CLOs primed for innovation amid volatility and regulatory pressure

Risk retention, the bogeyman of the US CLO market in 2014, is now a reality. But is it as scary up close as it seemed from afar? It seemed like it at the start of 2015, but now that new issuance has finally started to flow, it would appear that appetite for CLOs is still strong. However, loan price depreciation and poor equity performance over the fourth quarter is leading some investors to re-evaluate the attraction of the sector, and risk retention could force some managers to do the same.

It's unclear what the trajectory of the market will be in 2015, but one thing is for sure — things are about to get interesting. Increasing volatility could lead to more nuanced tiering between managers, based on performance rather than size, and while risk retention could be the writing on the wall for some issuers, it creates opportunities for others.

GlobalCapital assembled a crack team of CLO experts in New York to hear their views on the future of the market at a time of immense change.

Participants in the roundtable were:

Adnan Zuberi, managing director, BNP Paribas

Jeremy VanDerMeid, managing director, Monroe Capital

David Frey, portfolio manager, Highbridge Principal Strategies

Oliver Wriedt, co-president, CIFC Asset Management

Edwin Wilches, portfolio manager, Prudential Investment Management

Francis Mitchell, portfolio manager, Webster Bank

Cindy Williams, partner, Dechert LLP

Will Caiger-Smith, securitization editor, GlobalCapital (moderator)

GlobalCapital: Last year was a record-breaking year for CLO issuance in the US. This year, some analysts are predicting the same kind of numbers, but most are quite a bit lower. What are your expectations for supply in 2015?

David Frey, Highbridge: I think it's going to be quite a lot lower. My guess would be $60bn-$80bn, probably on the lower end of most strategists' forecasts. We're starting out the year quite a bit slower, we've had about $3bn in January so far. Everyone is on hold trying to figure out the implications of risk retention, and investors are working out how to pick the right managers, the ones that can weather risk retention. It's a similar paralysis to the one that hit the market at the beginning of last year, when Volcker hit.

On top of that, equity investors are highly focused on the call option and what that will look like in a post-risk retention world, and returns have been declining for some of the mark to market and hedge fund guys, which makes the equity raise tougher. All of that is combining to slow down the pace of issuance.

Adnan Zuberi, BNP Paribas: I would agree with Dave on the numbers. I think $60bn-$80bn sounds like a reasonable estimate, although looking at the current pace the market has come out with thus far, we will need an uptick in issuance to get to numbers like that.

One could also argue that about $20bn-$30bn of last year's issuance was actually borrowing from this year's issuance as dealers and managers alike rushed to issue

deals going into the end of 2014. The market ended the year at a high headline number but has started this year slowly, with deals searching for clearing levels. Overall, it should be a more normalised year for issuance.

Edwin Wilches, Prudential: I have a hard time getting to $60bn. On top of risk retention, and ugly month-end marks, the steep drop in oil prices has made people sit up and remember that these deals have credit risk. Equity NAVs traded down 15-20 points late last year and there are at least one or two dealers that are starting to move the early 2012-2013 vintage equity in order to get in front of Volcker. These topical factors make selling new issue equity challenging.

So you have this ugly technical where prices aren't great, secondary activity is picking up, business development companies are trading at negative NAVs, so they can't issue more shares to raise money to buy equities, compounded by the fact that some underwater warehouses won't securitize. On top of that there is risk retention, coupled with manager and dealer fees getting squeezed, and at some point it just doesn't work.

For new issue activity to pick up, something has to give. Either liability spreads come in meaningfully or loans dislocate from where CLOs are, meaning they go down on a technical basis, and then the arbitrage may start to work again. Otherwise it's a really challenging environment to get that marginal equity person to buy. If I receive a mandate to buy equity today, I have more options than ever before between the primary and secondary markets and would probably just buy secondary and have greater ability to pick and choose ramped pools.

Jeremy VanDerMeid, Monroe Capital: I am a little more optimistic, and the main reason is the recent widening in loan spreads. You can invest in double-B rated loans right now in the primary market with 4% to 5% yields, while single-B rated loans are closer to 6%- 7%. The technical shift on the liability side for CLOs is problematic, but loan spreads have responded accordingly to a point where the arbitrage for the equity still looks pretty attractive. If you are ramping a warehouse now and buying into this primary loan market you can build an attractive portfolio from both a ratings and an asset yield perspective. We have always taken a longer term approach when it comes to ramping our warehouses for both our middle market and broadly syndicated CLOs and I think that is even more critical in a market with this much volatility. The print and sprint method seems to work for some managers but you really have to time it perfectly to make the return work for the equity.

