July 29, 2013

By Electronic Submission

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2–3
Washington, D.C. 20219

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Alfred M. Pollard, Esq.
General Counsel
Federal Housing Finance Agency
1700 G Street, N.W.
Washington, D.C. 20552

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Regulations Division
Office of General Counsel
Department of Housing and Urban Development
451 7th Street, S.W., Room 10276
Washington, D.C. 20410-0500

Re: **Notice of Proposed Rulemaking, Credit Risk Retention**
SEC (Release No. 34-64148; File No. S7-14-11); FDIC (RIN 3064-AD74); OCC (Docket No. OCC-2011-0002); FRB (Docket No. 2011-1411); FHFA (RIN 2590-AA43); HUD (RIN 2501-AD53)

Ladies and Gentlemen:

The Loan Syndications and Trading Association ("LSTA")[1] is pleased to submit these fourth supplemental comments in response to the joint Notice of Proposed Rulemaking, 76 Fed. Reg. 24090 (April 29, 2011) ("NPRM"), concerning risk retention and the implementation of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").

These comments principally respond to agency officials' request, made during a meeting

[1] The LSTA, founded in 1995, is the trade association for the syndicated corporate loan market and is dedicated to advancing the interests of the market as a whole. The LSTA is active on a wide variety of activities intended to foster the development of policies and market practices designed to promote a liquid and transparent marketplace. More information about the LSTA is available at www.lsta.org.

366 Madison Avenue, 15th Fl., New York, New York 10017
Tel. 212.880.3000 Fax. 212.880.3040 www.lsta.org

with LSTA officials on May 9, 2013,[2] for further information and data regarding the potential ability of managers of Open Market Collateralized Loan Obligations ("CLOs") to borrow or raise funds to enable them to purchase and retain 5% of the fair value of any new CLO notes, as required under the agencies' proposed Credit Risk Retention Rule. *See* Part I *infra*. These comments also address an ancillary issue raised during the meeting, related to the role of the structuring bank in assisting in the issuance of Open Market CLO securities. *See* Part II *infra*. In addition, in response to a request during the meeting from agency officials, the LSTA on June 11, 2013 provided to agency officials the assumptions and inputs of the model employed by Harvard Prof. Victoria Ivashina in support of her conclusions set forth in the LSTA's third supplemental comment letter of April 1, 2013.

The LSTA's previous comments have explained that the credit risk retention requirement imposed by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") does not, and should not, apply to Open Market CLOs.[3] As a matter of statutory interpretation, Section 941's definition of "securitizer" does not encompass Open Market CLO managers or any relevant CLO entity, and thus the risk retention requirement does not apply to them.[4] Most fundamentally and consistent with the scope of Section 941, Open Market CLOs simply do not present the risk of the originate-to-distribute business model that the statute addresses and did not give rise to the 2008 Financial Crisis which Section 941 seeks to ensure will not recur.[5] Indeed, as demonstrated in the chart in Appendix A, CLOs have had a de minimis impairment rate: the CLO market performed well throughout the financial crisis and continues to do so today. Finally, the costs of imposing the risk retention requirement on Open Market CLOs would far outweigh any potential benefits. Imposing the risk retention requirement on CLOs will sharply curtail this market and the myriad public interest benefits it provides to companies seeking access to credit, to participants in the loan syndication process, and to investors.[6]

Although the LSTA maintains that CLOs are not subject to Section 941 and in any event should qualify for an exemption, it has consistently sought to develop an acceptable solution that will enable the CLO market to continue to function as a robust sector of the industry while meeting legitimate concerns agency officials may have. In that vein, the LSTA in its April 1, 2013 comment letter proposed a structure for risk retention by CLOs that satisfies the text and purposes of Section 941 (assuming that it applies), while avoiding the principal risks that the agencies' proposed rule poses to the CLO market, competition, and the public interest.[7] The LSTA's proposal was the subject of the May 9, 2013 meeting between the LSTA and the agencies.

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[2] The May 9, 2013 meeting included representatives from the LSTA and officials of the Securities and Exchange Commission, the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency.

[3] *See* Letter Comments of LSTA (Aug. 1, 2011) ("LSTA 2011 Letter"); Third Supplemental Letter Comments of LSTA (Apr. 1, 2013) ("LSTA 2013 Third Supplemental Letter").

[4] *See* LSTA 2011 Letter at 8–13; LSTA 2013 Third Supplemental Letter at 16–19.

[5] *See* LSTA 2011 Letter at 4–7, 13–14; LSTA 2013 Third Supplemental Letter at 18–19.

[6] *See* LSTA 2011 Letter at 14–17; LSTA 2013 Third Supplemental Letter at 20–22.

[7] *See* LSTA 2013 Third Supplemental Letter.

