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Lead Left Interview – Meredith Coffey

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On Wednesday, February 24th, Meredith Coffey, EVP of the Loan Syndications and Trading Association, testified before the House Financial Services Subcommittee on Capital Markets. The point of her testimony was four-fold: i) To explain the importance of loans to non-investment grade companies, ii) to explain the role CLOs play in this financing, iii) to explain what risk retention could do to CLOs, and iv) to describe a viable form of retention (H.R. 4166, or the "QCLO bill") that should work for lawmakers, regulators, CLOs and companies.

Meredith developed the following summary of her testimony for our Lead Left readers:

The reality is that the vast majority of American companies are not large investment grade corporations like Microsoft, McDonalds and Wal-Mart. Most are non-investment grade – of the 2,000 companies Moody's rates, more than 70% are rated below Baa3. These are cable companies like Cablevision, airlines like Delta and American, food companies like Dole and Del Monte, restaurant chains like Wendy's, Burger King and Dunkin Donuts, and – to burn those donuts off – gym companies like 24-Hour Fitness and Equinox.

The reality is that CLOs provide more than $400 billion of financing to companies such as these. So why do people get concerned when they hear "CLO?" In large part, it is because people assume that these must be "CDOs". But CLOs are not CDOs – and they didn't perform like them. CLOs are just simple and transparent portfolios of corporate loans and the proof is performance. Moody's calculated that the 10-year impairment rate for CLOs was 1.5%. For CDOs it was 44.8% – nearly 30 times the CLO impairment rate.

While CLOs are not CDOs, unfortunately risk retention will do considerable damage to CLOs – and the companies that rely upon them. In early February, Moody's issued a report on companies' need to refinance, and noted that "CLOs will meet a smaller portion of corporate refunding needs" due, in part, to risk retention.

And, in fact, even though it doesn't officially go live until December 2016, risk retention is already affecting CLOs. Starting in the second half of 2015, investors began requiring CLOs to be risk retention compliant– or at least have a detailed plan to comply. This is not because investors love

risk retention – rather investors wanted to invest only in CLOs that could refinance and whose managers could survive risk retention.

The result? Due in part to market weakness and in part to risk retention, CLO formation dropped 20% in 2015. And second half 2015 CLO formation dropped nearly 40% from first half levels. Moreover, risk retention already is picking winners and losers: 30 smaller managers that issued CLOs in 2014 were unable to do so in 2015, largely due to risk retention.

This is not just a CLO problem – it will impact a number of companies' ability to refinance their debt. Moody's said that non-investment grade companies will have nearly $700 billion of debt coming due in 2019-2020. Meanwhile, Bloomberg recently reported that Fed officials like Janet Yellen have begun worrying about credit availability, and the regulators themselves have said that risk retention will reduce the supply of credit.

So, what will happen? If US companies cannot refinance their debt because CLOs are not there for them, companies will either have to pay significantly more to alternative sources of credit like hedge funds. Or, worse, companies may not find credit, and this could lead to downsizing, job cuts or – at worst – possible liquidity crises.

But this scenario is totally avoidable. Instead of curtailing the CLO market, the LSTA asked the committee to consider and pass H.R. 4166, which contains a sensible alternative – the Qualified CLO or QCLO. How does the QCLO work? A CLO would have to meet requirements in six areas: i) Asset quality, ii) Portfolio diversification, iii) Capital structure, iv) Alignment of interest of manager and investor, v) Regulation of the manager, and vi) Enhanced transparency & disclosure.

If a CLO does this, then the manager can purchase and retain 5% of the equity which, along with subordination of its fees, would meet the 5% credit risk retention that DF requires. Thus, the QCLO not ONLY requires 5% credit risk retention, but it also adds restrictions into the mix. It is “Dodd-Frank Retention-Plus-Protections”.

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