The real hindrance to new CLO issuance is on the regulatory side as everyone is still trying to figure out the US market. There is enough ambiguity in the US that most managers are just structuring CLOs with shorter non-call periods to give them a refinancing option prior to the risk retention deadline. This solution works for now but you can only do this for a limited window as eventually you run out of time.

In Europe there is more clarity around risk retention and managers that can tap this market have a distinct advantage. The issue in Europe is that you have to be a proven CLO manager with established investor relationships and you need a diverse platform that can issue a European compliant CLO. We used the originator structure in Europe to execute on a middle market CLO last year and we plan to launch a broadly syndicated CLO this year in Europe using a similar structure. The end result is a US market still working through the rules where managers use short term solutions and a European market that is attractive but only accessible for some managers. This will certainly slow new issuance given the larger size of the US market but I still think we will reach at least $80bn in 2015.

Oliver Wriedt, CIFC: We're focused on the current CLO arbitrage. To us, that is the starting point for any discussion on issuance volumes in 2015. With BDCs trading at 85 cents of reported September NAV, one important equity investor group has been temporarily sidelined. Some permanent capital has been raised and this investor base has been very constructive on the market, but overall it's really about whether or not the arbitrage is compelling. The forward pipeline of loans is attractive but not deep. We're looking at two mega deals, but everything else is on the smaller side. Beyond that there isn't great visibility into what type of loans you'll be seeing this year. Overall volumes are going to be down year-on-year, so a lot of it really depends on whether the secondary loan market is going to be cheap enough to support current liability spreads.

Oliver Wriedt
CIFC

Importantly, the loss of the refinancing option at each payment date after December 2016 has investors highly focused on collateral yield. Furthermore, there are concerns about a modest rise in Libor hurting the equity arbitrage. Everything that has worked in favor of equity until now looks a little more daunting today.

For us it's really about where we can acquire loan portfolios. It turns out that December was a great time to print new CLOs, given the drop in loan prices. The current environment also looks pretty good from a loan pricing perspective, but the question is how long does it last. Eventually we expect liability spreads to tighten, but will they keep up with either diminished loan supply or rising loan prices? Only time will tell. Even if loans remain cheap, we're more comfortable with the lower end of the issuance forecasts. A $60bn new issue market creates plenty of opportunity.

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Francis Mitchell, Webster Bank: I have seen three new banks get involved as investors over the past month, but at the same time I have started to get cut back on my allocations for new issue deals, which hasn't happened for a while. So I'm starting to see deals being oversubscribed and spreads tightening. In double-As we were at 250bp maybe a month or so ago, and now we're at 230bp-235bp. We're also seeing looser terms in the deals. But I think there is still demand, so I'm probably in the $60bn-$70bn area.

Cindy Williams, Dechert: We have been hearing $60bn-$80bn. We also think a number of managers will be coming out with deals they believe will be risk retention compliant this year, so the equity will have more than a one-time option for refinancing. We're hoping there may be some regulatory relief on that issue with respect to deals that are closing between now and then end of 2016, when the rules become effective.

GlobalCapital: That brings us nicely to risk retention — the elephant in the room. What are investors looking for in managers in terms of their ability to weather the new rules?

Wilches, Prudential: Despite the fact that risk retention now forces managers to be well capitalized, the underlying premise for us has always been - do you have the resources to not only keep up with the new issue treadmill but also for when the market gets choppy? Can you support a downturn as well as the current market? Those are two different factors. Today we continue to focus on resources and risk retention.

My broader concern, as a triple-A debt investor, is more around M&A. There may be specific CLO managers that we don't necessarily line up with in terms of portfolio or management style and they could start buying out some of the smaller managers whose deals we own. Comparatively, in the investment grade market, M&As could lead to bonds getting downgraded on event risk.