In its proposal and at the May 9 meeting, the LSTA explained that its proposed structure for CLO risk retention is necessary due to the prohibitive costs to CLO managers and the adverse effect on their business models that would be caused by the proposed rule's requirement that they retain 5% of the fair value of CLO notes. Agency officials requested information from the LSTA that would assist them in determining whether CLO managers could or would borrow or otherwise raise funds to meet the agencies' proposed risk retention requirement. To that end, the LSTA conducted two surveys, described below in Part I. Issues related to the role of the structuring bank in CLO formation are addressed in Part II.

I. <u>IMPAIRMENT OF CLO FORMATION</u>

Two surveys produced the conclusions that the vast majority of CLO managers could not or, as a matter of rational economic decision-making, would not meet the proposed credit risk retention rules through market funding or self-funding and that, under the proposed rules, CLO formation would dramatically decline. The first survey, described in Part I.A, covered U.S. CLO managers responsible for more than 70 percent of the U.S. loan and CLO market. The second, described in Part I.B, surveyed prime brokers representing approximately half of the prime brokerage market, as well as term lenders comprising a very significant share of the market.

As detailed below, these surveys of term lenders, over half the prime brokerage universe, and 70% of the U.S. CLO manager universe demonstrate that borrowing money to purchase and retain 5% of the fair value of any new CLO notes is not a viable option for CLO managers. They also show that the vast majority of managers simply do not have the internal funding that would enable them to purchase and retain 5% of the fair value of any new CLO notes (and the few managers with such internal funding often would not devote such significant funds to CLO formation because anticipated returns do not align with what is required by their investors). As a result, and as the CLO managers noted, the agencies' proposed risk retention rules are expected to cause a reduction in new CLO formation of approximately 75 percent.

A. <u>CLO Manager Survey</u>

The LSTA developed and in June 2013 distributed a written survey directed to CLO managers to gauge the feasibility of borrowing or otherwise raising funds to meet the risk retention requirement set forth in the agencies' proposed rule.

The LSTA received responses from entities managing more than 70% of the U.S. loan and CLO market. Specifically, the LSTA received responses from 35 discrete money managers, representing total combined Assets Under Management ("AUM") of $7.5 trillion. *See* Aggregated Responses to CLO Manager Survey (Appendix B, Fig. 1). Of the total AUM of the responding managers, $420 billion reflects loan AUM. As of July 12, 2013, the size of the S&P/LSTA Leveraged Loan Index – which captures the vast majority of the institutional loan market – was $590 billion. In addition, the responding managers have a total CLO AUM of $228 billion, representing 509 individual CLOs. By comparison, Thomson Reuters LPC's Collateral product, which is estimated to contain nearly the entirety of the U.S. CLO market, tracks 730 CLOs with $284 billion in AUM. Thus, the CLO manager survey has produced a robust sample reflecting the views of a very substantial majority of the market. Moreover, the survey results spanned the breadth of that market, capturing the full range of CLO managers, from the very large to the very small.[8]

The survey first asked how many CLOs the CLO manager could or would issue if the manager was required to retain 5% of the fair value of each new CLO. Of the 35 respondents, 22 said they could not or would not issue any CLOs; six said they could or would issue one to two CLOs; one said it could or would issue three to four CLOs; and six said they could or would issue five or more CLOs. *See* Appendix B, Fig. 2. In aggregate, these managers, who currently manage 509 CLOs, estimated that they could issue approximately 69 CLOs in total if they were required to retain 5% of the fair value of the CLO notes.[9] In other words, if the proposed rules go into effect, as the current universe of 509 CLOs eventually phases out, only 69 new CLOs will replace them, reflecting a decrease in the market of 86 percent. The survey also invited respondents to explain the basis for their estimates of CLO issuance under the proposed risk retention conditions. The comments highlighted capital constraints as a major factor limiting CLO issuance under the proposed rules. For example, one manager stated, "[a]s a private company, we don't have the capital or net worth to meet the proposed requirements." Others similarly explained that "[we] do not have that amount of capital," and "[w]e are a 3rd party asset management firm, not a bank or insurance company and do not have sufficient cash to be able to invest this amount of money in any new deal."

The survey next asked whether managers could borrow or otherwise raise funding to purchase CLO notes. Of the 35 managers, 20 said they could not raise funding. Comments from these managers highlighted lenders' unwillingness to finance this kind of endeavor. For example, one manager explained "[t]here are no lenders willing to lend against CLO equity as collateral," while another commented that "[w]e do not have large treasury/balance sheets to be able to borrow such large amounts for each deal," and yet another described borrowing as "cost prohibitive" and emphasized the "difficulty in finding counterparties willing to lend against the CLO notes." Other comments indicated that borrowing would be impractical: "[a]t present, we do not believe it is practical for many CLO Managers to borrow money to make investments in CLOs in order to obtain the investment management contract." Likewise, one manager explained that "[b]orrowing money on a recourse basis on this order of magnitude would not allow us to continue managing CLOs" and pointed out that "[i]f a single deal went poorly, it could jeopardize the health of our entire firm."

