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By Electronic Submission

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Re: **Credit Risk Retention; Joint Further Notice of Proposed Rulemaking**
SEC (File No. S7-14-11); FDIC (RIN 3064-AD74); OCC (Docket Number OCC-2013-0010); FRB (Docket Number R-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 comments in response to the joint Further Notice of Proposed Rulemaking, 78 Fed. Reg. 57928 ("FNPRM"),[2] concerning risk retention and the implementation of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").

[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.

[2] Credit Risk Retention, 78 Fed. Reg. 57928 (Sept. 20, 2013; originally released Aug. 28, 2013).

The LSTA would like to draw the agencies' attention to a recently released paper issued by the Bank of England and the European Central Bank, "The case for a better functioning securitisation market in the European Union," (May 29, 2014) ("Bank of England Paper" or "BoEP"), *available at* http://www.bankofengland.co.uk/publications/Documents/news/2014/paper300514.pdf. That document is attached as Appendix A. Issued for public comment, the paper addresses the impaired securitization market in the European Union and includes policy options for consideration by European authorities. The analysis set forth in the Bank of England Paper has two principal implications for the agencies' current rulemaking concerning risk retention and the implementation of Section 941. Those implications relate to (i) the public interest consequences of adopting rules that impair a well-functioning CLO securitization market and (ii) the public policy and market benefits of regulators' identifying and distinctly addressing "qualifying securitisations" – benefits that also arise from the similar "Qualified CLO" approach proposed by the LSTA, SFIG, and SIFMA. Both are described further below.

First, the Bank of England Paper addresses and describes the very significant harm to the public interest that has arisen from the collapse of the securitization markets in Europe. As described in prior submissions by the LSTA, European regulators' misapplication of credit risk retention requirements has been a factor leading to that collapse, and the application of credit risk retention requirements – similar to those proposed by the agencies for open market CLOs – has contributed to the sharp reduction in European CLO issuance in particular.[3]

The Bank of England Paper quite candidly notes that "activity in public securitisation markets in Europe is largely moribund" and that "impediments to its revival include … structural factors, such as regulatory treatment of securitisation … ." BoEP, at 6.[4] While not disavowing risk retention, the paper underscores the adverse effect on CLO issuance of risk retention requirements: "retention requirements have the potential to act indirectly as a deterrent to some issuers, particularly those experiencing difficulty in funding retained portions. This may be particularly true of some non-bank issuers, including some CLO managers." *Id*. at 16.

The paper also canvasses the many potential benefits "to issuers, investors and the system as a whole" that an active securitization market produces and, by implication, the harm to the public interest that arises when regulation renders a securitization market "moribund." *See id*. at 7-9. In particular the paper describes how, "[f]or both banks and long-term non-bank investors, securitisation provides a means of diversifying their exposures to the real economy." *Id.* at 7. In addition, "the flexibility securitisations offer to customise cash flows and risk exposures can be particularly useful for those investors that have specific maturity, coupon, yield and risk preference needs, which can be difficult to satisfy elsewhere." *Id.* Moreover, an active

[3] *See, e.g.*, LSTA Letter Comment (Apr. 1, 2013) at 16; LSTA Letter Comment (Aug. 1, 2011), at 15 n.35.

[4] *See also* Ass'n for Financial Markets in Europe,"High-quality securitisation for Europe: The market at a crossroads" (June 2014), *available at* www.afme.eu/WorkArea/DownloadAsset.aspx?id=10823; *id*. at 4 ("Central bankers and policy makers are calling for a revival of Europe's securitisation market.").

securitization market provides "[a] funding tool to support real economy lending by banks and non-banks," producing lower costs, improved risk management, an expanded investor base, and increased diversification. *Id*. Active securitization also serves as an important "risk transfer device for originating banks" and "[a] means of generating high quality collateral to meet increased demand." *Id*. at 8.

A well-functioning CLO market provides all these public interest benefits described in the Bank of England Paper. As the LSTA has previously described, the agencies' proposed rules would impair the CLO market and would thereby harm the public interest by curtailing these and related benefits to businesses, consumers, and investors.[5]

Second, the Bank of England Paper proposes and describes the benefits of a regulatory response focused on defining and fostering "qualifying securitisation[s]." The point of focusing on "qualifying securitisations" is "to identify securitisations where their simplicity, structural robustness and transparency enable investors to model risk with confidence," which in turn would create "an increase in liquidity" and a revival of the securitization markets. *See* BoEP, at 19, 23. And, the principles determining which securitizations are "qualifying" would have important regulatory consequences: "These principles could provide a framework to aid various authorities (such as central banks and regulators) and market participants (such as credit rating agencies and investors) to set their own eligibility criteria." *Id.* at 20; *see id*. at 23.

