MEMORANDUM

TO: File No. S7-14-11

FROM: Jay Knight
Special Counsel
Office of Structured Finance
Division of Corporation Finance
U.S. Securities and Exchange Commission

RE: Meeting with Representatives of the Loan Syndications and Trading Association

DATE: June 13, 2011

On May 12, 2011, Katherine Hsu, Jay Knight, Rolaine Bancroft, and David Beaning of the Division of Corporation Finance and Eric Emre Carr of the Division of Risk, Strategy, and Financial Innovation met with the following representatives of the Loan Syndications and Trading Association ("LSTA"):

- Bram Smith – LSTA
- Meredith Coffey – LSTA
- Elliot Ganz – LSTA
- Gregory A. Stoeckle – Invesco Senior Secured Management, Inc.
- Doug Nappi – Nappi & Hoppe, LLC

The discussion included, among other things, the Commission's Proposed Rules for Credit Risk Retention. Handouts are attached to this memorandum.

Attachment

Risk retention and its impact on CLOs

Bram Smith – bsmith@lsta.org
Greg Stoeckle – gregory.stoeckle@invesco.com
Meredith Coffey – mcoffey@lsta.org
Elliot Ganz – eganz@lsta.org

The Loan Syndications and Trading Association is the trade association for the floating rate corporate loan market. The LSTA promotes a fair, orderly, and efficient corporate loan market and provides leadership in advancing the interest of all market participants. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans and related claims.

CLOs are not originate-to-distribute securitizations of non-transparent assets

- Assets
  - Pieces of large, syndicated loans to C&I companies
  - Loans are originated and syndicated *separately from* any securitization process
  - Loans are sold to hundreds of individual buyers (including CLOs) that make individual credit decisions
  - Loans are transparent: Individually rated, priced and reported on by trade publications
  - More than $400 billion of syndicated loans trade annually in the U.S.
- Manager
  - Generally an SEC registered investment advisor
  - Has a fiduciary responsibility to investors
  - Has a three-tiered fee structure to align interest
    - Senior fee (10-20 bps) paid regardless of performance
    - Subordinate fee (35-40 bps) paid only if portfolio performs and all notes are being paid interest
    - Incentive fee toward end of CLO life if equity hits a pre-negotiated IRR
    - Majority of fee is not paid if CLO underperforms
  - Is separate from the bank that sells the assets
- CLOs
  - CLOs are not permitted to originate loans
  - CLOs buy loans originated by many different banks in the secondary market
  - CLOs provide monthly trustee reports to investors that detail each individual loan
  - CLO managers trade these loans actively to minimize losses and maximize CLO returns

CLOs provide considerable financing to U.S. companies

- Shared National Credit Review tracked $1.2 trillion of funded commercial SNC loans in 2010
- Non-bank lenders provided $500 billion of these loans
- CLOs provide capacity for $250 billion of these loans
- Banks are a shrinking share of the non-investment grade market, creating greater need for non-bank lenders

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CLOs performed well in the worst financial crisis since the Great Depression

- CLOs performed as structured
  - In the worst of the GFC, loan prices and ratings declined
  - Some CLOs breached their "overcollateralization" triggers, and diverted cash to pay down notes
  - As CLO notes delevered and loan performance improved, nearly all CLOs came out of "OC" violation
  - Thus, they performed exactly as they were structured to perform
- There were practically no cash flow CLO payment defaults
  - According to Moody's research, there were two payment defaults on cash flow CLOs, and no losses for investors holding notes rated A and above
- Most CLO note downgrades were modest
  - Approximately half the note downgrades were due to a change in rating agency methodology, *not* the performance of the assets or structures
  - Of the notes originally rated Aaa by Moody's, 85% were rated Aa or better after the downgrade sweep
  - Moody's is revamping its rating methodology on CLOs, removing its temporary stress factor
- CLO tranches are now being upgraded
  - More than 430 CLO notes were upgraded in 1Q11

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Federal Reserve Board Study provided a number of recommendations

In its Study (http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf), the Board recommended that the Rulemaking Agencies should:

- Consider the specific incentive alignment problems to be addressed by each credit risk retention requirement established under the jointly prescribed rules.
- Consider **the economics of asset classes and securitization structure** in designing credit risk retention requirements.
- Consider the **potential effect of credit risk retention requirements on the capacity of smaller market** participants to comply and remain active in the securitization market.
- Consider the **potential for other incentive alignment mechanisms** to function as either an alternative or a complement to mandated credit risk retention.
- Consider the interaction of credit risk retention with both accounting treatment and regulatory capital requirements.
- Consider credit risk retention requirements in the context of all the rulemakings required under the Dodd–Frank Act, some of which might magnify the effect of, or influence, the optimal form of credit risk retention requirements.
- Consider that investors may appropriately demand that originators and securitizers hold alternate forms of risk retention beyond that required by the credit risk retention regulations.
- Consider that capital markets are, and should remain, dynamic, and thus periodic adjustments to any credit risk retention requirement may be necessary to ensure that the requirements remain effective over the longer term, and do not provide undue incentives to move intermediation into other venues where such requirements are less stringent or may not apply.

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Risk retention options do not work for CLOs

- Representative sample of 1,000 name portfolio
  - CLOs generally hold pieces of 150-250 individual loans; they simply do not have 1,000 names to sample from
- Vertical slice (of 5% of each liability tranche)
  - *Amount*: CLO managers are asset managers and generally do not have sufficient capital for 5% risk retention
  - *Balance sheet*: CLOs managers are asset managers, not large banks, and generally do not have a large balance sheet that holds such assets
  - *Return*: Even if the CLO manager has the capital and the balance sheet, capital is scarce and a 50 bps annual CLO fee is unlikely to be sufficient to use capital to earn an AAA rate of return
- "L" shaped option
  - Same issues as the vertical slice
- Horizontal first loss position (of 5% of the par value of all the ABS notes)
  - *Amount*: CLO managers are asset managers and generally do not have sufficient capital for 5% risk retention
  - *Balance sheet*: CLOs managers are asset managers, not large banks, and generally do not have a large balance sheet that holds such assets
  - *Note: Because this is a first loss position, it is far more than 5% of the expected loss*
- Cash reserve fund option that acts like horizontal first loss position
  - Same issues as the horizontal first loss
- *Third party investor similar to CMBS B-piece buyer?*
  - Inability to hedge/sell makes this untenable for investors with fiduciary responsibilities

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Dodd-Frank risk retention language and Footnote 42 in the Proposed Rules

- Dodd-Frank defines the securitizer as " (A) an issuer of an asset-backed security; or (B) 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**."

- In Footnote 42 of the Proposed Rules, the Agencies state that "the CLO manager generally acts as the sponsor **by selecting the commercial loans to be purchased** by an agent bank for inclusion in the CLO collateral pool and then manages the securitized assets once deposited in the CLO structure."

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