[8] The largest CLO manager that responded to the survey had total AUM of $3.9 trillion, while the smallest respondent had $1.1 billion in AUM. A comparison of the mean and median manager statistics also illustrates the range of respondent size: Taking all the responding CLO managers together, the mean size of total AUM was $214 billion, while the median was $18.8 billion; the mean loan AUM was $12 billion, while the median loan AUM was $8.8 billion; the mean CLO AUM was $6.5 billion, while the median CLO AUM was $5.2 billion.
[9] In estimating that these managers could issue approximately 69 CLOs in total, the LSTA interpreted the managers' responses in favor of CLO formation. For example, for respondents who indicated they would issue one to two or three to four CLOs, the LSTA attributed the high end of the stated range to each manager. Likewise, if a respondent indicated that the proposed rules would have "no impact" on his/her ability to do CLOs, the LSTA assumed that the manager would continue to issue his/her current number of CLOs, even if it was considerably more than five CLOs.

Of the remaining 15 managers, 12 indicated that they believed they would be able to secure financing,[10] either through borrowing alone (three managers), through raising equity (three managers), or through a combination of borrowing and raising equity (six managers). Although these 12 managers acknowledged that they *could* raise funding, half of them went on to make clear that they *would* not do so, and another four said only that they might do so. As one manager who would not raise funding for CLO issuance explained, "[t]heoretically we could borrow $25M for a CLO but we are purely an investment manager with public debt and … tying up $25M in capital for the life of a CLO is not our business model and not the risk profile investors in our company are expecting from us." Other commenters agreed: "raising that type of financing lies outside of [our] core strategic mission as an asset management firm"; "we could raise funds to co-invest in [these] deals but not at $25mm a clip as that would be too concentrated an investment for a platform of our size." Ultimately, only two of 35 managers said they could and would raise funding to invest in 5% of the fair value of a new CLO. *See* Appendix B, Fig. 3.

The survey also asked for the managers' prediction of the impact of the agencies' draft risk retention requirement on their CLO business in particular and on the U.S. CLO business in general. Eighteen managers – just over half of the respondents – stated that the agencies' proposed requirement would halt their CLO business altogether. Six predicted that the requirement would eliminate 75% of their CLO business, and another six said that the requirement would cut their CLO business in half. Only five of the managers expected their CLO business to remain unaffected by the requirement. With respect to the U.S. CLO industry in general, no respondent believed that the requirement would have no effect. Five managers predicted that the requirement would cut the U.S. CLO industry in half, while the rest thought the rule would cause the industry to decline by 75% (26 managers) or to cease altogether (four managers). *See* Appendix B, Fig. 4.

Finally, the survey invited respondents to offer any other observations on the agencies' proposed risk retention requirement. The comments included:

- "It is completely inconsistent with an asset management model; in our opinion, CLOs should be no different than a [separate] account or a mutual fund where assets are managed for third parties; we would never be expected to put 5% of the value of a mutual fund or a separate account at risk; CLOs should be no different – they are simply a means of levering the assets for third party investors; if a 5% risk retention [requirement] was invoked, the only managers that would likely continue to issue CLOs are those attached to private equity firms who are already raising equity capital – they would simply divert that third-party equity capital to CLO; CLO managers associated with large insurance companies or asset management firms would completely exit the business due to the unattractive economics."

- "This would take market competition out of the business. Only the very largest institutions would participate in the market which would significantly reduce market

[10] The last three responding mangers were uncertain whether they could raise funding.

liquidity."

- "A $25 million investment for a single [$500 million] CLO would be an unrealistic expectation for all but a few of the larger investment managers that have access to the public markets to raise capital. The proposed requirement would likely lead to a reduction in access to capital for corporate borrowers and an increase in the cost of capital. Neither of these outcomes would be good for the economy or opportunities for job creation."

- "This level of risk retention would lead to i) higher loan market volatility due to a substantial drop in the long term nature of the CLO buyer base, ii) CLO industry consolidation, iii) less competition and iv) job losses."

- "5% of the equity in a CLO would make sense, but not 5% of the notional size of the entire CLO which is what is being proposed. A majority of that risk is rated AAA. The real risk is the part of the transaction that is below investment grade."

The results of this survey of CLO managers thus indicate that borrowing or otherwise raising funds to meet the agencies' proposed risk retention requirement is not feasible or practical for most CLO managers and would dramatically curtail the CLO market. CLO managers' perception of the difficulties in borrowing funds for this purpose is borne out by the results of the LSTA's survey of potential lenders, as described below.

