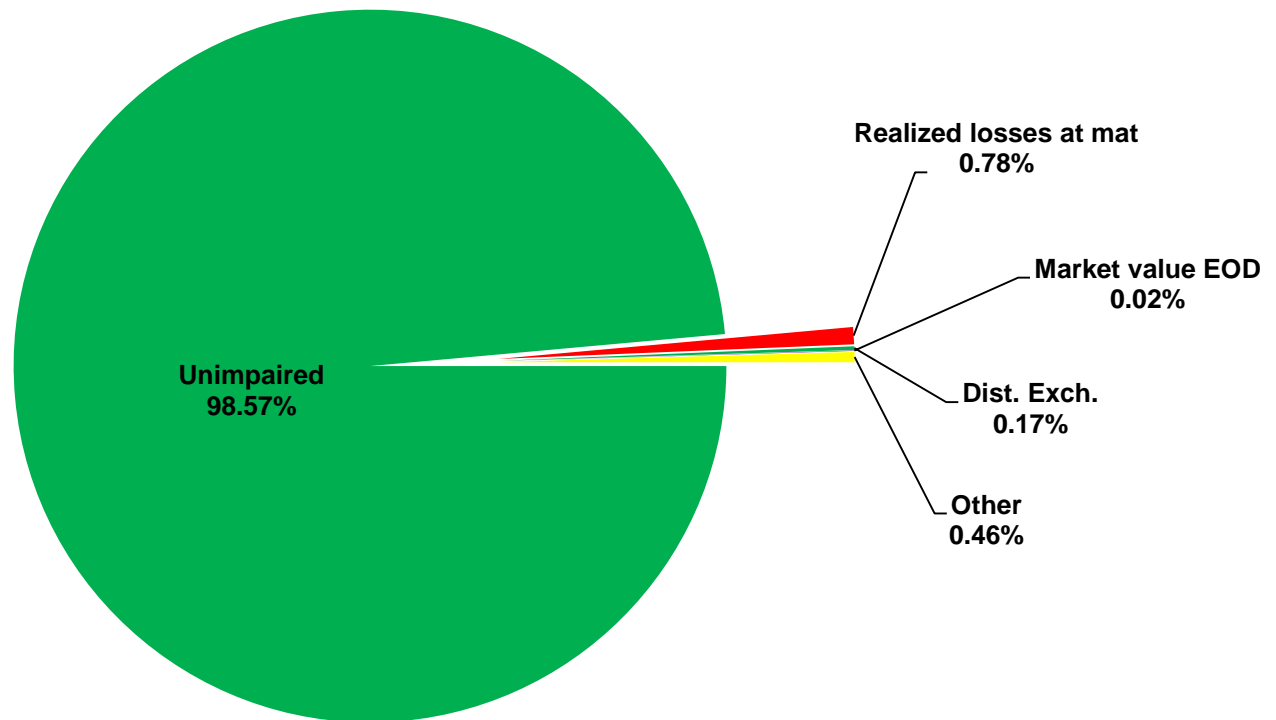
Bram Smith, Executive Director – LSTA, [bsmith@lsta.org](mailto:bsmith@lsta.org)

Meredith Coffey, EVP- LSTA, [mcoffey@lsta.org](mailto:mcoffey@lsta.org)

Elliot Ganz, General Counsel – LSTA, [eganz@lsta.org](mailto:eganz@lsta.org)

