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July 29, 2011

Office of the Comptroller of the Currency  
250 E Street, S.W., Mail Stop 1-5  
Washington, D.C. 20219

Federal Deposit Insurance Corporation  
550 17th Street, N.W.  
Washington, D.C. 20429

Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

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

Federal Housing Finance Agency  
1700 G Street, N.W.  
Washington, D.C. 20552

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

### **By Electronic Submission**

**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:

Attached are comments in response to the joint Notice of Proposed Rulemaking concerning the credit risk retention requirements authorized by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

These comments address collateralized loan obligation (“CLO”) directly but may have implications by analogy for other asset classes.

I submit these comments as a Senior Fellow of the Center for Financial Stability (CFS), but the views presented here are solely my own. They are based on my work at CFS (which included discussions with a number of market participants and other experts), my prior experience as a Senior Managing Director in Strategic Finance at Bear Stearns and on my insights from serving as a Senior Research Consultant to the Financial Crisis Inquiry Commission.

Respectfully submitted,

Kim Leslie Shafer  
Senior Fellow  
kshafer@the-cfs.org

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### Risk Retention for CLOs: Achieving its Objectives

**Kim Leslie Shafer**

July 29, 2011

#### Introduction

Section 941 of the Dodd Frank Act (DFA) was enacted because investors, including systemically significant financial institutions, suffered catastrophic losses, the result of very poor quality mortgages originated and securitized into mortgage-backed securities and then re-securitized into collateralized debt obligations (ABS CDOs<sup>1</sup>). Loan originators and securitizers were compensated based on the volume of production irrespective of the quality of the loans; they lacked ongoing “skin-in-the-game.” As an antidote to this originate-to-distribute model, the statute requires all securitizers or originators to be exposed to the risk of loan performance over time thereby incentivizing greater care about their creation. The theory is that retaining risk will better align the interests of the creators of the products with those of the ultimate investors, along the way counteracting asymmetries of information available to these different parties, thereby leading to better loan quality.

The Notice of Proposed Rulemaking (NPR) attempts to implement Section 941 by designing risk retention rules for securitization on an asset by asset basis; this means that the rules established for credit card securitizations may follow a different architecture than those for residential mortgage backed securities (RMBS) and those for collateralized loan obligations (CLOs). Since the risk retention rules for RMBS are inevitably tied to the future of Fannie Mae and Freddie Mac, second liens and other vexing issues, focusing instead on CLOs allows for a somewhat simpler practical look at the concept of risk retention, its merits and pitfalls, and alternative solutions.

These comments responds to three questions raised in the NPR and proposes alternative and more direct means to achieve the objectives of risk retention, as summarized below:

**(1) Should CLOs be exempt from risk retention?** No. The institutional segment of the loan market became an originate-to-distribute market with CLOs as the dominant investors. This led to analogous dynamics – although much less devastating results – as occurred in the mortgage and ABS CDO market. The similarities between the two experiences (loans and CLOs vs. mortgages and ABS CDOs) all relate to misaligned incentives and argue against exempting CLOs from risk retention. The differences between the two relate fundamentally to the quality and transparency of information, thereby highlighting different needs for improving information.

**(2) If risk retention applies to CLOs, then who should retain the risk?** Loan originators should take the predominant share as they have the most control over loan quality. CLO underwriters should participate because they too lack an alignment of interest with investors. Regulators have suggested

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<sup>1</sup> Many types of CDOs exist. Those composed of subprime RMBS, including mortgage derivative forms thereof, became known as ABS CDOs since subprime is considered an asset backed security (ABS).



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that CLO managers should be subject to risk retention<sup>2</sup>, and the incentives of CLO managers could be better aligned with investors than current practice. However, any risk retention imposed on managers by regulation should count fees as “sweat equity” risk retention, since many managers have limited access to capital. A sharing arrangement among two or three of these parties is appropriate.

(3) **Should the “permissible form” of risk retention differ depending on who retains the risk?** Yes. Regulators have offered up a menu of vertical, horizontal, random sample and other slices of risk as “permissible forms” of risk retention; loan originators would retain a portion of the loan facility and CLO securitizers would purchase a CLO slice. Any of these options could align interests between originators or securitizers and investors, with one caveat. Horizontal slices of tranching products are inherently subject to mispricing by underwriters, and such mispricing can feed bubbles. In fact, horizontal risk retention (of ABS CDOs and RMBS by underwriters) contributed to the financial crisis and demonstrates that risk retention alone could increase rather than diminish risk in the financial system. As a more effective and less perilous means of aligning interests than investing in loan or CLO slices, regulators should consider fees earned over time<sup>3</sup> payable in some subordinated position – to loan originators, CLO underwriters and CLO managers – as an allowable form of risk retention.

(4) **Can the objectives of risk retention be achieved by other means?** Yes. Risk retention is now embodied in statute and should not be repealed unless and until both interests have been aligned better and asymmetries of information ameliorated between product creators and investors. That said, the better policy would be to resolve both the misalignment and the information issues directly – largely by steps that private sector market participants could organize to take. Compensating originators or securitizers over time based on the performance of their products would change incentives directly.<sup>4</sup> Requiring the collection and disclosure of certain *market-wide* information not currently available could also prove surprisingly powerful in shifting incentives towards good performance of loans and CLOs, rather than merely greater volume.

