CLO market “prepared for Brexit”

Japanese risk retention rules provide “wiggle room”

The CLO market is ‘well prepared’ regardless of the outcome of Brexit. This was according to panellists at IMN’s recent CLO conference in London, who also suggested that further clarification around the Japanese risk retention rules could provide some comfort to CLO managers and investors, particularly in Europe.

One of the first topics discussed first centred around the issue of whether the CLO market presented systemic risks to the global economy, as suggested by certain high profile comments in recent months. One such statement came from the Bank of England’s Mark Carney who made a speech in February this year, comparing the leveraged loan and CLO market to the sub-prime mortgage market prior to the financial crisis in 2007.

Meredith Coffey, evp of research and analysis at the LSTA, commented that an important distinction needs to be made between credit risk and systemic risk, noting that credit risk has certainly increased in the US with an increase in leverage levels in CLOs, looser documentation and EBITDA adjustments. These factors all suggest that loss given defaults in CLOs will be higher but she added that there is no sign of defaults emerging right now.

Systemic risk is very different, said Coffey, commenting that the LSTA thinks it is actually much lower than it was in 2007. A major reason for this is that in 2007, banks were “stacking exposure” to subprime mortgages “that they couldn’t hold”, said Coffey, while banks today have much smaller and more manageable CLO holdings,

Speaking from the European perspective, Nicholas Voisey of the Loan Market Association said that it is “very superficial” to compare the CLO market with the subprime mortgage market, adding that the latter was very opaque and heavily concentrated in terms of asset class. The CLO sector, on the other hand, is far more transparent and CLO portfolios are multisector, providing diversity.

Additionally, said Voisey, while leverage multiples have increased in recent years and there has been weakening in documentation over the last 10-12 years

leveraged loans have performed well and so CLOs, also, have performed well. He added that “recovery rates are about 75%” and, even if they “are expected to drop to about 60%, CLOs are able to withstand that.”

A major announcement for the CLO sector was the recent establishment of Japanese risk retention rules and Coffey suggested that, as it stands, the ruling hasn’t been entirely about risk retention. She said that the “foundation” of the legislation is to ask a question of Japanese investors as to whether they have the systems and ability to analyse securitisation investments – if the answer is no, investors can’t invest.

However, she added that a part of the risk retention rule is more “asset focussed” as it seeks to determine that the assets are “not inappropriately formed”. There is however a “lot of noise”, added Coffey, about what this means, although the ruling outlines several things such as loan criteria, adequacy of claim collections ability, due diligence, underwriting and so on.

Coffey says that the end result is that the ruling ultimately has “wiggle room” and she suggested that “ambiguity in the rule is deliberate.” Nick Shiren, partner at Cadwalader, said that in Europe “it’s a slightly different analysis” where the question is whether European deals, which already comply with European risk retention rules, will be compliant with the new Japanese rules.

As such, he said that there are a number of similarities between the Japanese and European risk retention rules. He adds that, while the rules match up in many respects, there are some areas that need clarification, such as the issue of who can retain the stipulated 5%.

As it stands, the Japanese rules stipulate that it must be the originator or another party “deeply involved in the organisation of the structured product” which, said Shiren, provides for some flexibility as it has yet to be fully defined. Furthermore, there is a lack of clarity over the amount of risk retention required because under the Japanese ruling it refers to fair market value, while European rules refer to 5% of the nominal amount of the deal.

Shiren said, however, that the market takes the view that the Japanese rules won’t result in an amount higher than European rules. Generally, he thinks that European CLOs will likely comply with Japanese risk retention rules but he suggested that the market could benefit from further clarity.

With regard to the recently finalised Securitisation Regulations, Shiren also commented that the CLO and securitisation sector is still getting to grips with rules around transparency and the provision of data necessary for a securitisation to be compliant. Shiren commented that he has spent a lot of time on deals to ensure they comply with the article 7 transparency requirements, but

that there is still a lack of clarity about which entity is responsible for providing the information stipulated under article 7.

There are ongoing discussions about what happens in the event that an issuer, or related entity in a securitisation, is fined for lack of compliance with article 7 as, under the terms of the transaction, they would expect to receive indemnity. However, says Shiren, if the collateral manager suffers a loss due to the fine and it claims under the indemnity, it is “the investors who suffer” despite the fact that the rules are meant to protect investors.

Finally, panellists discussed how the CLO market is ready to withstand Brexit and Shiren commented that, at present, there are two major concerns with one being whether “UK collateral managers will be able to provide services to an Irish or Dutch SPV” after Brexit. The second issue at the moment is whether “collateral managers will continue as sponsor, or whether they will shift away from the sponsor structure to originator-manager structure”

Regardless, Shiren added that the CLO sector seems prepared regardless of the outcome of Brexit, although he does think some tweaks could simplify matters. He concluded: “Largely, collateral managers have worked out a Brexit strategy. However, expansion of the definition of sponsor under the Securitisation Regulation is very welcome...”

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