# Performance: CLO note impairments have been all but non-existent

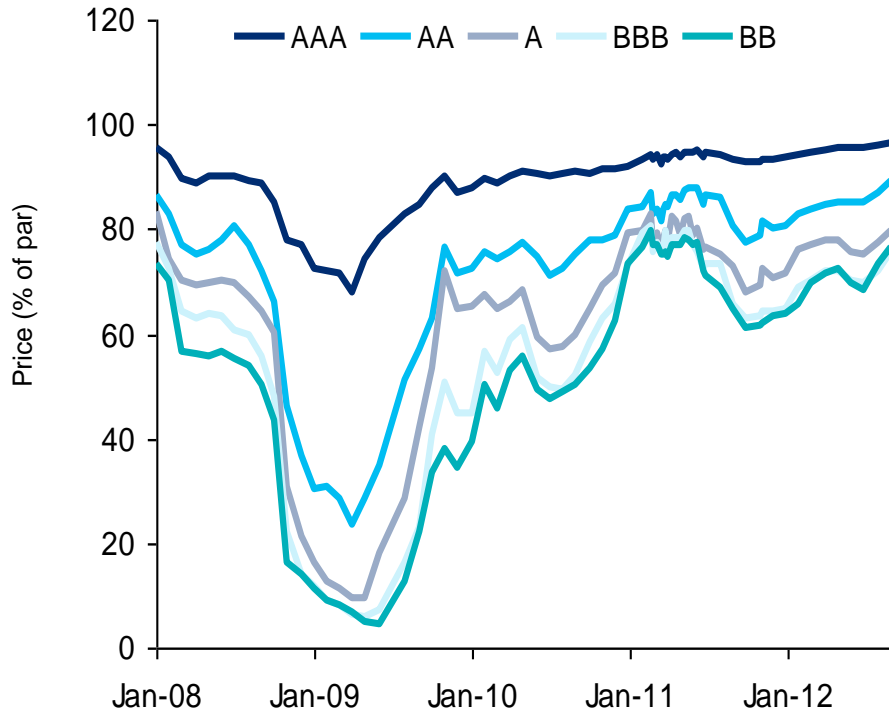
Cumulative impairment rate from Jan 1996 to May 2012