I also don't think we can take for granted that big managers will figure it out and the smaller managers are in trouble. Arguably, you could say that the larger managers may also need to compete with internal initiatives for capital. Every deal has to stand on its own two feet when you go to your board and say I need $25m for a new CLO business that's not really growing anymore. The question will be could the firm just seed an ETF, hedge fund, mutual fund, or some other new strategy versus putting $25m into a new CLO? The return may still make sense, but higher friction costs will result in a lower return on equity.

That being said, we still like the asset class a lot. It's evolving and will continue to evolve until the day that risk retention actually lands. I heard Cindy say on a panel that some of the enforcement actions are pretty serious, so it also has a lot to do with how managers behave. When you have civil action against you, the bar is high.

Mitchell, Webster Bank: Risk retention is not as big a concern for us as Volcker at the moment, but I would agree with all Edwin's points. Risk retention is very important and something we think about when investing in new deals — how committed is the manager to CLOs as a business? However, we're really focused on getting non-Volckerised deals into conformance due to the immediate financial impact and pressure from regulators.

GlobalCapital: Adnan, maybe you can offer an arranger's perspective on risk retention?

Zuberi, BNP Paribas: It is the biggest issue of the day from our perspective. Every investor wants to know about it, and these days you spend a significant portion of your meetings between managers and investors discussing risk retention rather than investors gauging the manager's view on the market and on credits and sectors. And there are some sectors that are shaky, so maybe investors should talk to managers about that.

Adnan Zuberi
BNP PARIBAS

There have been 115 CLO managers who have issued in the 2.0 space. There are managers with varying scale and size and they offer genuinely different styles for CLO investors. We find that managers for whom CLOs are a core part of their business are very far along with their risk retention planning, and we are seeing managers make plans to issue risk retention compliant deals this year — we have the first group of managers that want to issue at least one deal to make sure they have a structure that is viable, and there is a second group that want to set up a structure to ensure that every deal they do going forward is compliant. This topic is taking up a lot of oxygen in the market, and just having an idea of what to do isn't good enough anymore. You could be the biggest manager out there, but if you sit in front of an anchor triple-A investor and say 'trust us, we'll be alright', that just doesn't fly anymore.

A well-articulated and comprehensive strategy is needed, and that is happening. As Oliver pointed out earlier on, the equity is insistent on it. The refinancing option is really significant given where liability spreads are today and equity investors want to know whether this option will be available to them. There are also a lot of hybrid structures being developed where people are trying to comply with EU risk retention rules as well as the US version of the rules and we expect this is going to be an evolving story.

GlobalCapital: Jeremy, I believe Monroe is doing its first broadly-syndicated CLO at the moment, and that is going to be risk retention compliant?

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VanDerMeid, Monroe: Yes, we are ramping the warehouse now and we are going to use a structure that we expect will be compliant in both the US and in Europe. We used the originator structure for our middle market CLO in 2014 and we expect to utilize a similar structure for our broadly syndicated CLO using the manager as originator to comply with both markets.

Jeremy VanDerMeid
MONROE CAPITAL

It's interesting when you analyze the impact of risk retention on smaller managers versus larger managers. I don't think you can just bifurcate the market and say that the smaller managers will be hurt and the larger managers will benefit. They key point to risk retention, as Adnan mentioned, is managers that have an established CLO business with a clearly defined risk retention strategy. We have been managing CLOs since 2006 and this is a critical component for our platform. We are certainly on the smaller end of the market as far as CLOs under management, but we view the risk retention as a net positive for our firm due to our multiple funding sources and ability to agent and hold our deals across multiple funds. We have a BDC, private debt funds and managed accounts that can help us meet the 'skin in the game' requirement and we can also arrange and sponsor deals if necessary and invest across multiple funds.

GlobalCapital: Oliver, as one of the largest managers in the market, what is CIFC's plan for risk retention?

Wriedt, CIFC: For us it's not a question of do we issue risk retention compliant deals or not. It's really about how many we issue before the 2016 deadline. To us, everything comes down to the arb. We are big investors in our own transactions. Adnan was describing the holy grail, which is how to comply with risk retention in both the US and Europe, thereby locking in much more compelling liabilities through the European investor base, and in the US to retain the refinancing option.