Since risk retention is a response to the financial crisis, understanding the dynamics of certain expansionary forces in that bubble is essential. I contend that no loan or CLO market participant was positioned to provide market discipline, including CLO investors. Instead, competitive pressures within the syndicated loan and CLO markets exacerbated the financial crisis and supported self-reinforcing bubbles. Part I of these comments outlines the bubble dynamics of the originate-to-distribute loan market and its interplay with CLOs. Banks, when they stopped retaining meaningful loan exposures, stopped providing market discipline and looked instead to distribute whatever investors would accept (just as in the mortgage market, although with much less excess). CLOs subsequently became the dominant buyers of institutional loans, just as ABS CDOs became the (even more) dominant buyers of

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<sup>2</sup> Other commentators on the NPR have argued: (1) CLOs have performed generally as expected -- their market price nosedive during the financial crisis, notwithstanding. (2) The plain language of DFA does not apply to CLO managers as “sponsors” of a securitization. (3) If CLO managers must retain the proposed 5% *of par* – rather than 5% of the *credit risk* of a securitization – CLO new issuance will largely stop and that segment of demand for leveraged loans will disappear. See e.g. comment letter dated June 10, 2011, from American Securitization Forum, pp. 133-8. This comment letter does not contradict those contentions; rather it focuses on other market dynamics and competitive pressures to illuminate broader policy.

<sup>3</sup> Such fees should be recognized as income only when received and should not be hedged or sold.

<sup>4</sup> This approach could be readily implemented if fees were paid over time at some subordinated level. Current discussions that tie increasing amounts of bankers’ compensation to their company’s stock price performance provide much less direct incentives, with many intervening variables and uncertainties.



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subordinated subprime RMBS. The incentives of CLO and CDO managers, as well as the design of these products and the knowledge base of their investors, contributed to expanding bubbles. Yet CLOs clearly had a materially milder impact than ABS CDOs; why and how matters to the prescription for risk retention.

With this background, Part II then explores the efficacy of risk retention for CLOs as a proposed solution to these bubble dynamics. For banks, whether as loan originators or CLO securitizers, risk retention may align interests but will provide market discipline only if implemented together with improved risk management and appropriately aligned compensation policies; implementing risk retention alone will not correct the tendency towards bubbles. Not only will risk retention likely fail without these additional measures, risk retention may be an unneeded burden if these measures – along with certain information improvements – are in place.

While more comprehensive information about individual companies and loans would contribute towards better market discipline, the collection and dissemination of certain new market-wide information could make a marked difference in diminishing loan bubbles. Banks compete vigorously in volume-based league tables, but data on loan performance by agent banks or CLO performance by underwriter is difficult to find and its absence reinforces the inadequate concern for loan quality. Other information about the loan market and the distribution of CLOs, if widely available, could also make a material difference in flagging excesses in the markets. These more direct measures to counter conflicts of interest and to supplement gaps in information would more effectively support market discipline and have fewer unintended systemic negative consequences than risk retention alone.

### Part I: How the Problems with Loans and CLOs Developed

**Part of the syndicated loan market became an originate-to-distribute market.** The syndicated loan market developed as a means for banks to provide large loan facilities to companies without violating prudential regulations for single-borrower exposure. A lead or agent bank would organize a group of banks to provide jointly the loan so that each would own a reasonable sized piece. Historically, commercial banks that syndicated loans kept a portion of the loan (often called term loan A's<sup>5</sup>) in their portfolios, but this practice markedly changed with the development of term loan B's. Agent banks distributed all of the syndicated term loan B to institutional buyers and retained none if possible, although the agent bank did tend to retain part of the short-term revolving lending facility to the borrower. Investment banks that originated term loans distributed them much as they did high yield bond<sup>6</sup> offerings. The distribution to institutional investors technically occurred in the secondary market<sup>7</sup>, but the time between the closing of the loan facility and sale of the loans to investors was quite short. Banks liked the originate-to-distribute business since it generated fees without any continuing regulatory capital charges if loans were sold down to zero.

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<sup>5</sup> Some loan facilities have term loan A's and B's, which would be *pari passu*. However, often term loan B's displaced the A's entirely. Their differences reflect their design for banks or for institutional buyers. Term loan A's tend to be shorter in maturity than term loan B's; also A's amortize whereas B's are essentially bullet maturities. Term loan A's tend to be rated BB and have lower yields than term loan B's which more commonly are rated single-B or occasionally CCC and yield more.

<sup>6</sup> High yield bonds, unlike leveraged loans, are securities and are covered by investor protections of securities laws.

<sup>7</sup> CLOs may not buy loans until they have entered the secondary market.



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The originating banks competed for syndication business from corporate borrowers based on relationships and their ability to distribute loans on terms favorable to borrowers, including higher leverage, looser covenants and lower borrowing rates. Once banks stopped retaining meaningful loan exposures, they stopped providing market discipline and looked instead to distribute loans on whatever terms investors would accept.