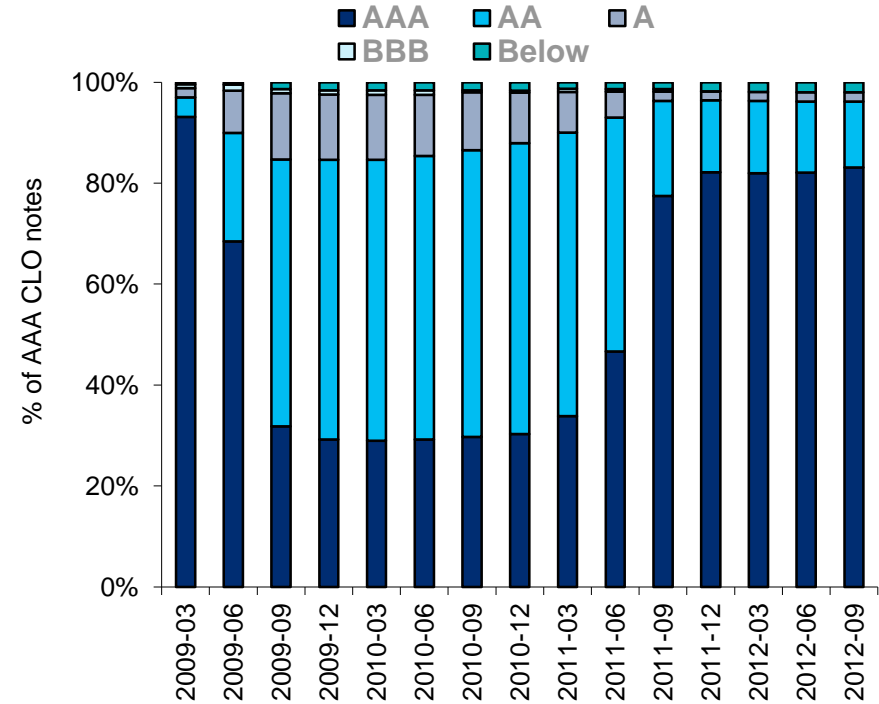
Source: Moody's Investors Service

# Performance: CLO prices and ratings recover

CLO 1.0 secondary prices recover



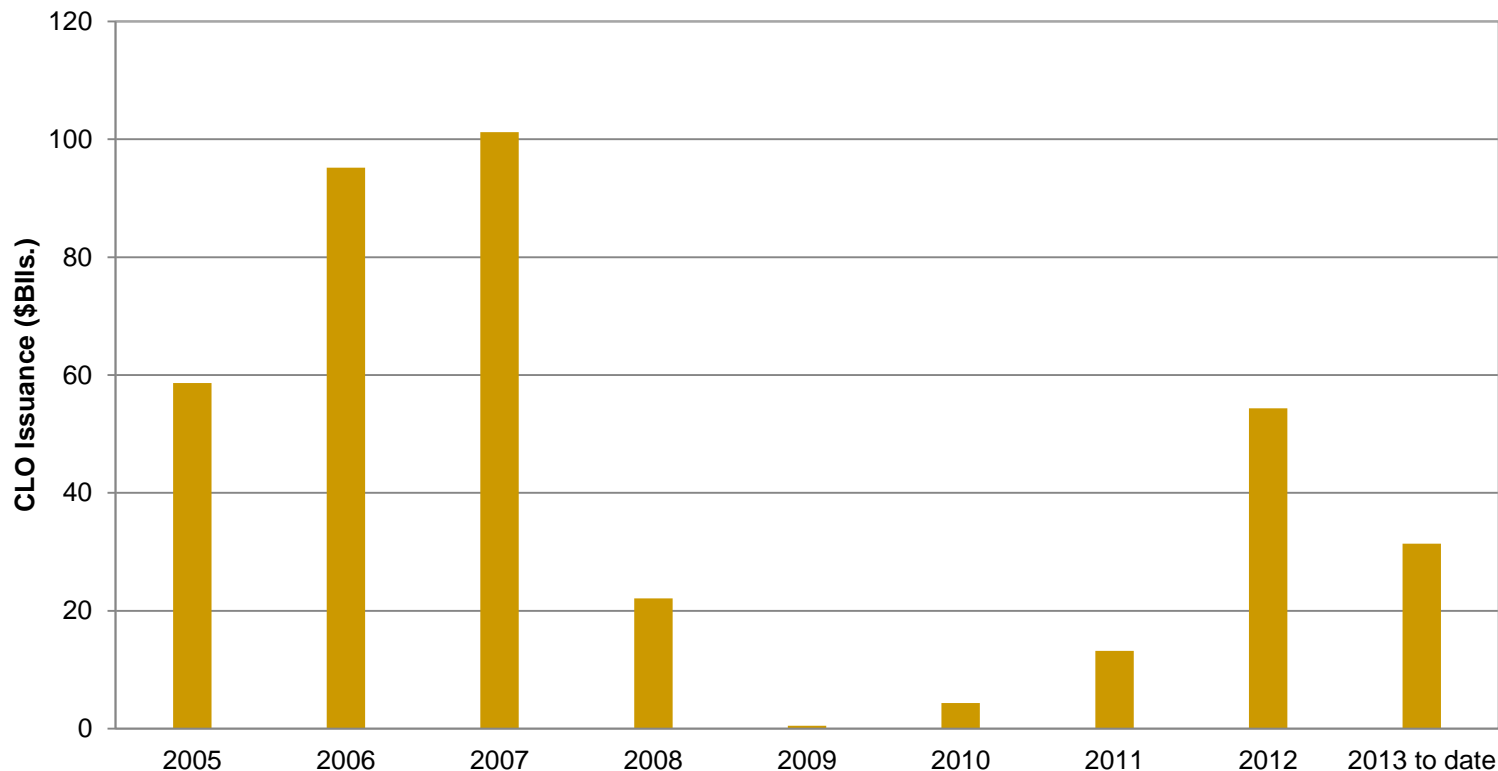
CLO AAA notes downgraded, but recover



Source: Citi Research, Moody's

# Performance: Because CLOs performed, satisfying investors, CLO issuance has returned materially

U.S. CLO issuance



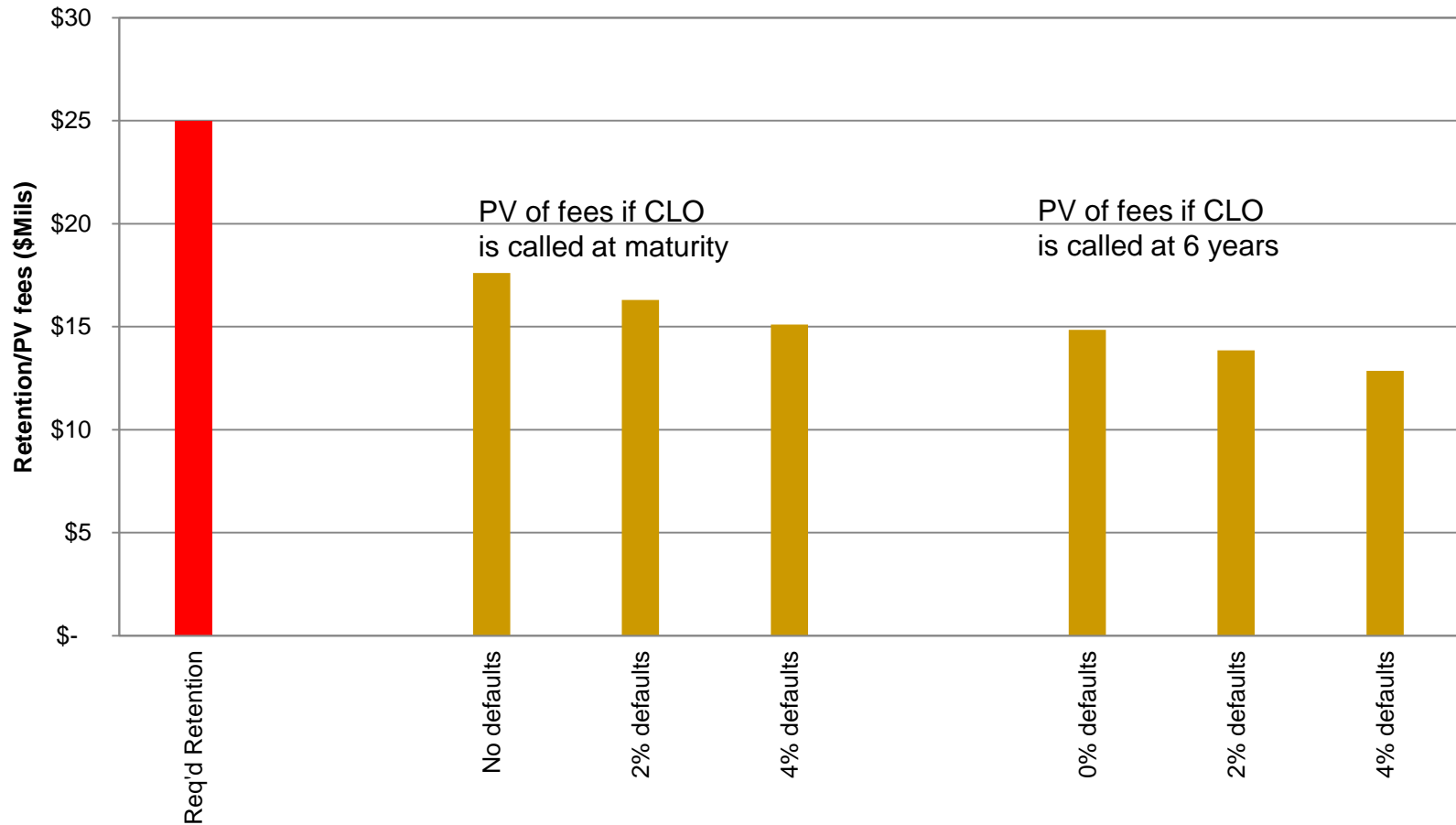
Source: Thomson Reuters LPC

# It is simply not feasible for managers to hold 5% of the face value of open market CLOs

- While CLO issuance has returned, the imposition of a 5% FV retention on the CLO manager will hamstring the market
- CLO managers are simply managing the portfolio
- CLO managers have no balance sheets that the assets were on ...then shifted off of
- CLO managers have very limited balance sheets generally
- CLO managers earn an annual fee of approximately 50 bps per year to manage a CLO (with the potential of a performance based incentive fee)
- The present value of that 50 bps for a 10 year CLO is *well less than 5% of the face value of the CLO*
- The proposed rule would require managers to invest *well more than all* of their income from the CLO simply for the right to manage the CLO
- It's simply not economically viable

