



European Banking Authority
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By Electronic Submission

EBA Discussion Paper on simple standard and transparent securitisations - EBA/DP/2014/02

Ladies and Gentlemen:

The Loan Syndications and Trading Association (the “LSTA”¹) appreciates the opportunity to comment on the European Banking Authority’s (“EBA”) Discussion Paper (“DP”) on simple standard and transparent securitizations dated 14 October 2014. The LSTA is the trade association for the \$3.4 trillion U.S. syndicated loan² market, which includes an approximately \$1.5 trillion non-investment grade loan market. The U.S. non-investment grade loan market includes an \$850 billion “institutional” loan market, comprised of loans sold to non-bank investors. Open Market Collateralized Loan Obligations (“Open Market CLOs”³) are an important investor base in the institutional market. As of December 2014, Open Market CLOs provided more than \$371 billion in financing to companies.⁴ The LSTA does not represent CLOs or CLO managers per se. However, they are an important source of financing to U.S. companies and therefore the LSTA appreciates the opportunity to offer a perspective on how CLOs could fit within the principles of the simple standard and transparent securitizations. We also refer to and endorse the comment letter submitted by the Loan Market Association (the “LMA”) (the “LMA Letter”) that outlines

¹ The Loan Syndications and Trading Association is a not-for-profit trade association that is made up of a broad and diverse membership involved in the origination, syndication, and trading of commercial loans. The 380 members of the LSTA include commercial banks, investment banks, broker-dealers, hedge funds, mutual funds, insurance companies, fund managers, and other institutional lenders, as well as law firms, service providers and vendors. 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. Since 1995, the LSTA has developed standardised practices, procedures, and documentation to enhance market efficiency, transparency, and certainty.

² Shared National Credit Program 2014 Review released by the Federal Deposit Insurance Corporation (“FDIC”), the Board of Governors of the Federal Reserve System (“Fed”) and the Office of the Comptroller of the Currency (“OCC”) (November 2014) *available at* <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20141107a1.pdf>.

³ The LSTA’s definition of “Open Market CLO” ensures the high quality of CLO assets while accounting for the market reality that assets acquired in open market transactions often include a mix of senior, secured loans, and non-senior secured loans. An Open Market CLO is a CLO “(i) whose assets consist predominantly of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in open market transactions or [from other non-balance sheet CLOs] and of temporary investments, (ii) that is managed by a manager, and (iii) that is not a balance sheet CLO.”

⁴ ThomsonReuters LPC Leveraged Loan Monthly, December 2014.



the European CLO market, European CLO structure and performance, and the impact that a retrenchment in the CLO market would have on European borrowers.

As the DP commenced by describing securitizations that performed well and those that performed poorly, this letter will first discuss U.S. CLO performance during the past 20 years, including the financial crisis. Next, the letter will explain how Open Market CLOs do not have the characteristics of securitizations that ran into difficulties during the 2007-2009 crisis. Finally, the letter will describe a “Qualified CLO” and how it would align with many of the principles of simple standard and transparent securitizations.

Historical Performance of Open Market CLOs

Open Market CLOs have existed in the U.S. for more than 20 years. Despite the financial markets undergoing the worst financial crisis since the Great Depression, Open Market CLO credit performance has been phenomenal. Both Standard & Poor’s and Moody’s Investors Service (“Moody’s”) have chronicled CLO performance in the past 20 years. Moody’s reported that of the 5,176 CLO tranches they rated between January 1, 1996 and August 1, 2014, only 58 – or 0.8% - suffered any losses. No note rated Aa or Aaa suffered any losses⁵. Between 1994 and 2013, Standard & Poor’s rated 6,141 CLO tranches and only tracked defaults on 25 – or 0.41%.⁶ According to Wells Fargo, this performance greatly surpasses the performance of many asset classes, including equivalently rated corporate bonds. For instance, there were no defaults through history for AAA and AA rated CLO notes; the default rate for equivalently rated corporate bonds was 0.42% and 0.48%, respectively. The cumulative default rate for A rated CLO notes was 0.45%; it was 0.82% for A rated bonds. BBB rated CLO notes had a cumulative default rate of 0.47%; for BBB rated bonds, it was 2.37%. BB rated CLO notes had a cumulative default rate of 2.26%; for BB rated bonds, it was 9.23%. Finally, the cumulative default rate for B rated CLO notes was 2.61%; for B rated bonds, it was 21.4%.⁷ In fact, the DP acknowledges CLO performance. Figure 16 graphs realized and expected losses in US Structured Credits. Unlike SF CDOs, TruPs, IG Corporates, Market Value CDOs and HY bonds, CLOs are identified as having no realized or expected losses. Thus, if historical performance is a barometer, it is clear that Open Market CLOs should be considered safe securitizations.