B. <u>Survey of Bank Term Lenders and Prime Brokerage Firms</u>

In addition to the written survey of CLO managers, the LSTA also conducted a series of calls and meetings with potential sources of funding to gauge lenders' willingness to provide funds to enable CLO managers to meet the agencies' proposed risk retention requirement. To the extent that commercial and investment banks in the United States are willing to lend to fund managers, they typically make loans available through term lending or prime brokerage lending, methods that are described in greater detail below. The LSTA therefore contacted several bank term lenders as well as the four top prime brokerage firms, which together constitute over half of the prime brokerage market. LSTA's discussions with these lenders confirm that borrowing funds for risk retention is not a viable option for CLO managers.[11]

1. <u>Term Lenders</u>

Term lending, at bottom, is simply a form of corporate lending. As with the provider of any other corporate loan, a lender to a fund manager considers the manager's entire business, including its balance sheet, mix of businesses, fee stream across its many funds, free cash flow (EBITDA), and other factors. Although a lender may take a security interest in a fund manager's

[11] *See also* Asset-Backed Alert, Banks Shoot Down CLO Financing, 5 (July 26, 2013) (Appendix C) ("Collateralized loan obligation dealers are advising issuers in Europe not to expect financing for any securities they hope to retain. … Underwriters have … let [issuers] know they would view such arrangements [borrowing against equity holdings to retain the senior and mezzanine slices] as carrying too much market risk.").

senior fee streams and other collateral, a term loan, unlike short-term funding, is not an asset based loan where only a borrower's highly liquid assets are included in a borrowing base. Generally, the term loan lenders stated that they would lend a percentage of the present value of a borrower's senior fee streams and between 50% and 75% of the value of senior securities (such as AAA or AA rated CLO notes) held by the borrower.

Applying this framework to CLOs demonstrates the difficulties that CLO managers would encounter if they sought to obtain adequate funds through term lending. In the discussions the LSTA conducted with term lenders, the lenders said that they would give no credit whatsoever for securities further down the capital chain than AAA or AA notes (and therefore clearly would give no credit for equity). According to Wells Fargo research, AAA and AA notes account for approximately 61% and 11% (or 72% total) of CLO capital structures in 2013, respectively. Thus, assuming corporate term funding were available and that the CLO manager held its interests as a vertical slice (proportionate to the overall allocation of the CLO notes), a CLO manager would be able to borrow only 50% to 75% of the value of 72% of its holding of CLO interests. That amounts to between 36% and 54% of the value of the interest the CLO manager would have to retain. Stated differently, for a $500 million CLO with the typical capital structure outlined above, the manager could secure only $9 million to $13.5 million of funding and would still need to provide $11.5–16 million of funding from its own pocket. Moreover, this is the best case scenario: because no lenders would give credit for equity positions, a CLO manager would not be able to borrow at all to retain a horizontal equity slice.

Furthermore, the term lenders told the LSTA that term financing, as a corporate loan with recourse to the borrower, is generally made available to only the highest credit quality, largest fund managers and is not widely available to most CLO managers. For example, it has been reported that Bank of America recently arranged a $700 million term loan to fund Guggenheim Partners.[12] Guggenheim is a very large fund manager with more than $145 billion under management across many different funds and strategies. Guggenheim's EBITDA is reportedly $250 million per year. In contrast, most CLO managers have far fewer assets under management, and their fee streams and EBITDA are much more modest. The median CLO manager in the LSTA Manager survey had assets under management of $18.8 billion.

Based on term lenders' assessments and lending criteria, obtaining term financing that could support risk retention obligations equal to 5% of the fair value of a CLO is unrealistic for all but a handful of managers. Even if a CLO manager managed ten $500 million CLOs, that manager would earn gross fees of only $25 million per annum (of which only $7.5 million is senior), based on a typical 50 bps per annum fee arrangement. Unless that CLO manager is part of a very large fund manager such as Guggenheim, the term lenders' criteria indicate that the CLO manager would likely attract no term financing and certainly not enough to cover the $250 million in equity or other securities that the proposed risk retention rules would require.

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[12] *See* Chris Donnelly, Guggenheim outlines talk on $700M term loan, Standard & Poors LCD Daily Wrap-Up, 5 (July 9, 2013), *available at* http://www.lcdcreditmarketnews.com/na/2013/07/09/LCD%20Daily%202013-07-09.pdf.

2. Prime Brokerage Firms

Prime brokerage is the other funding source theoretically available to CLO managers to finance their CLO risk retention requirements. The LSTA's discussions with the top four U.S. prime brokers (who together are responsible for fully half of the $1.6 trillion of prime brokerage loans outstanding), however, made clear that, for a number of reasons, CLO securities are not the type of assets that a prime broker would finance at any price.