# Manager fees wouldn't even cover required retention

Required retention vs. present value of manager fees



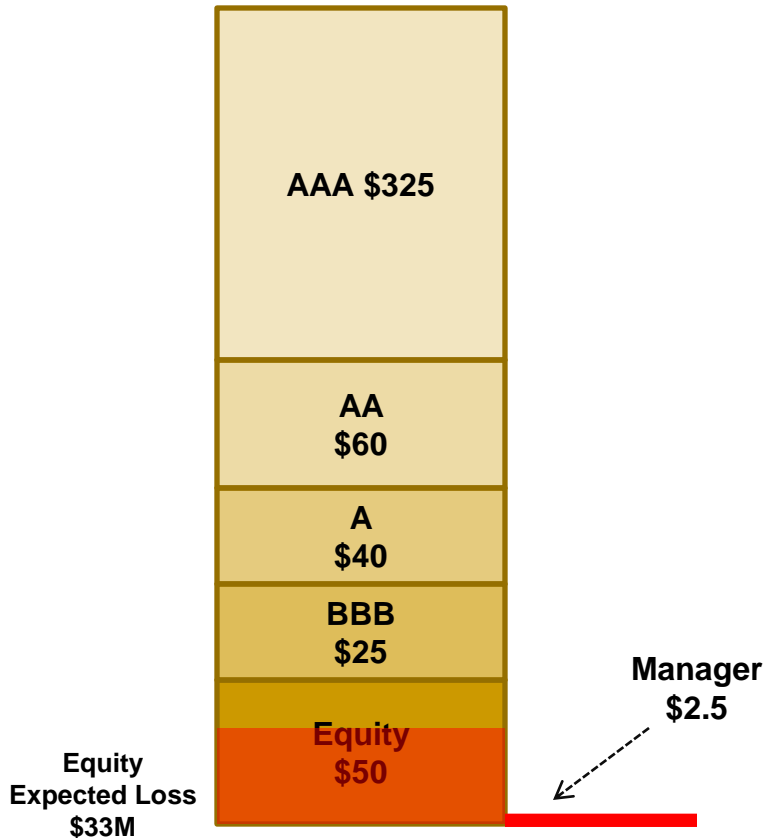
Source: CLO Model Calculations

# LSTA's April 2013 Proposal

- **The Proposed Retention Rule would require managers to purchase \$25 million of equity for a new \$500 million CLO**
- **CLO managers simply cannot comply with this requirement; \$25 million could be nearly *twice what they earn for managing a CLO***
- **LSTA's risk retention proposal has very real skin in the game, but should be feasible for most managers**
  - CLO manager purchases 5% of the equity of the CLO out of pocket
  - Senior, sub and fee stream are replaced by ownership of Class M Unfunded Notes that create a similar income stream
- **The equity purchase alone is nearly 5% of the credit risk, because the vast majority of the credit risk resides in the first loss position**
- **In addition, holding Class M Unfunded Notes gives the manager another 5% of the credit risk because the Notes are weighted toward the bottom of the capital stack**

# Example of \$500M CLO with manager equity retention

## \$500 million CLO



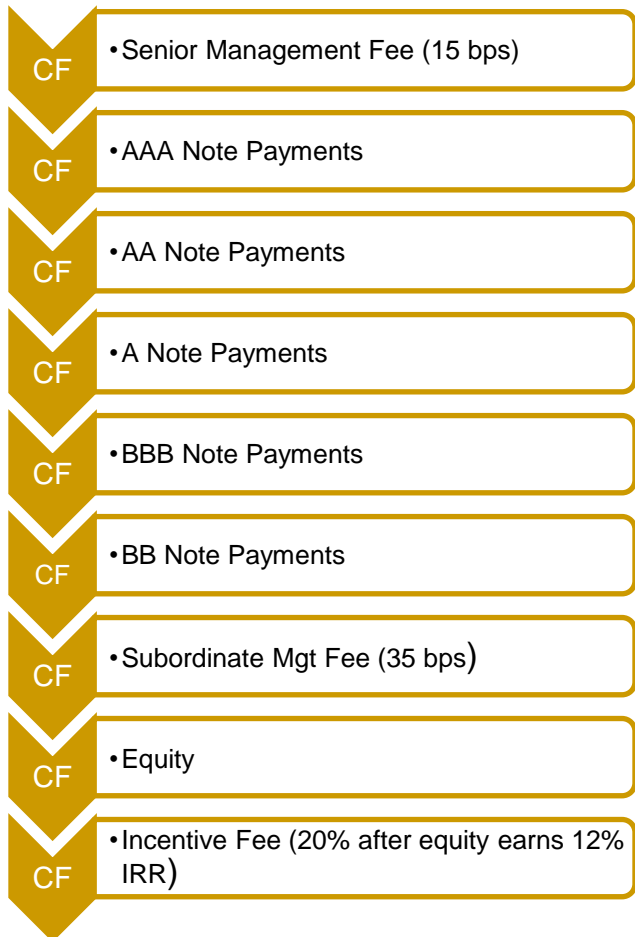
## Manager purchases 5% of equity

- Manager must contribute \$2.5 million of equity in LSTA's Proposal
- The manager's equity contribution equates to 14-20% of the manager's full compensation for managing the CLO... just to do his job
- This is the first loss position in the CLO
- Based on historical loan performance, the manager's expected loss is \$1.65 million
- This is a very serious commitment from the manager



# LSTA's Framework for Class M Notes

## Current Structure & Fee Stream



## Proposed Structure & Income Stream