**Underwriting standards declined as the distribution of loans to institutional investors, including CLOs, became the dominant model.** Leverage multiples increased, the proportion of covenant-lite loans grew, dividend recapitalizations became more common and more single-B rated loans (rather than BB-rated) were issued during the boom years preceding June 2007. CLO volume, including the number of CLO managers, grew rapidly starting in 2003. Low interest rates during this extended period may well have influenced this decline in standards even more than the development of the CLO market. Nonetheless, investors are a diverse group and became materially more numerous with the CLO market's rapid expansion.<sup>8</sup> Loan investors primarily negotiated on interest rate or price rather than covenants or degrees of leverage (with the latter terms primarily negotiated by the agent banks). Another factor that contributed to declining underwriting standards was that CLOs were better able to accommodate single-B rated loans than other, more conservative loans.

**The quality of loan information declined over the past decade.** As the number of investors in a loan syndication increased from one or two dozen banks to one or two hundred CLO managers and other institutional investors, companies communicated less.<sup>9</sup> Banks themselves, when they no longer retained<sup>10</sup> significant loan exposure, performed less in-depth credit analysis on those borrowers. At the peak of the credit bubble syndicating banks allowed investors only a day or two to evaluate credits before indications of interest had to be submitted, whereas a decade ago investors typically had a week to review documents, perform analyses and attend issuer calls/meetings. When each investors' allocation amounted to only a few million dollars in size - especially common for CLO managers - the economics to support in-depth diligence also declined.<sup>11</sup> Further, when competition for assets heated up, managers who asked many questions or requested time for analysis did not see their allocation requests fulfilled. These troubling trends allowed borrowers to make more aggressive assumptions about their business prospects and/or negotiate less restrictive covenants, but truly inaccurate information was not a significant issue with loans - unlike mortgages.

**The CLO market contributed significantly to the loan bubble.** Initially the institutional buyers of syndicated loans were largely loan mutual funds, insurance companies, high yield funds and hedge funds. The highly levered loan market grew rapidly from 2003 through the first half of 2007 in line with the meteoric expansion of the CLO market. Indeed, CLOs exceeded 60% of the institutional loan market each year from 2000 through 2006.<sup>12</sup> The extensive demand from CLOs for loans allowed many

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<sup>8</sup> According to S&P, in 1997, approximately 40 institutional managers invested in leveraged loans across 67 vehicles. By 2005, 225 managers participated in the leveraged loan market, across 571 vehicles.

<sup>9</sup> Other causes may include Regulation FD. Whatever the cause, loan investors tend to agree that quality declined.

<sup>10</sup> These statements apply to loan facilities for larger companies. Middle market loans tend to be distributed to a small group of investors and the originator tends to retain a significant portion of the loan facility.

<sup>11</sup> Perhaps large institutional investors with larger allocations could drive a better process were they a more significant share of the market.

<sup>12</sup> S&P Leveraged Commentary & Data.



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companies access to loan financing that otherwise would have had to rely, or rely more heavily, on issuing high yield bonds.<sup>13</sup>

CLOs as buyers of loans are different from most other loan investors in several respects that, taken together, tend to support the expansion of asset bubbles: First, loans once within CLOs are not marked to market by design (except for “market value CLOs”). Marking the loan portfolio to market could indicate how risky the loans are but does not necessarily indicate how the CLO is performing – for example, if loans bought at lower prices increased overcollateralization, the CLO ultimately could benefit. Second, CLOs by design are term financing and their managers typically cannot be fired easily – unlike a loan mutual fund where investors can pull out their money rapidly. Third, once a CLO is raised the manager generally must keep the funds invested in loans rather than cash.<sup>14</sup> CLOs managers are thus under less immediate scrutiny than other loan managers and have incentives to keep buying loans even if they fear a loan bubble.<sup>15</sup>

**While loan originators look to loan investors to provide market discipline, CLO investors are particularly ill-suited to provide that discipline.** CLO investors effectively choose an asset class, hire a manager and then invest for a particular risk-return by choosing a certain tranche. While many CLO investors became knowledgeable about the structural features of this product, many were not. In the end, CLO investors relied on the track record of the managers and the risk profile determined by the rating agencies in making investment decisions. Mostly, CLO investors were not knowledgeable about individual loan positions and were too far removed to influence loan underwriting quality. CLO investors may not have understood the correlation models of the rating agencies, although reviewing stresses of different loan default and recovery assumptions was commonplace.

Moreover, CLOs by design are more illiquid longer term investments than mark-to-market vehicles. This makes their performance more difficult to measure except over long periods of time. Additionally, good market-wide performance can mask less discriminating credit work by a manager. Given that CLO investors may not know how their investments will turn out for several years, their ability to provide discipline in the loan market is limited. In the absence of such pressure from their investors, CLO managers cannot effectively provide loan market discipline either.

**The CLO-magnified bubble in the loan market exacerbated the financial crisis.** Agent banks became overly dependent on the CLO “take-out.” They made firm underwriting commitments with the expectation that demand from CLOs would continue to allow quick distribution of syndicated loans.

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<sup>13</sup> Indeed the institutional segment of the highly levered market shifted from 8% in 1997 to 57% in 2007 with high yield bonds declining from 40% to 20%. Institutional term loans replaced both bonds and other loan facilities. Source: S&P/LCD, Thomson Reuters LPC, Merrill Lynch. In addition, second liens, which are in essence a hybrid between loans and high yield bonds, developed to provide higher yields for higher risk to hedge funds and CLO buyers (until rating agency rules changed in 2007 to make them less attractive to CLOs).

<sup>14</sup> Even though new CLO issuance mostly stopped in 2007, many existing CLOs are still within their multi-year reinvestment periods – meaning that they must replace loans that mature. CLOs consequently have continued as a source of demand. Note that even with very limited new issuance CLOs currently remain nearly 40% of loan investors.