Prime brokerage lending is essentially short term securities lending. The prime brokers indicated that they lend short-term against a percentage of the value of highly liquid securities. They stated that they finance only the most liquid and transparent securities, and the loans are subject to daily margin calls. Consequently, as the prime brokers explained to the LSTA, a security must have two main characteristics to be eligible for this type of financing: there must be a readily available market where the security can be traded immediately, and the security must be a type that the prime broker can lend (rehypothecate) overnight.

Prime brokers correctly perceive that CLO securities do not have either of these characteristics. The secondary market for CLO securities is relatively small and is conducted in a private, bespoke market where there is no ready market to execute a trade. Given this lack of liquidity, CLO securities could not be rehypothecated by the prime broker. Moreover, under the proposed risk retention rules, the CLO notes could not be sold or hedged, thus making them unavailable for rehypothecation in any event. The prime brokers therefore stated that they simply would not finance CLO securities.

The prime brokers further explained that CLO securities are even less attractive to prime brokerage firms because not only do they lack the required characteristics for prime brokerage financing, they are also highly correlated to the performance of the loan recipient (*i.e.*, the fund manager). In addition, CLO equity is already highly leveraged, and, as a matter of valuation, the prime brokers said that they would likely advance only a very small percentage of the notional value of equity – if anything at all – again leaving the CLO manger with a large gap to fill between the cost of the equity and the amount it could finance.

Finally, in addition to these practical obstacles to obtaining financing through prime brokerage, financing risk retention obligations with short term debt implicates important policy considerations. Federal Reserve Governor Jeremy Stein recently emphasized that banking regulators must safeguard against maturity transformation problems, and specifically noted that CLOs did not introduce this risk.[13] But funding CLO risk retention through prime brokerage could create such volatility and maturity transformation problems. CLO managers would, in effect, be borrowing short term on a mark-to-market basis in order to invest in long term assets. If the value of CLO notes began to drop, CLO managers would be forced to sell assets to raise money for margin calls – creating exactly the type of destabilizing spiral that transpired in many

[13] *See* Jeremy C. Stein, Governor, Speech at the "Restoring Household Financial Stability after the Great Recession: Why Household Balance Sheets Matter" research symposium sponsored by the Federal Reserve Bank of St. Louis, St. Louis, Missouri: Overheating in Credit Markets: Origins, Measurement, and Policy Responses (February 7, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/stein20130207a.htm#f19.

other markets in the 2008 financial crisis.[14]

II. STRUCTURING BANK ROLE

At the May 9, 2013 meeting, a major CLO portfolio manager provided an overview of the mechanics of CLO formation and the roles played by the different participants in CLO issuance. The legal implications of the role of structuring banks in CLO formation are especially important and underscore an important flaw in the rationale that certain agencies have offered for extending credit risk retention requirements to CLO managers.[15]

The manager described how the structuring (or agent) bank operates under a service agreement with the CLO manager, who in turn is acting as the agent for the CLO itself. In that capacity, the "structuring group," a separate unit of the structuring bank, generally underwrites and distributes the various tranches of the CLO securities and assists the CLO manager in obtaining the appropriate ratings from the rating agencies. Separately, the CLO manager will begin to identify a portfolio of loans that will be purchased with the proceeds of the securities issued by the CLO. Those loans are typically secured through purchases by the CLO manager in its sole discretion on behalf of the CLO from a range of sources, including the trading desks of many of the major investment banks. Among the sources may be the trading desk that is affiliated with the structuring bank itself. In those instances, the trading desk is a distinct business division from the structuring group, and, unlike the structuring group, is adverse to the CLO manager. Importantly, the CLO manager, as the purchaser of the loans on behalf of the CLO, is not directing or controlling the activities of the trading desk of any investment bank that is selling loans to the CLO manager. Conversely, no trading desk, including the trading desk affiliated with the structuring group, has any say in the selection of loans by the CLO manager.

As the manager's explanation at the May 9 meeting confirmed, a CLO manager is acting only as the purchaser of the loans – and that is so whether its actions are viewed independently or in conjunction with the acts of the structuring bank providing services under contract to the manager. Neither the CLO manager nor the structuring group acting on its behalf is selling or transferring securities, either directly or indirectly – much less doing so "to the issuer." Dodd-Frank Act Section 941(b) (Exchange Act §15G(a)(3)(B)). Thus, the CLO manager's role in assisting the CLO in purchasing securities does not bring the CLO's or the CLO manager's actions within the scope of Section 941, and the credit risk retention obligation imposed by that section cannot be applied to the CLO manager. This result also makes sense as a practical matter, because Section 941 was designed to address the structuring of securities offerings

[14] In theory, another possible source of financing could involve repurchase agreements ("repos"), in which a client sells a security to a bank on day one and repurchases it 30 to 90 days later at a pre-negotiated price that takes into account a financing premium. Because repurchase agreements require the transfer of title to the security, the LSTA does not believe such agreements are an eligible way to finance CLO securities in light of Section 941's prohibition on selling or hedging securities retained to meet the statute's risk retention requirement. In any event, LSTA contacted a prominent bank engaged in the repo business and confirmed that repos present the same limitations as other forms of financing (limited to well-capitalized counterparties, available only for AAA or AA CLO securities which could be financed only for 60%-85% of their value, and inherently short-term in nature). As such, repurchase agreements are not a viable way for managers to finance their risk retention requirements.