We have yet to finalize our structure, but what we're solving for is a construct that will allow us to be compliant in both jurisdictions. The spread between issuing a non-compliant deal into the US debt market versus issuing a compliant deal in both jurisdictions is significant. We're talking about hundreds of basis points of IRR differential. So whilst it has become difficult to execute on non-compliant deals, the compliant transactions are a walk in the park. The motivation for us and others like us to figure it out is high. We expect to have multiple vehicles, because we expect this to be an evolving process. Being well capitalised and focused on this business as our principal business are key factors in our decision making process.

Frey, Highbridge: We are working through the issue the same way almost everyone in the market is. There are a few managers who for luck more than foresight are already compliant. There are others, large or small, having the same issue, which is that this business, which was a service business, has now become a very capital intensive business. There are very few models out there where the asset manager and the investor with the assets to put to work are the same entity, it's normally a service they're providing on behalf of other people.

The misalignment of incentives that troubled the CDO and subprime markets through the originate-to-distribute model really doesn't apply, in my view, to open market CLOs at all. Managers have fees that are deeply subordinated to the performance of the CLO, there are incentive fees contingent on performance, and there is very good transparency on deal performance.

The issue is that while the bigger firms have access to capital, they have to work out whether a 50bp CLO business is the best use of their capital, or is seeding public vehicles or private equity funds or other much higher margin products is more worthwhile. We are looking at structures where the manager can meet the spirit and the letter of the risk retention language but also partner with third party capital sources who find it an interesting strategic investment.

The rule has only been out a couple of months and there is still a lot of uncertainty — no one wants to be caught offside with a structure that doesn't work, as happened with the first couple of European compliant deals. When that happened, the investors bore the brunt of it, but in the US case, managers are going to take the hit.

I've been close to this because of my role at the LSTA. We are in front of regulators discussing whether a refinancing of an existing CLO should actually be considered the same as a new CLO and therefore does the refinancing have to be risk retention compliant, and that is going to be a five body decision process that will take a long time.

Zuberi, BNP Paribas: In the US, the onus of risk retention is put on the manager whereas in the EU, under the CRR rules, the onus is on the investor and not the manager, to satisfy the regulations. However, there is a middle ground where you could comply with both, and that creates an opportunity.

There are structures in the market where third party investors who want to directly invest as closely as possible in a deal can find a way into this new world of risk retention compliant deals. At the same time, new investors who could not access investments into CLO management platforms can now do so. It doesn't work for everyone, but given the number of managers who have done CLO 2.0 deals we expect there will be some bold moves by managers in this market to change the way they do business. This is an opening for managers who want to significantly increase their AUM, and by the end of this year we expect a lot of different types of deals. That is the silver lining we see in risk retention.

VanDerMeid, Monroe: Yes, I agree that risk retention creates a potential opportunity for managers. You certainly need access to capital so if a manager doesn't have diverse funding sources or a parent company with a large balance sheet, I could see the need to partner with a third party. As I mentioned previously, I think managers who have multiple funding sources and the ability to agent and sponsor their own deals will be in the most optimal position for risk retention. There is a lot of complexity when it

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comes to third party investor discussions and this only gets more difficult in the current regulatory environment.

Williams, Dechert: We are talking to a number of asset managers. When risk retention first came out many people started looking at setting up a minority-owned affiliate with some third party equity and trying to solve for risk retention on a deal-by-deal basis. There are people who are still looking at that option, but if you want to satisfy risk retention by having a minority owned affiliate where you, the manager, have a controlling financial interest in that affiliate, the accountants are going to look at it from a facts and circumstances perspective and want to make sure the manager has the power to direct the activities that most directly impact the affiliate's economic performance. That means that if risk retention is satisfied by holding equity in the CLO, the minority-owned affiliate is likely going to own the majority of the equity, and the accountants are going to require that the call option be exercised by that minority-owned affiliate controlled by the manager. That has given managers and lead equity investors some pause.

Cindy Williams
DECHERT LLP

Speaking of the holy grail of a vehicle that is both EU and US compliant, we are seeing people looking at setting up new managers that would be capitalised, and for EU purposes would be entities of substance that would be able to own loans for their own account and sell them into CLOs. These capitalised managers would be registered investment advisors, and would be self-managed. They would have third party capital coming into the new manager and potentially capital coming in from another established manager that could second staff and support services to the new manager.