This regulatory approach is very similar to – and is designed to produce the same public policy benefits as – the "Qualified CLO" approach proposed by the LSTA, SFIG, and SIFMA in their comments of January 10, 2014 and discussed with agency officials thereafter. Under that proposed approach, the agencies' risk retention rules would apply distinct risk retention requirements to managers of Open Market CLOs that meet a series of requirements designed to ensure high quality underwriting and to protect investors. A CLO meeting the requirements would be treated as a "Qualified CLO." The manager of a Qualified CLO would be able to satisfy the rules' risk retention requirements by retaining a five percent interest in the CLO's equity – in addition to retaining credit risk through a deeply subordinated and deferred compensation structure. *See generally* LSTA, SFIG & SIFMA Letter Comment (Jan. 10, 2014), at 6-15.

The principles identified by the LSTA for defining "Qualified CLOs" closely resemble and are more robust than those identified by the Bank of England Paper for defining "qualifying securitisations." At the most fundamental level, a Qualified CLO readily satisfies the Bank of England Paper's principles of "simplicity, structural robustness and transparency." BoEP, at 23. The Qualified CLO's overwhelming investment in senior secured loans, the clear industry understanding of those assets, and the established legal structure of CLOs assure its simplicity; all the particular requirements for a Qualified CLO, including the 8 percent equity floor, further

[5] *See, e.g.*, LSTA, SFIG & SIFMA Letter Comment (Jan. 10, 2014), at 2-3 (and sources noted); LSTA Letter Comment (Oct. 30, 2013), at 11-20; LSTA Letter Comment (April 1, 2013), at 20-22; LSTA Letter Comment (Aug. 1, 2011), at 14-17.

strengthen what is already a robust and time-tested structure; and a Qualified CLO assures investors of transparency to the level of individual loan performance. *See* LSTA, SFIG & SIFMA Letter Comment (Jan. 10, 2014), at 6-10.

The same is true of the particular requirements associated with these general principles. A "qualifying securitisation" would be limited to "loans, advances or financings that are homogenous in respect of their asset type" and would exclude derivatives. BoEP, at 23. The securitization would have clearly defined legal interests, payment priorities, and voting and enforcement rights, and would provide transparency through "[s]ufficient loan-level or granular pool stratification data … available at the time of securitisation" and through "[u]pdated loan-level performance data and standardised investor reports" thereafter. *Id*. at 23-24. In comparison, a "Qualified CLO" under the LSTA's proposal would meet and considerably exceed these requirements. For a CLO to qualify for the proposed modified risk retention requirement and be deemed a Qualified CLO, its governing transaction documents would have to include requirements related to: (1) asset quality; (2) portfolio composition; (3) structural features; (4) alignment of the interests of the CLO manager and investors in the CLO's securities; (5) regulatory oversight; and (6) transparency and disclosure. *See* LSTA, SFIG & SIFMA Letter Comment (Jan. 10, 2014), at 6-10. The LSTA's proposal sets out detailed requirements that would have to be satisfied within each of these six categories. *Id.*

The benefits of adopting the "Qualified CLO" approach to credit risk retention are precisely those sought and identified by the Bank of England and European Central Bank in their "qualifying securitisation" proposal. By creating a mechanism that maintains a well-functioning CLO market and by providing a transparent and structurally sound investment product, the Qualified CLO approach would ensure prudent asset selection and underwriting, protection of investors, increased access to and competitive pricing of credit, and other public interest benefits associated with CLOs' continued provision of credit and investment products. *See id*. at 11-15. These are also, of course, the objectives that Congress sought to accomplish through Section 941.

The LSTA appreciates the agencies' consideration of these comments and would be pleased to provide additional information that might assist the agencies' decision-making. Please contact Meredith Coffey at (212) 880-3019 or Elliot Ganz at (212) 880-3003 if you have questions regarding these comments and the relevance of the Bank of England Paper to the LSTA's "Qualified CLO" proposal or to the rulemaking.

Sincerely,

R Bram Smith

R. Bram Smith
Executive Director
Loan Syndications and Trading Association (LSTA)

Appendix A

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Bank of England and European Cental Bank. "The case for a better functioning securitisation market in the European Union." May 2014. Available at https://www.ecb.europa.eu/pub/pdf/other/ecb-boe_case_better_functioning_securitisation_marketen.pdf