[15] *See* LSTA 2013 Third Supplemental Letter at 17–18.

posing risks arising from the originate-to-distribute model of securitization, which is absent for Open Market CLOs.[16]

* * * * * *

The LSTA's surveys described above confirm that the vast majority of CLO managers could not viably borrow funds, and do not have the internal funding, to purchase and retain 5% of the fair value of any new CLO notes. As a result, the managers anticipate that the proposed risk retention rules would cause a reduction in new CLO formation of approximately 75%.

Such dramatic costs are unwarranted and would be imposed without securing any public interest benefits. CLOs are an important source of financing to U.S. companies, do not engage in maturity transformation (and thus do not introduce this source of volatility into the market), are not originate-to-distribute securitizations, and played no role in the 2008 financial crisis. Imposing the agencies' proposed risk retention requirement on CLOs would serve only to shutter an otherwise robust market and slash lending to U.S. companies while delivering no countervailing benefits. The LSTA has pointed out that there are multiple alternatives available to avoid these drastic results while securing all the market and public interest benefits intended by the statute – including through the use of a targeted exemption and the risk retention structure set out in the LSTA's letter of April 1, 2013.

The LSTA would be pleased to discuss further these alternatives and the surveys set out above and appreciates the agencies' consideration of the additional information provided in these comments. Please contact Elliot Ganz at (212) 880-3003 or Meredith Coffey at (212) 880-3019 if you have any questions regarding the points or issues addressed in these comments.

Sincerely,

R Bram Smith

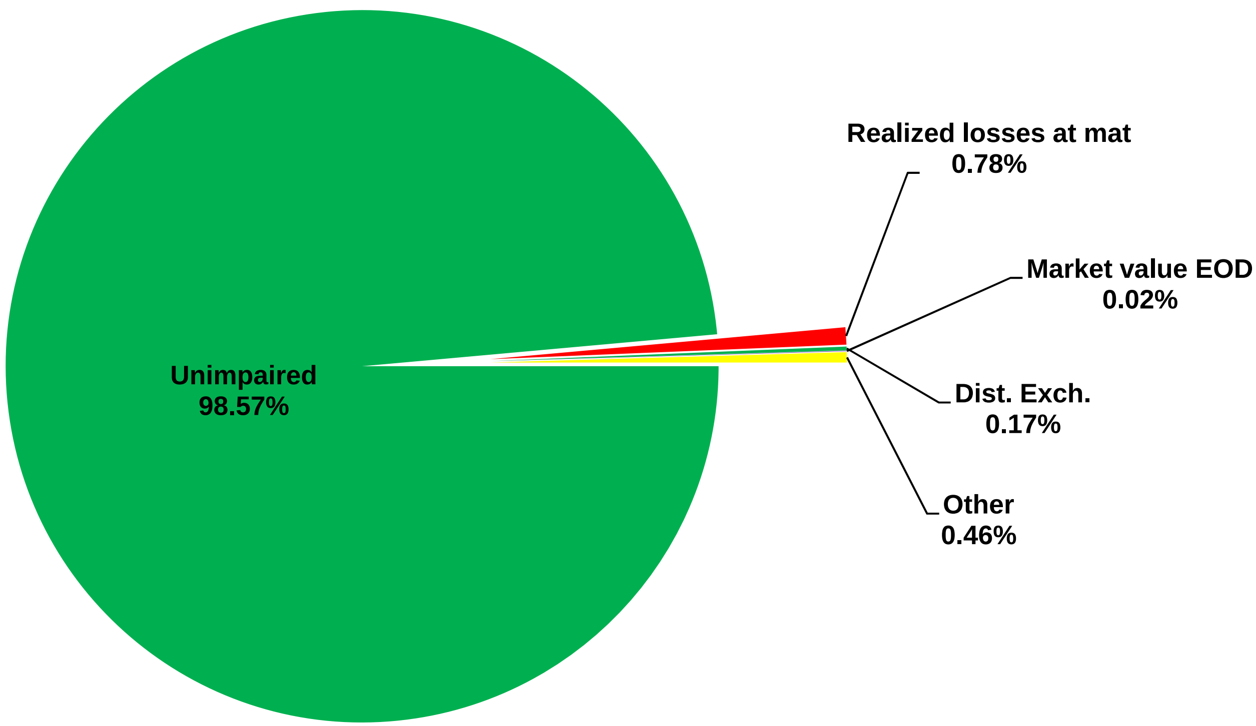
R. Bram Smith
Executive Director

[16] *See* LSTA 2013 Third Supplemental Letter at 16–18.