A major reason that CLOs performed so well during the financial crisis is that they do not have the four specific elements that the Prime Collateralized Securities (PCS) Association identified as likely to create difficulties during periods of financial turmoil.

- a. **Originate to distribute model:** Open Market CLOs are not originate to distribute securitization vehicles, but instead are more akin to mutual funds. The CLO manager is not paid upfront, but rather is paid an annual fee – and if the CLO does not perform, the CLO manager’s payments may be cut off. Thus, there is incentive to select performing assets.
- b. **Leverage:** CLOs typically were leveraged 8-12 times and thus had sufficient subordination to protect the mezzanine and senior notes. Moreover, the industry proposes to tighten and codify this standard. In the “Qualified CLO” proposal, CLO leverage would be capped at 12 times.
- c. **Maturity transformation:** Open Market CLO notes typically have an 11-12-year legal final maturity, whereas the assets – institutional term loans – typically have a 7-8 year maturity. In

⁵ Moody’s, “Losses to Remain Infrequent on US Cash Flow CLO Tranches”, CLO Interest, September 2014.

⁶ Standard & Poor’s Ratings Service, “Twenty Years Strong: A Look Back At U.S. CLO Ratings Performance From 1994 Through 2013”, Ratings Direct, January 31, 2014.

⁷ Wells Fargo Securities, “The CLO Salmagundi: CLOs vs. Corporates – A Default Rate Comparison”, Structured Products Research, March 14, 2014.



addition, Open Market CLOs face limits on investing in assets with a maturity later than the legal final maturity of the notes. In this manner, maturity transformation risks are minimized.

- d. **Transparency:** Open Market CLOs disclose all their holdings on a monthly basis through the trustee report. The Qualified CLO proposal would expand and codify the information provided on a monthly basis in the trustee report.

In addition to the structural characteristics that supported performance, the fact that CLOs are actively managed worked in their favor. Because managers can sell deteriorating credits before default, they can maintain a higher asset quality in the CLO portfolio. While CLOs in their original format worked well, the industry has proposed a tighter standard going forward – the Qualified CLO.

The Qualified CLO Proposal

The industry recognizes that there is value in tightening, standardizing and codifying the characteristics that permitted Open Market CLOs to perform well over the past 20 years, including through the financial crisis. As a result, the industry has proposed the concept of a “Qualified CLO”, which supports much of the DP Recommendation 3 – to reduce the major non-credit related risks of a securitization that were identified during the crisis, including i) the use of an originate to distribute mode, ii) the use of leverage, iii) the exposure of investors to substantial refinancing risk and iv) the lack of disclosure – while adding additional levels of protection. The Qualified CLO proposal is described in detail below.

In January 2014, SIFMA⁸, SFIG⁹ and the LSTA submitted a comment letter¹⁰ to the Fed, the FDIC, the OCC and the U.S. Securities and Exchange Commission (collectively, “the agencies”) proposing the concept of a higher quality CLO (a “Qualified CLO”). The Qualified CLO would have governing transaction documents that must include requirements related to: i) asset quality; ii) portfolio composition; iii) structural features, including minimum leverage; iv) alignment of the interests of the CLO manager and investors in the CLO’s securities; v) regulatory oversight of the CLO manager; and vi) transparency and disclosure. Requirements of and rationales for each category are described below.

1. CLO Asset Quality Protections.

CLOs invest in non-investment grade corporate loans, and are an important source of financing for U.S. non-investment grade companies. While not altering CLOs’ asset base, the Qualified CLO proposal would codify the minimum amount of senior secured loans, would prohibit investment in ABS or derivatives, and would limit the number of “covenant lite” loan (defined below) investments. By applying these restrictions, the Qualified CLO realizes several of the DP’s proposals, in particular by prohibiting resecuritizations.

The CLO would be required to:

⁸ SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

⁹ SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs.

¹⁰ LSTA, SFIG & SIFMA Letter Comment (Jan. 10, 2014).