<sup>15</sup> Note that the converse is true as well. Upon the bursting of a bubble, mark-to-market leveraged investors can create greater downward price volatility whereas CLOs can better ride out the storm. Loan investors using total return swaps (TRS) for leverage who could not raise additional capital were subject to forced selling of their portfolios; this phenomenon was part of the loan price collapse in 2008.



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When the CLO market abruptly shut down in the summer of 2007, banks were saddled with enormous loan commitments reaching \$300 billion. Loan prices started to drop from par to below 90 in February 2008 but did not really crack until September 2008. In December of that year loan prices declined to unprecedented lows in the mid-60s.<sup>16</sup> Previously, syndicated bank loans had never dropped below the 90s. Just at a time when bank capital and liquidity were scarce because of mortgage related losses and SIVs, the huge loan exposures of too-big-to-fail (TBTF) institutions compounded the problem. Thus, the firm underwriting of loans by banks exacerbated the credit crisis. In effect, the market suddenly enforced not just 5% but 85+% risk retention on the agent banks and they lacked the supporting capital, not to mention the long-term oriented credit analysis, to hold the loans.

**The same incentives existed in the CLO market for managers and underwriters as existed in the disastrous ABS CDO market. Only the differences between the two products explain the vast differential in their performance.** CLO managers, as well as other loan asset managers, seek to add assets under management in order to earn fees. Both ABS CDOs and CLOs allowed managers to grow assets for an expected term of five to ten years with limited capital investments.<sup>17</sup> Small groups of asset management professionals, often on the basis of track records at larger institutions, could set up shop. This often benefited individual managers, many of whom had significant expertise, but it did add to competitive pressures, whether in growing demand for loans to fill CLOs or for subprime securities to fill ABS CDOs, and did mean that smaller managers needed to do a certain number of deals to keep the lights on. Short-term pressures to raise enough assets could overshadow a less conservative manager's desire for good long-term performance for investors.

Initially, market practice had been for CLO and CDO managers to invest in a meaningful first loss or equity tranche to demonstrate an alignment of interests with investors, but this practice diminished over time for several reasons. Many smaller managers lacked capital and even some larger managers did not have a ready source of capital. Also, underwriters that wanted managers to retain more than a token equity slice would lose business to other dealers who offered more relaxed terms. CLO investors in turn were so eager for allocations that they did not insist; in addition, investors in the senior tranches saw a potential conflict of interest between buying the safest loan collateral (their interest) and the highest yielding collateral (equity investors' interest) so they did not insist on equity participation by managers. Conversely, investors in equity sometimes were insufficiently sophisticated to insist on this and at other times were too disparate to have enough market power to insist. Then, as equity participation by managers diminished, more and more credit professionals sought to become CLO and CDO managers, thereby feeding the demand for product and the respective bubbles in loans and RMBS.

The differences between their products, rather than the incentives for their managers and underwriters, explains why ABS CDOs performed so poorly and CLOs did not. ABS CDOs and CLOs both relied heavily on rating agency assumptions and methodologies, but the similarities between the two products end there. Rating agency assessments proved largely correct for CLOs and disastrously wrong for ABS CDOs. For ABS CDOs both the ratings on the underlying RMBS and the correlation assumption for creating the CDO capital structure were seriously miscalculated and/or were premised on inaccurate data. For CLOs,

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<sup>16</sup> LSTA/LPC Mark-to-Market Pricing.

<sup>17</sup> CLOs were less levered than ABS CDOs so that a manager who did invest in 20% of the equity in a \$300 million CLO would need roughly \$5 million whereas a similar percentage in a mezzanine ABS CDO could be only \$2 million. Also, loan collateral had to be acquired at premium prices whereas subprime ABS sold at discounts to par; this contributed to the smaller equity amounts needed for ABS CDOs.



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the rating agencies' track record in rating the underlying loans was relatively good – Enron and Worldcom, notwithstanding – and the correlation assumption regarding loans (which relies on diversification by industry) proved far less problematic than with ABS CDOs.<sup>18</sup> Further, the information available to loan investors, including CLO managers, turned out to be far more accurate than mortgage information provided to RMBS investors. This is not surprising since many more informed parties get involved in the origination of corporate loans. Only the mortgage broker, the originating lender and perhaps a due diligence firm typically reviewed mortgage files. In contrast, for corporate loans, accountants, auditors, lawyers, rating agencies, bank supervisors, as well as the originating lender reviewed the company, so misrepresentations tended to be few. Another difference between the two products stems from ABS CDOs being a re-securitization; running stresses of assumptions for the underlying collateral in analyzing an ABS CDO was quite difficult to do whereas analyzing different default and loss assumptions for loans – and their timing – was relatively straightforward for CLOs. As a consequence, subordinate CLO investors may have relied less on ratings and more on their own views of expected loan defaults. Note that these differences in performance all relate to the quality of information provided and investors ability to analyze that information. However, in 2007 CLO investors did not make these distinctions between CDOs and CLOs and fled the market.