More people are looking at that option now. It is more complicated and it does change the structure of a manager somewhat, but it has a lot going for it. For one, you don't have the problem of who exercises the call option. Obviously if the manager holds the majority of the equity it may still be the party exercising the call option — but this option gives you the ability to be both US and EU risk retention compliant and enough capital to enable you to do a number of CLOs.

GlobalCapital: So we're seeing a splintering of CLO management structures. You have to wonder whether this regulation, which is designed to tame the CLO market, is going to give regulators even more headaches by introducing another layer of complexity to the market.

Wriedt, CIFC: We've seen little to no innovation in CLOs in the post crisis world. In the current market, you're going to see a lot of new structures and exciting opportunities. We think this dynamic will attract new capital to our asset class. There is a tremendous opportunity here for private equity capital to come in. We also expect there to be new permanent capital vehicles. We saw a successful IPO in the autumn, and they have scaled up nicely. The non-BDC RIC market is very interesting. Of the two done, one is trading at a premium to book, the other is trading at a slight discount to book. That's certainly a heck of a lot better than a lot of the BDC dynamics at the moment from an IPO or equity issuance perspective.

You also have the European vehicles, some of which have scaled up nicely, so between private capital coming in and permanent capital in the equity markets, we could see some very interesting new entrants help tackle this challenge that the market is facing.

GlobalCapital: What about some of the attempts we've seen so far to deal with risk retention in the here and now? For example, recent deals that include unfunded 'ghost' tranches that could be used to refinance the deal after 2016 without being subject to risk retention?

Zuberi, BNP Paribas: Clearly the intent of the regulators was to give the market time to absorb and adapt to the regulations. But this valuable economic option —refinancing — has been caught up within that. So any variation or structural innovation that can preserve the optionality for the future, should the regulators decide this was not their intent, is a positive development. It's meant to be a two way conversation, and in Europe, the regulators have been proactive with Q&As that specifically address points that need clarification. Those deals have just taken a particular view on the rules.

Wilches, Prudential: It's an option. Time will tell whether it can get exercised or not. From an investor's perspective, it is not the most hateful thing. Anyone who has that option is going to have to seek legal counsel and decide whether they can use it. If they don't think it's within the spirit of the law, then the option isn't worth much.
When the rule came out, we received a lot of calls asking about different structures: longer reinvestment periods, longer non-calls, and asking what we were willing to give up. The one feature that helped 1.0 deals get through the crisis well was longer reinvestment periods, which allowed managers to add value. We can all debate when the cycle will turn next, but we came out of a trough and changes will likely happen in the next few years, so that makes the optionality of that reinvestment period really valuable. Or you go the other way — late last year some issuance went to one-year reinvestment periods before they went static, and other such options.

Wriedt, CIFC: At CIFC, we think the longer reinvestment period is a win for everyone. The debt investor gets to lock in very attractive liabilities for longer. It gives the manager the opportunity to manage through a full credit cycle, and our friends on the banking side get their fees paid over a longer period of time, so those upfront costs don't hit you so hard.

It is something that we have been very focused on. It's frustrating how little traction we've got with this initiative so far. We were up to seven year reinvestment periods before the crisis, and now we're a full three years shorter. We've all seen how long these 1.0 deals can be around, we've got quite a few of them, and obviously it's a delight

to see them remain outstanding. We think you can have much cleaner deals if you concede to longer reinvestment periods, because this whole struggle around what happens post-reinvesment period goes away.

GlobalCapital: Speaking of reinvestment and active management, let's talk about oil and gas exposures and issues around supply in the loan market. What are your biggest concerns there?

Frey, Highbridge: Energy is obviously the sector that is out of favour. Both the CLO debt and equity markets have been so tier-focused in terms of favouring the bigger over smaller ones, and there hasn't been much focus on the quality and differentiation of underlying portfolios.

That is changing. There has been much more dispersion in terms of industry sector performance in the loan market, starting in the fourth quarter. Debt investors who were focused on tiering are now back to looking at the market value of portfolios and OC tests, which highlight those positions that are underperforming. That is healthy.