Appendix A

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

Cumulative impairment rate from Jan 1996 to May 2012



Source: Moody's Investors Service

Appendix B

AGGREGATE RESPONSES TO CLO MANAGER SURVEY

Fig. 1: Characteristics of Survey Respondents

	Total AUM ($Bils.)	Loan AUM ($Bils.)	CLO AUM ($Bils.)	CLO Count	Years of CLO mgmt
Total	7498.3	420.3	227.7	509	430
Mean	214.2	12.0	6.5	15	12
Median	18.8	8.8	5.2	11	13

Fig. 2: Expected CLO Formation Under Proposed Rules

Number of CLOs if managers have to retain 5% of fair value	0	1–2	3–4	>/=5
Count of respondents	22	6	1	6

Fig. 3: Fundraising

Could you raise funds?		
	Yes	12
	Uncertain	3
	No	20
If you could raise funds, how could you do it?		
	Borrowing	3
	Raising equity	3
	Combination	6
If you could raise funds, would you?		
	No	6
	Perhaps	4
	Yes	2

Fig. 4: Expected Impact on CLO Market

	Impact on your CLO mgt	Impact on market's CLO mgt
No Impact	14%	0%
Shrink it 50%	17%	14%
Shrink it 75%	17%	74%
Stop it altogether	51%	11%

Appendix C

www.ABAlert.com

Asset-Backed ALERT

THE WEEKLY UPDATE ON WORLDWIDE SECURITIZATION

JULY 26, 2013

Santander's Vision Extending Beyond Autos

Banco Santander is embarking on a major expansion of its consumer-financing arm in the U.S., with securitization as a key funding source.

The Dallas operation, Santander Consumer USA, until now has focused on writing and securitizing auto loans. Going forward, it plans to add personal loans, credit cards and private student loans to the mix.

Personal loans would be the first of those assets tabbed for securitization, likely during the first quarter of next year, with deals backed by credit cards and student loans following later in 2014. That sequence reflects the fact that the personal-lending push is closest to a full-scale launch.

Santander Consumer already has been buying unsecured loans to consumers with weak credit histories via a pilot program arranged with catalog retailer **Bluestem Brands** and peer-to-peer lender **LendingClub.** The agreement with Bluestem,

See VISION on Page 8

Regional Banks Locking in Higher Yields

Reversing what looks like a fortuitously timed exit from the market, regional banks have suddenly re-emerged as major buyers of asset-backed bonds.

After about a year of putting only minimal amounts of capital to work in the sector, about 10 of the institutions ratcheted up their new-issue purchases in recent weeks — including **BB&T, Fifth Third Bank, Huntington Bankshares, KeyBank** and **PNC.** The shops have been especially keen on floating-rate offerings in major asset classes including auto loans and credit cards, where they hope to lock in higher yields that took hold in mid-June.

The purchases are coming in amounts of $30 million to $40 million a pop. "They're the kinds of orders that drive the sale of tranches," one source said.

The heightened buying continues a series of flock-like shifts in regional banks' investment strategies. In mid-2012, when spreads on five-year credit-card paper with triple-A grades were hovering around 30 bp over one-month Libor, the shops

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Sweeteners Disappear for CLO Investors

Collateralized loan obligation underwriters are shying away from a long-held custom of offering different returns to investors in the same securities.

While it's unclear which banks have moved away from the "variable pricing" format, sources confirmed that several of the shops have drafted policies barring the practice in recent months while others have implemented informal bans. A few, however, have continued with the tactic.

Variable pricing most commonly serves as an enticement for an investor to take on a particularly large or hard-to-place batch of securities, with the buyer typically paying a slightly lower dollar price than other holders of securities from the same class. In some cases, the underwriters are the ones offering the sweetener. In others, it's particularly influential investors that insist on favorable treatment.

Likewise, there are conflicting accounts of whether underwriters or investors —

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THE GRAPEVINE

Eric Kolchinsky, the former **Moody's** executive who complained to the **SEC** that the rating agency knowingly assigned high grades to low-quality collateralized debt obligations, has a new job. Kolchinsky now heads a newly formed structured-securities group in the **National Association of Insurance Commissioners'** New York office, with a focus on defining the methods used to rate securitized products purchased by insurers. To start, however, he's developing a staff, policies and a technology infrastructure for the effort. Kolchinsky had been working as a consultant ever since Moody's fired him

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Banks Shoot Down CLO Financing

Collateralized loan obligation dealers are advising issuers in Europe not to expect financing for any securities they hope to retain.

