Lead Left Interview – Meredith Coffey

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This week we speak with Meredith Coffey, Executive VP of Research, Loan Sales and Trading Association (LSTA), the leading industry association for the loan market.

TLL: *Meredith, you and the LSTA have been in the forefront of trying to knock some sense into regulators on how CLOs are being negatively impacted. How's that battle going?*

MC: (Laughing) Well I wouldn't quite put it that way! Education on the loan and trading industry has always been a cornerstone of the LSTA's mission statement. It's become increasingly critical in the wake of Dodd-Frank and Leveraged Lending Guidance, to name two major regulations affecting our industry, to get that message out.

TLL: *Why is it so difficult for regulators to understand that CLOs didn't cause the financial crisis.*

MC: There have been a lot of broad brushes that have swept securitization of loans into the same category as bonds and mortgages, which obviously is not the case. But that's taken a lot of explaining to get to this point, particularly regarding how well CLOs behaved during the downturn. (Have I mentioned that not one CLO AAA or AA note has lost money in their 20-year history?!)

"The post-crisis CLO managers have shown themselves to be amazingly adaptable."

TLL: *Let's take the Volcker Rule. How is that affecting CLO structures?*

MC: First we had to deal with the notion that banks were prohibited by Volcker from owning CLOs. But of course, banks invest in CLO AAA and AA notes, not the CLOs themselves. Secondly, bank-owned CLOs will not be able to hold bonds. That's not a problem in new, so-called CLO 3.0 structures, but it is for pre-crisis models.

TLL: *So what will banks which own bond-investing CLOs have to do?*

MC: Either they will have to try to get the managers to try to amend the CLOs to remove bond baskets…or banks will have to sell their positions. While we think vintage CLOs that are 90% invested in loans should be grandfathered, we were not able to get the regulators there. The most recent outcome was that the Fed provided for a two-year window for banks to get CLOs amended…or to unload them. While that*does* help the situation, it doesn't solve it.

TLL: *And how much of a problem remains?*

MC: Before the Fed extended the conformance period, banks would have had to amend or dispose of more than $100 billion of CLO notes – most likely in a fire sale scenario – in the next few months. Now that the conformance period has been extended, banks will probably have to conform or divest $40-50 billion of notes in the next 18 months. Still a very material amount – but it's a smaller amount in a longer period of time.

***TLL:** Where do we stand on the risk retention issue?*

MC: That's a separate issue from Volcker. Dodd-Frank requires the CLO manager to retain 5% of the total size of the vehicle as equity. For, let's say, a $450 million CLO that means over $20 million in equity. That would put smaller managers out of business.

***TLL:** Which of course would hurt market liquidity, increase spreads, and make it tougher for companies of all stripes to get financing. Classic unintended consequences.*

MC: Yes. But the good news is that we're still negotiating. At the moment, we've proposed creating a higher credit standard CLO – a Qualified CLO or QCLO – that would permit the manager to retain 5% of the equity, rather than 5% of the total size of the vehicle.

***TLL:** You've always said the best thing to remove stigma from CLOs was rename them. Now you have!*

MC: (laughs) Good memory! The new CLOs would need to meet six protective criteria to qualify as a QCLO. We believe those six criteria would meet the regulators' policy objectives – like strong underwriting standards – and would also permit the market to continue to function. We think it's a win-win…but we'll see if the regulators agree.

***TLL:** As if that's not enough, what other things are CLO managers worried about?*

MC: Well, let's see. There's FATCA (Foreign Account Tax Compliance Act) that requires foreign institutions, including CLOs and off-shore accounts, to report information on their U.S. investors to the IRS (or to appropriate entities in their issuing jurisdictions). That's a compliance issue with significant penalties for non-compliance. But after years of work, we are getting there.

***TLL:** What about bank appetite to finance the triple-A rated debt tranches? After all, they comprise the majority of CLO capital.*

MC: Yes, and until the Volcker Rule gets sorted out, it's not clear what the impact will be.

***TLL:** Isn't this all about education, though? Won't everyone finally understand that CLOs are not "risky."*

MC: That's certainly our hope, and as I said, our mission. The research from the rating agencies has been helpful in that regard. As the recovery has demonstrated, CLOs as financing vehicles have shown to be good for all parties.

***TLL:** Review those benefits for us, Meredith, please.*

MC: Glad to. First, of course, CLOs are match funded instruments: They have long-term assets that are funded by long-term, non-mark-to-market liabilities. Consequently, issuers have more consistent access to capital through cycles, outside of bank debt. That has brought greater stability to the loan market. Moreover, thanks to CLOs' efficient structure, cost of capital is lower, which again helps issuers.

TLL: *So everyone wins. Sounds like regulators should put a stop to that right now.*

MC: I think there's a growing recognition of the overall benefits. But it's a long process to educate the agencies on why CLOs, for example, are helpful to market efficiency and liquidity. You want long-dated duration matching. Otherwise, companies' access to liquidity in a market downturn is hampered.

TLL: *Do you think regulators 'get it'?*

MC: I think there's a growing understanding about the market; it may be a question of political will.

TLL: *If I may speak for market participants, the real frustration is that the response from regulators to the LSTA's exhaustive and incredibly patient education process on how the loan market works and why certain regulations will make matters worse, not better, is more complex regulations.*

MC: It has been challenging. But the good news is that we've made headway on a number of critical issues for the loan industry. The post-crisis CLO managers have shown themselves to be amazingly adaptable. Whatever happens, we hope the best managers will figure out how to survive. They usually do.

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