The mentality of equity has also changed, as has the mentality of hedge funds who were just clipping coupons. Even though CLO a cash flow product, all of a sudden people are looking at the NAVs of the equity they have. In some CLOs, particularly those with energy exposures, those NAVs have dropped significantly.

David Frey
HIGHBRIDGE PRINCIPAL STRATEGIES

Energy is about 4% of the loan market. There are a lot of CLOs where it is 8%-10%, and those are coming back to bite people. I think the market will move away from tiering and towards fundamental analysis of what is in these pools, what is the manager's style, their credit process and the performance of the portfolios. In our own investments we have even seen significant dispersion in portfolio credit quality within the same firm, from one deal to the next, so we don't believe tiering is the right way to look for value in the market.

GlobalCapital: Jeremy, how does that compare to your conversations with investors in your deals?

VanDerMeid, Monroe: We certainly see an increased focus on portfolio selection and risk. Frankly I think this is good for the market as a strict tiering system based on manager size is problematic. Credit selection and analysis related to underlying portfolio metrics such as leverage, cash flows, and loan to value — these are the details we like to focus on when we meet with investors. I always prefer it when investors dig into credit because our strategy has always been to buy and hold with a very conservative investment strategy. We don't chase a lot of speculative industries like oil and gas, we don't chase yield and our portfolios tend to be much lower leveraged than the market in general.

I also think manager behavior through the last economic cycle is critical for investors. We spend a lot of time with investors looking at how we managed our portfolios through periods of economic stress and high defaults. One of the best features of a CLO is the transparency it provides to investors — they can literally go month by month through trustee reports and track defaults, CCC exposure, WARF and OC build to get a read on a manager's historical performance and behavior through a cycle.

Covenant lite deals are always a topic of discussion but I think this feature is here to stay. Frankly I would be just as concerned with other structural features in these deals such as addbacks and synergies included in EBITDA, equity cures, permitted indebtedness and language for restricted payments. We recently saw a deal where half of the adjusted EBITDA presented by the arranger was in the form of synergies and addbacks.

We always consider these structural features when we underwrite our deals and we like to dig into credit agreements to go a step further in our underwriting as these features add an additional element of risk. You won't see the impact in this benign credit environment but the real test will be when defaults spike, as we did not see this level of structural weakness in deals going into the last economic cycle. The impact on recovery rates could be material and this should also be a key focus for investors when it comes to the fundamental credit analysis.

Mitchell, Webster Bank: The market has got tighter around language and then get looser on other language, and often it varies hugely from deal to deal. A lot of it has to do with larger investors, and the specific type of investor that drives the deal. Our investment size is really up to $25m, we like to anchor the double-A tranche.

Recently we have seen deals where there is a cov-lite limit tied to the WARF. In one of the most recent deals, the WARF goes up to 3,500, and they'll bring the pari passu definition of cov-lite to 50% if the WARF breaches 3,300. There is some goofy language, there's no other way to describe it. It is very frustrating that some investors are allowing these types of changes. We've also had some deals where language has been extremely tight, but I think investors have thrown in the towel when it comes to cov-lite. For us, and other bank investors, it is a hot-button issue because we ourselves don't make cov-lite loans and risk officers see it as an added risk factor. So it may not seem like a big deal for other investors but for us, it can be. Total indebtedness is also a very big issue for us — deals are sneakily moving into middle markets without marketing themselves as such.

As far as overall language and structure, I've seen some deals come very loose as either new investors have driven the deal, or foreign banks have driven the deal. There have also been some deals with quite tight language, like CIFC's deal in December, which, personally, I thought was really well done. So it's a mixed bag right now.

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Wilches, Prudential: For us, total indebtedness is more important than cov-lite. It has nothing to do with a distaste for the middle market, it's more about economics. If we get paid for a broadly syndicated deal, we don't want style drift in terms of the assets that end up in the portfolio. I really think the underwriting of the manager is the key factor in CLO tranche investing. But if I ever need liquidity in the secondary market, I also don't want to have to ignore an entire bank buyer base because the cov-lite language doesn't look right.

Edwin Wilches
PRUDENTIAL FINANCIAL

Part of the cov-lite increase has to do with the loan market growing up and moving away from bank lending to a more institutionalised base. As the market matures, the marginal buyers such as multi-sector funds and high yield bond funds that buy loans aren't as sensitive about covenant-lite.