Another development significantly differentiated the ABS CDO market from the CLO market: mortgage credit derivatives came to dominate (synthetic and hybrid) ABS CDOs whereas synthetic loan collateral and correlation trading had little effect on CLOs. Often equity exposure to ABS CDOs was merely part of a trading strategy net short of mortgages, whereas equity investors in CLOs wanted to be long loans. This need to raise real equity dollars from third party investors moderated the CLO-led loan bubble, while its absence accelerated the bubble in mortgages and ABS CDOs. Synthetic versions of loans, called loan credit default swaps or LCDS, could develop more broadly in the future and lead into similar treacherous territory.

**How CLOs exacerbated the financial crisis is quite different from how ABS CDOs significantly contributed to causing the crisis.** ABS CDOs were disastrous because they supported and exacerbated the bubble for subprime mortgages and because the value of their most senior AAA-rated tranches fell from par to pennies. These prices did not recover as the underlying mortgage backed securities (rated AA down to BBB) became almost worthless from mortgage losses many multiples higher than those expected. In contrast, pricing for CLO tranches followed the plunge in loan prices cited above, dropping to the 60s for AAA rated tranches but then rebounded sharply in 2009. Many observers in 2008 had expected annual syndicated loan default rates to skyrocket to 15% or even 20% but the rate jumped to 12% and only briefly. Both loan and CLO prices then recovered, to the high 90s currently for loans and low to mid 90s for CLO AAAs. CLO downgrades were widespread as the rating agencies changed their criteria, but only two defaults occurred and upgraded ratings are now pending as the rating agencies moderate their criteria.

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<sup>18</sup> ABS CDOs are a re-securitization of already securitized subprime mortgage-backed securities. CLOs in contrast are a first order securitization of rated loans to corporations. The length of performance history relied upon by the rating agencies for assigning subprime ratings was quite short, whereas corporate ratings have a track record dating back to the 1930s.



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CLO underwriters did not retain significant risk exposure to CLO tranches in the same way certain TBTF institutions did with their ABS CDOs.<sup>19</sup> Perhaps this was another reason that the CLO market remained smaller than the ABS CDO market, thereby inflicting less damage. The broader distribution of CLO AAA paper also meant that the 40 point rather than 90+ price crash was broadly distributed amongst banks and monolines. Since CLO paper did not default – unlike the ABS CDO tranches – many investors did not have to mark these positions to market.

While this discussion generally supports the good performance of CLOs, two cautionary comments are warranted. The loan market was unfairly hurt by the mortgage and ABS CDO mess but it was also partially saved by the abrupt end of the credit bubble. In other words, if the CLO market had not shut down in 2007, loan quality and ultimately CLO performance might well have deteriorated far more. Second, many loans owned by CLOs are approaching their maturity dates, often referred to as a “wall of maturities.” CLOs are current buyers of loans as they must replace any runoff, but reinvestment periods for outstanding CLOs will largely end in 2012 to 2014. If the existing loans cannot successfully be refinanced in the present environment (because too few CLOs are being issued and other demand does not materialize), then loan defaults could increase significantly causing CLO performance to suffer. If loans and CLOs perform well only when loans can be refinanced and purchased by new CLOs, then touting their strong performance is merely a circular argument.

### Part II: Risk Retention Does Not Address the Problems as Effectively as Other Measures Can

Risk retention rules are designed primarily to counteract the misalignment of interests, including those that result from asymmetries of information, inherent in any originate-to-distribute securitization process.<sup>20</sup> Such conflicts of interest, along with information disparities, exist between loan originators and loan investors as well as between CLO underwriters and CLO investors. CLO managers, of course, are both loan investors and parties to CLOs with somewhat divergent interests from CLO investors. Examining information and conflict issues in the loan and the CLO markets separately reveals the limited utility of risk retention alone.

The nominees for retaining risk under the NPR are some combination of CLO managers, CLO underwriters and loan originators – or perhaps a third-party if the CMBS model is followed. The very arguments that suggest CLO managers do not fit within the plain language of DFA support the understanding that CLO underwriters are “securitizers” for risk retention purposes<sup>21</sup> and agent banks are “originators.” The discussion below considers these parties and how better to align interests and improve information flows in order to moderate the development of asset bubbles.

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<sup>19</sup> A possible explanation for this difference is that the natural arbitrage for CLOs worked better but that ABS CDOs needed very tight pricing of the AAA tranche for the arbitrage to work. Banks with balance sheets thus took on super-senior exposure because the fee income from the ABS CDOs was attractive.

<sup>20</sup> Federal Reserve Board, “Report to Congress on Risk Retention” (October 2010). A third element is pro-cyclical economics, as discussed in Financial Stability Oversight Council, “Macroeconomic Effects of Risk Retention Requirements” (January 2011).

<sup>21</sup> A “securitizer” is defined as an ABS issuer or “a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.” DFA Section 941(b). Typically, the CLO underwriter finances the accumulation over 6 to 9 months of 50% to 90% of the initial loan assets by the (special purpose vehicle) CLO issuer until the CLO securities are issued at closing. Managers select the loans, but the CLO underwriter does the transferring and takes the market value risk of the accumulating portfolio should the CLO fail to close.