- a. have at least 90 percent of its assets comprised of senior secured loans and cash equivalents;
- b. have 100 percent of its loan assets issued by companies;
- c. have no assets that are ABS interests (including CDO of ABS, CDO squared, or synthetic ABS) or derivatives – provided that this limitation would not prohibit an Open Market CLO from acquiring loan participations or any interest related to or in a letter of credit, or entering into derivative transactions to hedge interest rate or currency rate mismatches;
- d. not purchase assets in default, margin stock, or equity convertible securities;
- e. acquire only loans held or acquired by three or more investors or lenders unaffiliated with the CLO manager;
- f. hold only loans to borrowers whose accounts are subject to an annual audit from an independent, accredited accounting firm;
- g. have no more than 60 percent of its assets comprised of “covenant lite” loans;¹¹ and
- h. at the time of purchase of any asset, comply with the requirements of part 1.a and 1.g and the CLO asset portfolio protection requirements in part 2 below or, if not in compliance with any such requirement, maintain or improve the level of compliance after giving effect to such purchase.

2. CLO Asset Portfolio Protection Requirements.

The DP suggests that a simple and standard securitization should be well diversified, and the industry agrees. However, the level of diversification proposed by the DP – no more than 1% in any individual name – could be counterproductive as it would be difficult to have in-depth knowledge of any individual asset for either the CLO manager or its investor. In this way, over-diversification could actually reduce the safety and transparency of the CLO. The Qualified CLO proposal recommends a well-diversified (but not over-diversified) portfolio of assets.

- a. No more than 3.5 percent of the CLO’s assets may relate to any single borrower.
- b. No more than 15 percent of the CLO’s assets may relate to any single industry.
- c. No more than 20 percent of the CLO’s assets may relate to non-U.S. borrowers

¹¹ For this purpose, a “covenant lite loan” is a loan for which the underlying instruments neither (1) require the obligor to comply with any maintenance covenant nor (2) contain a cross-default provision to a financing facility of the obligor that requires the obligor to comply with a maintenance covenant (including one which may apply only upon the funding of such other loan or financing facility); provided, that if such loan is pari passu with another loan of the obligor which would not be a covenant lite loan under the criteria described above, such loan shall be deemed not to be a covenant lite loan.



(and no more than 10 percent may relate to borrowers outside the U.S. and Canada).

- d. Each loan asset held by the CLO shall be denominated in U.S. dollars.

3. Structural Protections.

The DP noted that securitizations that contained high levels of leverage tended to run into difficulties in the 2007-2008 crisis. The Qualified CLO proposal addresses this directly by requiring equity of at least eight percent, as well as requiring an automatic deleveraging mechanism.

- a. The CLO's equity would have to be at least eight percent of the value of the CLO's assets.¹²
- b. The CLO would have to have overcollateralization and interest coverage tests, and if any such test falls below the required level specified for the transaction, available interest collections (and if necessary, available principal collections) must be applied to repay the CLO's debt in order of seniority until compliance with the applicable test is restored.

4. Alignment of Managers' and CLO Investors' Interests.

The DP noted that many securitizations whose underlying assets were originated by financial institutions that ran an "originate to distribute" model performed badly. The Qualified CLO is explicitly not an originate to distribute model; indeed balance sheet CLOs are explicitly excluded from the Qualified CLO proposal. The manager is further aligned with its investors through the fee structure and the requirement that the manager must purchase and retain 5% of the equity of the Qualified CLO.

- a. The CLO must be an Open Market CLO rather than a balance sheet CLO.
- b. The holders of the CLO's equity (excluding Manager Risk Retention Equity as defined below) must have the right to remove by vote the CLO manager for cause.
- c. A majority of the CLO manager's fees, including any incentive fee, must be subordinated to payments then due in relation to the CLO's rated notes.
- d. The CLO manager's discretionary sales of assets on behalf of the CLO issuer are limited each year to 30 percent of the principal amount of the CLO's assets (other than sales of defaulted or credit-deteriorated, credit-risk, or credit-improved loans).
- e. The CLO manager (and/or one or more of the affiliates of the CLO manager and/or its knowledgeable employees and other employees) must buy and, during the holding period, hold (and not hedge) five percent of the CLO's equity (the "Manager Risk Retention Equity").

¹² For purposes of this requirement, the CLO's equity is the most junior class of securities issued by the CLO (excluding any non-economic security such as the issuer's common stock) and any additional class(es) of securities junior to the rated notes.