I believe a broader risk today is the overall contagion effect across the market and the lack of liquidity. The oil and gas sector in loans isn't large and it shouldn't move an entire CLO market, but in the high yield bond market, energy is a meaningful component and there were a lot of outflows in that sector in 2014. Those outflows, combined with super low interest rates, led to an increase in retail bank loan outflows as investors tossed the baby out with the bath water. We'll see what happens should emerging market sovereigns start to get in more trouble. There is strong technical pressure now that loans aren't just contained in CLOs and separate accounts — they're part of this broader institutional world. The good thing is there is more issuance, the bad thing is there are fewer disciplined investors and more volatility.

The last few months have been great from a credit perspective as it gave people more discipline and reminded them to think about credit. That's healthy, it's like a gut check for the market.

Wriedt, CIFC: At the end of the day, the manager is tasked with creating a portfolio that offers good relative value with acceptable risk. We have been surprised at the lack of risk management in Q3 and Q4. It has been less about investors not paying attention; it's more that there was an expectation that managers manage risk. When you see the market moving against you and you're running big overweights in energy or marginal retail, you have to manage risk. The typical CLO structure is a 10 or more times levered structure and you cannot take that level of volatility. Ye,s it's a cashflow structure, but everyone I know marks to market, and when your equity and mezz are underwater, you haven't done that good a job.

Last year was a great study of who has been paying attention to market risk and who had more of a buy and hold strategy. The latter approach feels like the 1.0 mindset, which delivered fairly mediocre performance. We're in a total return market and volatility is here to stay. This is a great investment environment, but if you want to deliver a high spread portfolio then your best idea can't simply be to overweight energy and get on the rollercoaster ride. There's got to be more to it than that.

We thought a lot of the manager tiering was silly and didn't make sense. It will be interesting to see whether we get a new tiering based on performance. We've certainly seen debt spreads widen significantly based on simplistically what is the energy exposure. We feel you have to add in everything else that is trading with an eight-handle, gross it up and work out where you stand on a mark-to-market basis. We're keen to see whether the market continues to differentiate. There are some new brands that have emerged because they've done well, and some of the old ones may be questioned because they've done less well.

GlobalCapital: Let's talk about Volcker. It's been a topic for some time, and the LSTA keeps popping up with another letter or a lawsuit around Volcker. A lot of market participants seem to be wary of a legislative solution, so if that's not on the table, are people doing enough to solve for Volcker?

Wilches, Prudential: Francis may disagree, but I think Volcker is a bit more of a non-event today relative to last year. Half the 2.0 market has been Volckerised, and there is still some runway for the banks to figure it out by 2017. There are a lot of amendments coming through, and the banks have negotiating power given their size and market presence. The equity investors now have the carrots of the covenant-lite bucket and the S&P recovery rates to help them along. We've also seen some non-Volcker deals coming to the secondary market, so to the extent you're not bound by Volcker rules, you can buy them. It's more about how much you want to get paid for the lack of liquidity if you ever need to sell them.

Also, these deals are getting shorter every day, and at some point they're going to be three-year bonds and shorter. If you take a step back, you get to a point where in 2017 banks either sell this at a loss or just go to the mezzanine/equity investor and pay them the amendment fee.

Part of the rub is banks asking for Volckerisation and equity investors being OK with it, but not wanting to foot the bill for the amendment, which is fair. I believe there was one deal that opened a side pocket for a few quarters to eventually get to the fees for Volckerisation.

Mitchell, Webster Bank: We have already started to take an OTTI (Other Than Temporary Impairment) write-down on our portfolio, which is between $300m and $500m. Other banks haven't done this — they say they believe they can hold these securities to maturity so they're not taking losses. For us, the losses haven't had a material impact, but it is a frustrating situation. Three of our deals were

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just upgraded a full notch to triple-A, but we have to mark them to market and take a write-down due to pricing, not performance. We now hold our entire portfolio at a wider discount margin.

I have proactively contacted our managers on a quarterly basis for the past year. There are some deals where if you do have a JPM or a Wells as an investor, they tend to get things done. But then there are some of the 2013 deals that were a lot more broadly syndicated, with a lot of smaller banks in there who hold $10m-$20m clips. That is the catch — who is going to be the voice for all these banks and negotiate on their behalf?