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**Loan originators are best positioned to control loan quality but are insufficiently incented to do so.** In the loan syndication process the misalignment of interests between originators and investors is a greater concern than information asymmetries. As discussed previously information asymmetries may have led to increasingly optimistic assumptions in the loan market, but the veracity of company information and ratings generally were not problematic. Instead, the lingering concern in the originate-to-distribute loan market is that all short-term incentives promote volume over quality. Loan originators have short-term incentives to increase volume/issuance and only more limited inchoate long-term “franchise” incentives related to loan quality. Competitive pressures mean that loan syndicators compete for assignments from borrowers by offering the most flexible terms. Compensation for the banks and the bankers is based on origination volume, not loan quality, on revenue generated rather than loan performance.

Were originating banks to retain unhedged part of each syndicated loan, their incentives would be better aligned with investors’ interests; information about companies might become less superficial and leverage might be more restrained.<sup>22</sup> Also, a more appropriate allocation between high yield bond financing and loan financing might be restored, if banks hesitated to provide the most highly leveraged or loosely covenanted loan financing. However, requiring originators to retain risk could merely increase the risk on TBTF bank balance sheets without improving loan quality. This is the conundrum of risk retention.

**Bank regulatory agencies supervise the loans on banks’ books but cannot provide sufficient loan market discipline.** Bank supervisors very extensively review syndicated loans but in the end they have limited resources and are no longer reviewing all loans. They do not review as intensely those syndicated loans that are fully distributed to investors. Furthermore, if a loan has been completely distributed, agent banks may not keep as extensive ongoing information so that bank supervisors will not see performance information about loans of size to the financial system. Former Comptroller of the Currency John Dugan advocated that banks should not have lower underwriting standards for the loans they syndicate and fully distribute than those for loans held in portfolio<sup>23</sup>, but this proposal has not been implemented across the loan market. Also, some bank holding companies do not retain portfolios of loan exposure outside their trading activities. Were banks as “originators” required to retain risk exposure to the loans they distribute, supervisors would see these loans and capital standards would apply. However, it is also worth remembering that the bank regulators did not prevent the hung loan problem in 2007 – as they, like the banks themselves, had come to believe in the voracious CLO demand for loans. DFA empowers regulators to review employee compensation arrangements that encourage inappropriate risks<sup>24</sup>, but they have thus far shown reluctance to use this authority expansively. Thus, relying on bank supervision seems as dubious as relying on rating agencies or CLO investors to provide market discipline.

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<sup>22</sup> The significant asymmetry of information is between the company that is borrowing and the investors who are lending. The (private) equity investors in the company that is borrowing have the most skin-in-the-game and have the incentive to do a thorough review before investing in the company. Historically, such sponsors would add equity if a company ran into trouble, and loans had very high median recovery rates as a result. However, equity investors who have earned fees or dividends, thereby significantly reducing their effective equity investment, may become less willing to prevent defaults.

<sup>23</sup> See e.g. <http://www.occ.treas.gov/news-issuances/news-releases/2007/nr-occ-2007-109.html>.

<sup>24</sup> DFA Section 956(b).



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**CLO underwriters' interests, like loan originators' interests, are misaligned with investors. Paying placement fees over time and based on product performance would more directly align interests.** As with other investment banking transactions CLO underwriter fees are based on origination volume, are paid at closing and are not related to the ultimate performance of the loan or transaction. CLO bankers in turn are compensated based on revenue generated rather than CLO performance. The conception has been that bankers, as well as rating agencies<sup>25</sup> and other professionals, have completed their role once the CLO securities have been created and distributed.

Underwriters and CLO managers are incented to arbitrage the rating agency criteria, thereby promoting greater statistical risks than the CLO models measure. Like their compatriots in loan origination, bankers do not stop issuing deals when markets are overheating.<sup>26</sup> Their incentives are to continue and not to ask market-wide questions.

One way to redirect underwriters' focus would be to pay placement fees over time, rather than upfront at closing, and at some subordinate level. Relating the receipt of fees to CLO performance would align underwriters' and investors' interests, even without a risk retention investment of capital. Such fees would directly tie bankers' incentives to product performance.<sup>27</sup> At a minimum, fees structured in this way should count as a "permissible form" of risk retention. Such a rule would not stop bubbles but it might well slow them down – which could materially limit their destructiveness.

**Among the parties who might retain risk, CLO underwriters should participate but they should not retain horizontal slices of CLOs.** The parties that might be required to retain risk could include the loan originator, the CLO underwriter, the CLO manager or perhaps a third party investor in CLO equity. As argued above, loan originators are in the best position to control loan quality, and regulations should favor their dominant participation. CLO underwriters, however, are the parties that indirectly purchase the loans for a CLO securitization and thereby may become subject to this regulation as "securitizers."

Requiring underwriters to retain a horizontal first loss position should set off warning signals, despite better aligning interests with investors. A key cause of the financial crisis, after all, was oversized risk retention of ABS CDOs by certain TBTF institutions. Some of those institutions retained enormous exposure to the senior most tranches at prices below market clearing levels, thereby effectively subsidizing CDO originations and increasing their issuance. The CDO bankers did not object to the subsidy as it enabled them to issue more CDOs and generate more fee income, for which they took credit without regard to their banks' retained exposure. Risk retention of horizontal or equity portions of CLOs by underwriters inevitably would lead to mispricing of those (riskiest of) tranches. A narrow vertical slice would mean that market distribution of the remainder would establish unsubsidized pricing, whereas a horizontal slice would not.

Bank capital requirements will vary depending on which type of risk is retained. (The low capital charges against super senior ABS CDO slices had encouraged their excess retention and thereby their excess

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<sup>25</sup> Shifting rating agency fees to a smaller upfront and larger ongoing, monitoring fee would better align their interests as well.