- f. For each of the first two years, distributions related to the Manager Risk Retention Equity cannot exceed an amount equal to the sum of (i) 30 percent of the purchase price of such equity and (ii) the amount of taxes that are reasonably expected to be required to be paid with respect to the Manager Risk Retention Equity for the related period (entitlements in excess of such distribution limit may be retained in an account solely for the benefit of the holders of the Manager Risk Retention Equity).¹³
- g. All holders of CLO securities that are U.S. persons within the meaning of Regulation S under the Securities Act of 1933, as amended, must be Qualified Investors.¹⁴

5. Regulatory Oversight.

In order to ensure that regulators have a view into the securitizations, the Qualified CLO explicitly recommends regulatory oversight.

- a. The CLO manager must be a registered investment adviser.¹⁵
- b. All purchases and sales of the CLO's assets must be conducted on an arm's-length basis and in compliance with the Investment Advisers Act.

6. Transparency and Disclosure.

The DP noted that during the crisis it became clear that many investors did not have sufficient information on the credit risk of their asset backed holdings to perform a reasonable assessment. The Qualified CLO would have extensive disclosure requirements on a monthly basis. The monthly trustee report would include information regarding:

- a. A list of CLO assets, including with respect to each asset: obligor name; CUSIP (or security identifier) if applicable; interest rate; maturity date; the type of asset;

¹³ For purposes of this requirement, the CLO's equity is the most junior class of securities issued by the CLO (excluding any non-economic security such as the issuer's common stock) and any additional class(es) of securities junior to the rated notes.

¹⁴ "Qualified Investor" means (1) with respect to securities that require the payment of principal and interest, an investor that is a "qualified purchaser" within the meaning of Section 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), or an entity owned exclusively by "qualified purchasers," or (2) with respect to securities that do not require the payment of principal and interest, (a) if the Qualified CLO relies on Section 3(c)(7) for its exclusion from the definition of "investment company" under the Investment Company Act, (i) a "qualified purchaser," (ii) a "knowledgeable employee" within the meaning of Rule 3c-5 promulgated under the Investment Company Act, or (iii) an entity owned exclusively by "qualified purchasers" or "knowledgeable employees," and/or (b) if the Qualified CLO relies on Rule 3a-7 for its exclusion from the definition of "investment company" under the Investment Company Act and such securities are not "fixed-income securities" as defined in Rule 3a-7, (i) a "Qualified Institutional Buyer" within the meaning of Rule 144A under the Securities Act, (ii) a person (other than any rating organization rating the issuer's securities) involved in the organization or operation of the issuer or an affiliate, as defined in Rule 405 under the Securities Act, of such a person, or (iii) any entity in which all of the equity owners come within the immediately preceding clauses (i) and/or (ii).

¹⁵ This designation entails a range of obligations that protect investors. See generally <http://www.sec.gov/divisions/investment/iaregulation/memoia.htm>.



and market price for each asset where available;

- b. With respect to the portfolio of assets: the aggregate principal balance and aggregate adjusted collateral principal amount thereof (adjusted as required by the CLO transaction documents) and the percentage of such aggregate adjusted collateral principal represented by each asset;
- c. Each applicable overcollateralization test and interest coverage test (and the level of compliance in relation to each test);
- d. Purchases, repayments, and sales; and
- e. The identity of each defaulted asset.

Thus, between the six pillars of the Qualified CLO – asset quality, asset diversification, structural protections, alignment of interests of the manager and investor, regulatory oversight, and transparency and disclosure – the industry proposal seeks similar objectives as the DP. The Qualified CLO tightens and codifies best practices that led to Open Market CLOs having among the lowest default and loss rates of any asset classes, including corporate bonds. At the same time, the Qualified CLO retains the characteristics that make CLOs attractive to investors. By doing so, this ensures that companies continue to have access to the corporate credit markets on reasonable terms.

We would like to thank the EBA for continuing to engage on these issues of great importance to the market, and we appreciate the opportunity to comment. We would be pleased to provide additional information that might assist the agencies' decisionmaking. Please contact Meredith Coffey at 1-212-880-3019 or Elliot Ganz at 1-212-880-3003 if you have questions regarding these comments.

Best Regards

A handwritten signature in black ink, appearing to read "Bram Smith". The signature is fluid and cursive, with a long horizontal stroke at the end.

Bram Smith
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