It's not up to the managers, but they do have to facilitate this trade, even though it can be pretty difficult. Some managers paint the picture that it will get done somehow and ignore it, but others actually facilitate a dialogue. Unfortunately what we have found is that it is not always up to only the CLO equity holders and the triple-A investors. Equity investors have been tough to work with, but for several deals it has been a question of getting mezz investors involved.

About 35% of our entire portfolio has been Volckerised, with three or four deals done. But I think we'll see a lot more. I don't see legislation fixing this, so it comes down to what is the bid going to be for non-Volckerised paper that has slightly rolled down the curve to 2017. If all the banks are going to sell at the same time, how is that going to affect pricing? I think you're going to see banks taking some losses, both when they sell and through OTTI.

Francis Mitchell
WEBSTER BANK

For those affected by Volcker, it is a big deal. I'm not actively investing in new deals from managers that don't facilitate the process of fixing prior deals. I know it's not up to them, but if I don't get the sense that they will use their resources to sort it out, I'm not going to invest. There are other larger investors that do the same, and I think it is the right approach. This is a metric in which you can understand the character of the manager, not a quantitative measure of performance, but it can be just as important.

Frey, Highbridge: I agree it is still a problem. Logically it makes sense that triple-A guys give up something on cov-lite and the new recovery ratings and the equity gives up the bond bucket. If it was just a bilateral negotiation between the equity and the triple-A it would get done pretty easily. The problem is you have a bunch of mezz layers in the middle and it's not clear what the advantage is for them.

The current rules only cover CLO bonds that were held by the bank prior to July 2015. There is a lot of concern in the market about whether that causes a reduction in liquidity, if a dealer bank can't buy bonds as a trading position and facilitate normal market-making activities because they bought a bond in August 2015 and now that is not covered by the two year extension. We already saw a lot of non-Volcker triple-A bonds come up for sale last year. There is a decent chance that there could be a flood of selling right before July this year or July 2017, especially if banks are already writing down assets. It has the potential to cause some dislocation in the market, as well as leading to a much bigger bifurcation between where compliant and non-compliant deals trade. There could then be some spillover into where Volcker-compliant deals trade, or into other asset classes on a relative value basis.

One would have thought that a triple-A CLO bond that only has the ability to remove the manager under certain circumstances should not be seen as the equivalent of a seed investment in a hedge fund. I believe the regulatory logic is flawed, but it's not up to me.

Zuberi, BNP Paribas: Francis made an important point. As a dealer, we see some of our manager clients being put in a difficult position, where triple-A investors believe that these managers somehow have the ability to Volckerise a transaction, when there could be equity or mezzanine investors in the deal who are not amenable to the process. And so sometimes, there can be a bit of tension between managers and the different classes of investors. Investors need to have realistic expectations of what the different parties in the process are capable of doing.

GlobalCapital: Moving onto Europe, how much value do you see there? Obviously Europe is a very different market dynamic to the US, but are their opportunities for US managers out there?

VanDerMeid, Monroe: We saw demand from European investors up and down the CLO capital structure for the middle market deal we closed in 2014. The investor base is certainly not as deep as it is in the US, but we did see a fairly diverse mix of investors in the form of insurance companies, banks, hedge funds, etc. I think the key issue for a European execution is familiarity with the manager. We had a good reception as several of these European investors were investors in our CLO 1.0 deal and they were very familiar with our platform and our track record. I think it would be very difficult to execute in Europe in this market unless you investors who were familiar with your platform and comfortable with your performance and behavior as a manager through the last credit cycle.

Zuberi, BNP Paribas: I think we are seeing currently six US CLOs in the market that are European risk retention compliant. While in the past, it was predominantly dollar-denominated middle market deals that were marketed to European accounts, now only two of those six are middle market deals while the others are broadly syndicated. That is an indication of things to come as managers will continue to be enticed by the better execution in Europe. The real question for us is how deep that market is at the end of the day. At the moment, there is a handful of investors across the board participating in the admittedly limited number of USD CLOs that are structured to be CRR-compliant, but the trend is clearly there, and investors have told us that they want to see more top tier managers coming to market with compliant deals. ▲

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