<sup>26</sup> Despite these incentives, disclosure and information issues have not to date been a significant concern about individual CLOs. This may result from the absence of derivatives, which came to dominate ABS CDOs, or more simply from the rebound in CLO prices.

<sup>27</sup> Bankers might prefer this sort of deferred compensation arrangement were it an alternative to substantial compensation in company stock, which necessarily more indirectly relates their work to their compensation.



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origination.) The capital charge for loans or vertical slices presumably would be 7 to 8%. This charge might well discourage banks from originating CLOs were they alone to bear the full risk retention load. The capital charge for CLO equity, however, should be close to dollar for dollar as the risks of loss are considerable.<sup>28</sup>

**Risk retention alone will not correct the tendency towards bubbles. Risk retention requires improved risk management and appropriately aligned compensation schemes.** Risk retention does address the misalignment of interest, as retaining part of a loan gives the bank an interest in its performance. The theory is that banks would perform intensive credit underwriting – both in terms of information gathering on companies and negotiating covenants and leverage – once they put their own balance sheet at risk. Similarly, CLO underwriters in theory might slow down in an overheated market or rebalance investor protections. In theory, proper capital, loss reserves and risk management would somehow inevitably follow retained risk. Yet, if the revenue from origination is all recognized at closing irrespective of future performance, and banker performance reviews and compensation are related only to upfront revenue, then risk retention could merely add to bank risks rather than change any incentives to improve loan or CLO underwriting. Good risk management, again as recent history attests, does not inevitably follow bank investments; in fact, it typically loses out to revenue pressures.

If risk retention requires proper risk management and compensation incentives to fulfill its objectives, it may be simpler merely to implement the latter rather than the former. The fee arrangements suggested above are a direct way to align incentives.

**CLO managers' interests are not fully aligned with investors under current fee arrangements without an equity or sweat equity contribution. Regulators should count managers' sweat equity as a "permissible form" of risk retention.** CLO managers, in contrast to underwriters, are paid over the life of the transaction since loan selection or monitoring duties are ongoing. Senior fees supposedly allow managers to cover their costs<sup>29</sup> with any subordinated fee or later incentive fee providing real upside. If a manager does not invest in the CLO equity, then under standard fee arrangements they have no real loss potential. The eagerness of credit professionals to become CLO (or CDO) managers – particularly when some managers no longer needed to invest in roughly 20% of the equity<sup>30</sup> – supports this point. Many asset managers do not risk their own capital to manage money, but the long term lock-up of funds

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<sup>28</sup> If capital should be one for one for a horizontal slice, then why not have a third party provide the capital? A third party might seek a lower return on capital than a bank and might well be less systemically significant. The objection to this arrangement is that such parties cannot sufficiently influence underlying loan quality, so their participation would support the bubble dynamics described previously.

<sup>29</sup> Rating agency criteria have dictated that senior fees are paid prior even to the AAA-rated tranche. Rating agencies designed this rule so that a AAA investor would retain a manager even in disaster scenarios. From an individual deal perspective this rule is logical, but from a market perspective it encourages too many CLOs. A better rule would be to pay some managers their senior fee (of 10 to 15 basis points) *pari passu* or junior to the AAAs.

<sup>30</sup> In a \$400 million CLO, the equity tranche would be approximately \$33 million. A 20% share would be \$6.6 million and a manager would typically earn \$2 million in fees annually plus a back-ended incentive fee. Note that 5% of the CLO par amount would be \$20 million, the amount of risk retention in the NPR. Were the "credit risk" for the CLO considered to be in line with the below investment grade tranches, then 5% of roughly \$65 million would be only \$3.25 million. If instead tranches rated below AAA were considered a proxy for the "credit risk" of the CLO, then 5% of roughly \$130 million would be \$6.5 million. These numbers vary based on the leverage within CLOs, and new CLOs in 2011 are less levered than those issued in 2007.



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coupled with the difficulty of assessing CLO performance underscore the need for managers to have some downside risk for poor performance. Either an equity or sweat equity investment would align interests with the downside risk that investors bear.

If the subordinate management fees had to be reserved or reinvested within the CLO – for perhaps three years – then a manager could have skin-in-the-game even without making an upfront equity investment. Recognizing that managers often have limited access to capital, such a sweat equity type of investment should be permitted whereby fees kept within the CLO rather than paid out quarterly could be counted towards any risk retention requirement. As with the suggestion above for loan and CLO bankers, tying personal compensation of CLO managers to product performance matters a lot, especially if the equity source ultimately is a third party.

**Certain market-wide, rather than deal specific, improvements in information could counteract tendencies in the loan and CLO markets towards bubbles.** Better information should translate into more responsible loans and securitized products. If better transaction-related information is needed and the veracity of such information cannot be assured, risk retention may be the best way to compensate for that asymmetry. However, if the information needed is more market-wide, then promulgating better market-wide information may support market discipline more effectively than risk retention. The information asymmetries between borrowers and investors were much less severe with syndicated loans and CLOs, than with mortgages (where data veracity has become a central controversy). However, certain market-wide information, not currently collected about loan and CLO market participants, could help investors and regulators spot developing bubbles and/or educate investors and regulators about performance issues.

