NEWS ANALYSIS

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Widespread risk retention sell-off unlikely

After the recent repeal of risk retention for open-market CLO managers in the US, a widespread sell-off of risk retention capital is thought to be unlikely as managers will still keep some skin in the game. Furthermore, while there is agreement that the repeal has lowered barriers to entry, opinion is divided as to whether it will lead to an influx of new CLO managers.

“I do not think there will be a widespread trend of managers selling their risk retention pieces. Perhaps managers who are capital constrained will feel compelled to sell, but generally people will be economically rational, particularly given the widening markets,” says Joyce DeLucca, partner at Hayfin Capital Management.

DeLucca adds that some compliant CLOs will have incorporated risk retention into the documentation and, along with structural restrictions, it cannot be easily sold off. She also suggests that the underlying investment thesis for capital in CLO equity will still hold after the ruling and so it will still make sense to keep the holdings.

David Quirolo, partner at Cadwalader, also highlights the fact that several managers have a lot of stored capital as a result of risk retention allowing them to take equity positions in their CLOs, or they may maintain it to optimise warehouse facilities.

DeLucca seconds this point and adds that the rollback of risk retention provides CLO managers a degree of flexibility in that it allows them to access this capital more opportunistically than before the repeal.

In terms of the impact on supply, DeLucca thinks that there is a “very real” impact whereby there are a number of deals coming to market to reset or refi that might not otherwise have been done. She adds: “This should dissipate as we move through the heavy April and July payment dates, and many deals are building in flexibility to reset or refi on any business day rather than only on a payment date.”

In terms of the management landscape, Quirolo suggests that the ruling lowers the barriers for entry, which could bring new players and greater diversification into the market. DeLucca is less bullish however and says that, while there may be new entrants, it is unlikely to be overwhelming.

DeLucca says: “Small managers without balance sheet or some other capital source will still face an uphill climb. The reversal of risk retention is only part of the story and does not change the larger trend toward size and scale.”

“Without access to capital,” DeLucca continues, “managers remain subject to the cost of the marginal dollar which generally puts pressure on management fees. That is a much tougher business model in a market that has evolved towards the institutional player, and all of the infrastructure requirements that entails. A capital constrained manager is simply at a competitive disadvantage on so many fronts.”

Despite the ruling, it seems likely that managers will maintain some risk retention capital as it puts them in a stronger position relative to other managers and Quirolo adds that, while true, it will not be to the same extent as the previous 5% requirement. This is a sentiment echoed by DeLucca, who adds that where managers maintain involvement it will likely be in the equity and mezz tranches.

On the investment front, European firms will be negatively impacted by the much smaller number of US CLOs that they can invest in, as they will not meet EU risk retention rules. Additionally, the number of dual-complaint CLOs being issued will see a drop-off, although Quirolo suggests that “if you look to the issuance landscape when European risk retention was in place but did not apply to the US, US managers still issued some European compliant CLOs”.

He continues: “They will therefore most likely continue to issue some deals that meet European risk retention rules, should the economics makes sense. The number of such deals issued may shrink, however.”

DeLucca adds a positive slant on the diminishment of dual-compliant CLOs and the shrinking investable universe for European investors, suggesting it could be a technical positive for euro liability spreads. Additionally, she concludes that US managers will still consider issuing European-compliant transactions and that it could be a differentiator for US managers in terms of appealing to European firms looking to invest in the US dollar market.

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