The warnings appear to put a quick damper on an idea that some CLO managers in the region had been batting around in recent weeks: That they could meet more stringent risk-retention rules by tapping credit facilities from their underwriters.

The discussions had been among the latest to emerge in the wake of a May 22 announcement by the **European Banking Authority** that it would soon stop allowing CLO issuers to count equity held by outside investors toward a 3-year-old requirement that they retain 5% interests in their deals. Amid grumbling that the change would render many deals uneconomical, certain managers suggested that they could use bank financing to keep "vertical slices" of their offerings.

Under that scenario, the issuers would use cash to retain equity interests in the transactions while borrowing against those holdings to hold onto the issues' senior and possibly mezzanine slices. The problem is that underwriters have since let them know they would view such arrangements as carrying too much market risk. And even if a bank was willing to offer financing, it likely would do so only in the form of a 30-day repurchase agreement — which wouldn't be suitable for risk-retention purposes.

"Some people kind of flippantly are putting across the idea that you can just get financing for it," one dealer said. "People who traffic in this space, who know what banks do and what collateral they lend against, think that is not a practical solution whatsoever."

A CLO manager expressed a similar view, suggesting that banks' credit officers would be willing to lend against leveraged loans directly but not in the more-volatile form of a securitized transactions. Still, he's holding onto the idea that some underwriters might get on board if it led to more bookrunning assignments. ❖

Delays Don't Last for MBS Issuers

Improved market conditions have prompted **J.P. Morgan** and **Redwood Trust** to move ahead with mortgage-bond offerings that had been on hold.

After the values of home-loan securities took a beating along with other fixed-income products late last month, both issuers postponed jumbo-loan securitizations that had been on track for early July. But they've since changed their minds again, moving ahead with the deals after only slight delays.

J.P. Morgan's $621 million offering began making the rounds on July 22, with underwriting duties handled in-house. Redwood followed the next day by floating $400 million of bonds with **Bank of America** serving as bookrunner.

When they initially delayed the deals, J.P. Morgan told industry contacts that it might be back closer to the end of the month. Redwood said it would sit out until conditions improved, without setting a specific timeframe. Their faster-than-anticipated returns, meanwhile, can be attributed to a rebound in mortgage-bond values since then.

Indeed, indications are that Redwood stands to place a five-year batch of triple-A-rated bonds from its transaction at spreads that would be roughly in line with the 221 bp level achieved for a similar piece of its last broadly distributed securitization on June 12. Had it tried to price the bonds around the end of last month, the REIT likely would have paid some 30 bp more, a source said.

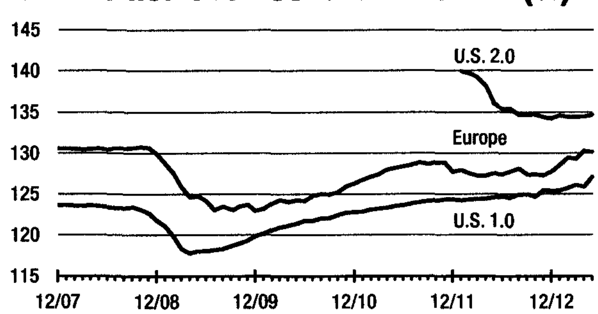
A five-year slice of pass-through securities from J.P. Morgan's deal is making the rounds at 215 bp over swaps.

Redwood has completed eight SEC-registered jumbo-mortgage securitizations totaling $4 billion this year, plus one privately placed deal of $463.6 million. J.P. Morgan has completed two transactions totaling $1 billion. It was last in the market May 29 with a $442.5 million issue. ❖

CLO Performance Diverges

Performance indicators for collateralized loan obligations completed before the credit crisis headed in opposite directions in May, depending on the location of the deals' collateral. In Europe, managers took advantage of strong demand for leveraged loans from distressed-asset funds to unload some of their lower-rated receivables, **Moody's** analyst **Aniket Deshpande** said. The result was that the percentage of loans rated "Caa1" or lower in their CLO pools fell 158 bp to 11.22%, according to an index maintained by the rating agency. At the same time, senior over-collateralization levels among those deals fell 10 bp to 130.1%. In the U.S., the volume of loans with "Caa1" ratings in so-called CLO 1.0 pools rose 60 bp to 6.5%. But senior over-collateralization levels improved 149 bp to 127.08%. With that in mind, Moody's upgraded 287 classes of securities from 107 pre-crisis CLOs on July 15. Among CLO 2.0 transactions — those completed in 2010 and later — performance indicators remain strong. Senior over-collateralization levels for those deals were up 20 bp in May, to 134.67%.

CLO Senior Over-Collateralization (%)



Source: Moody's