1. Data on performance of loans by agent banks and CLO performance by underwriter is not readily available. Such information would be a relatively low cost means to spark competition towards good product performance rather than just volume. Bankers notoriously compete for top placement in *volume-based* league tables. Alternative measures would incent competition based on performance, even though methodological debates inevitably would arise over how to measure this. Bank management and regulators, as well as investors, would find such information useful.<sup>31</sup>
2. Rating agencies should also be tasked with gathering and presenting information about how syndicated loans are different today from the historical data upon which their CLO models are based. Rating agencies' models should be more sensitive to how markets have moved and their criteria are being arbitrated. If rating agencies or others gathered the information, CLO underwriters might be obliged to disclose it. Typically, CLO underwriters market CLOs using historical information about the loan asset class; yet, the loans targeted for CLOs could be lower rated, have higher leverage or otherwise differ materially in their risk profile than the general loan market of prior years. Presenting more of this type of information would help investors make better investment decisions and raise potential red flags against deteriorating standards. Disclosure requirements for CLOs, which are covered by securities law protections, should prevent selling a product based on factors that have changed materially, but reliance on the protective phrase "past results do not predict future performance" has diminished care in disclosure. Promulgation of this type of information could well slow or diminish the escalation of bubbles.

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<sup>31</sup> The Shared National Credit Review may already have much of this loan information. Rating agencies have some as well regarding deals they rate.



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3. Data typically has not been collected on the tranches of CLOs that end up re-securitized in other structured vehicles. Rating agencies should track this information and disclose it, i.e., the percentage of various CLO tranches that are sold to other CLOs or securitized products. Analogous data to this was not collected in the ABS CDO market and is part of the *ex post* uproar that a seeming ponzi scheme had developed.<sup>32</sup>
4. Finally, regulators should receive access to CLO documents and performance information.<sup>33</sup> Beyond mere access to the product documents, data on categories of investors in these products would also help regulators understand where risk in the system has been distributed; however, the efficacy and efficiency of such a data collection effort should be evaluated in the context of other recent data initiatives.

### Conclusion

(1) The syndicated loan market became an originate-to-distribute market and loan quality deteriorated, all within a context where the protection offered by securities laws has not applied. CLOs became the dominant buyers of syndicated loans and contributed to the bubble in the loan market. The bubble in the loan market exacerbated the financial crisis.

A. Investors in loans, in part because they became so numerous, cannot effectively push for quality loan underwriting. Investors in CLOs, because of inherent and even desirable design features of CLOs, are even less able to influence loan quality.

B. CLO managers were subject to the same incentives and therefore analogous – although materially less severe – perils as the disastrous ABS CDO market. The generally good performance of CLOs and limited defaults to date of loans reflect the better quality of loan information and transparency of CLO modeling, when compared to that for mortgages and ABS CDOs. Nonetheless, the loan market may have avoided excesses because of factors that will not exist in the future.

These facts support regulatory intervention.

(2) The misalignment of interests within loan origination and CLO origination contributed to the loan bubble. Competitive pressures undermined each market participant's ability to provide market discipline. All incentives supported greater issuance, not quality control. Risk retention would better align interests between product creators and investors but is not needed to correct information asymmetries in the loan market. Nonetheless, without improvements to risk management or banker compensation systems, risk retention by itself will not achieve the objective of more responsible loan underwriting and could even increase risk at systemically significant financial institutions.

A. Risk retention would improve loan quality only if (i) the parties that retain the risk are actually in a position to influence lending standards and (ii) the risk actually impacts the individuals involved. Risk retention by loan originators, the agents for loan syndicates, would be most effective for improving loan

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<sup>32</sup> CLO BB tranches were purchased by other CLOs or CDOs much as BBB ABS CDO tranches were packaged into CDOs or CDO<sup>2</sup>, but the prevalence of this interconnection appears to have been considerably less.

<sup>33</sup> CLOs and CDOs were issued as 144A offerings so that the SEC and bank regulators did not have access to these documents.



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quality. CLO underwriters are the “securitizers” of CLOs and should not escape any risk retention regulations; however, any horizontal slice retention is dangerous, subject to mispricing and requires high capital at a minimum.

B. Requiring fees for loan or CLO origination to be payable only in relation to reasonable performance measures – which could be achieved by deferring and subordinating payments – would impact both originator revenues and the personal compensation of their employees, thereby better aligning the personal incentives of the bankers with those of investors. With those fee arrangements in effect, meaningful capital investment by banks in risk slices may not be necessary.

C. Similarly, CLOs should not be a risk-free upside-only endeavor for an asset manager; delaying some management fees and/or requiring an equity investment would achieve a better alignment of interests with investors than current practice. Allowing CLO managers to contribute sweat equity if any risk retention is imposed on them, either as an alternative to risk retention, or as a “permissible form”, would achieve that goal.

(3) While information asymmetries were much less severe with loans and CLOs than with mortgages and ABS CDOs, some improvements in *market-wide* information collection and disclosure are still needed. Such information could help flag developing bubbles and/or support market discipline. Several specific measures are discussed above, but creating league tables based on loan and CLO performance could prove a surprisingly powerful incentive for agent banks and underwriters to care about quality, not just quantity.

Together, these direct measures to improve information and align interests could improve product quality and moderate bubbles, thereby better achieving the objectives of risk retention than risk retention itself.

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