Who Knew that CLOs were Hedge Funds?

February 10, 2014

U.S. financial regulators found themselves on the receiving end of an outpouring of concern from lawmakers last Wednesday about the risks to the banking sector and debt markets from the treatment of collateralized loan obligations ("**CLOs**") in the Volcker Rule final regulations. Regulators and others have come to realize that treating CLOs as if they were hedge funds is a problem and we now understand from Governor Tarullo's testimony that the treatment of CLOs is at the top of the list for the new interagency Volcker task force. But what, if any, solutions regulators will offer — and whether they will be enough to allow the banking sector to continue to hold CLOs and reduce the risks facing debt markets — remains to be seen.

The best solution — recognizing that CLOs are not hedge funds and that banking entities should therefore not be subject to any prohibitions under the Volcker Rule on holding interests in CLOs — may be too much to expect. Given the risks and impracticality of banking entities divesting their interests in legacy CLOs and of legacy CLOs organized before the final Volcker Rule regulations were published on December 10, 2013 divesting their bond portfolios, however, regulators should offer solutions that allow the banking sector to retain interests in legacy CLOs which are backed, in part, by bonds.

CLOs and the Volcker Rule: What a Mess We're In

Most Legacy CLOs May be Off-Limits for Banking Entities Under the Volcker Rule Regulations

CLOs that hold assets in addition to loans, such as bonds, are categorized as "covered funds" under the Volcker Rule final regulations. Although the senior tranches of CLOs that are typically held by banking entities are commonly thought of as debt interests, to the extent that such interests include the right to remove the collateral manager for cause, such interests could be deemed to be "ownership interests" under the Volcker Rule final regulations. As a result, banking entities will be prohibited from holding such otherwise debt interests in any such CLOs after the end of the Volcker Rule conformance period on July 21, 2015, or later if the Federal Reserve extends the conformance period.

This outcome surprised debt markets and the banking sector, which had expected loans and other extensions of credit, such as bonds, to be treated the same for these purposes under the final Volcker Rule regulations, as they had been in the proposed Volcker Rule regulations released in November 2011. Regulators have emphasized that, consistent with the statutory language of the Dodd-Frank Act, CLOs that hold only loans are not covered funds. Analysts estimate, however, that most legacy CLOs hold at least some bonds, and nearly *all* CLOs are authorized to purchase and hold bonds. The typical bond bucket is in the range of 10% of the assets in the CLO.

The banking sector, including both U.S. and foreign banks, many of which will be subject to the Volcker Rule, are estimated to hold approximately 70 percent of the most senior, AAA-rated outstanding CLO debt tranches that may be recharacterized by the final Volcker Rule regulations as ownership interests, as well as a substantial proportion of outstanding AA- and A-rated CLO debt tranches subject to the same recharacterization risk. Requiring banking entities to divest their interests in CLOs with a bond bucket is likely to rattle debt markets and curtail lending. RBS reported a 60% drop in CLO issuances in January, after the publication of the final Volcker Rule regulations. Given how much of the market in these debt tranches banking entities own, the main beneficiaries will be investors outside the banking sector who will be able to buy performing AAA assets at a steep discount, and the main losers will be companies and small entrepreneurs who will find it harder and more expensive to borrow money.

No Easy Way to Make CLO Vehicles Volcker Compliant

Some have downplayed the problem, arguing that legacy CLOs may conform to the carve-out for loan-only CLOs by selling off their portfolios of bonds. The realities of conforming legacy CLO vehicles, however, are more knotty than suggested.

While collateral managers may have the discretion to liquidate an existing portfolio of bonds, banking entities will need certainty that CLOs that are not covered funds today will not buy bonds in the future. Amending CLO documentation to permit only loans to be held will generally require the approval of a majority of all tranches of investors. Not only would it be costly to organize a diverse group of CLO investors to take action, but as divesting bonds could reduce returns for holders of more junior CLO tranches, **according** to analysts, not all investors are likely to support any such amendments.

Going Back to First Principles: CLOs and the Objectives of the Volcker Rule

Absent a regulatory solution, the potential limits on the market's ability to absorb legacy CLOs being divested by banking entities and the possible opposition of other CLO investors to amending the governing documents of CLOs to eliminate the ability to hold bonds could be intractable obstacles to compliance by banking entities with the final Volcker Rule regulations. Given that barring banking entities from holding CLOs backed in part by bonds does little or nothing to further the Volcker Rule's objectives, the most straightforward solution is not to treat CLO vehicles as if they were hedge funds.

The Volcker Rule is Meant to Prohibit Investments in *Hedge Funds*

Indeed, who knew in 2010 that CLOs were similar in any way to hedge funds? We ought to remember, instead, that the Volcker Rule was not intended to foreclose the banking sector from investing in securitizations.

When President Barack Obama **announced** his support of the Volcker Rule in January 2010, he said the objective was that "[b]anks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers."

What is more, the Volcker Rule's prohibition on hedge fund investments was never meant to bar the banking sector from investing in *any* type of fund. Rather, the Volcker Rule's prohibition on banking entities investing in hedge funds was meant to be a prophylactic against evasion of the Volcker Rule's prohibition on proprietary trading. As Senator Jeff Merkley, a sponsor of the Volcker Rule, **stated** on the Senate floor in the summer of 2010, as the Congress debated the Volcker Rule, "if a financial firm were able to structure its proprietary positions simply as an investment in a hedge fund or private equity fund, the prohibition on proprietary trading would be easily avoided, and the risks to the firm and its subsidiaries and affiliates would continue."

Why are CLO Vehicles Treated Like Hedge Funds?

Congress understood that banking sector investments in CLOs are not a channel for indirect proprietary trading and do not expose investors to the types of risk or threats of evasion that may arise from investments in hedge funds.

Indeed, Congress declared in the Dodd-Frank Act that nothing in the Volcker Rule should be "construed to limit or restrict the ability of a banking entity . . . to sell or securitize loans." It is true enough, as regulators are at pains to point out, that the Volcker Rule final regulations do not block banking entities from holding CLOs backed solely by loans, and this narrow view may satisfy the technical requirement of the statute. Even so, with analysts **pointing** to the Volcker Rule as the cause for the slow pace of CLO issuances so far this year, it seems the regulators have thrown up at least some hurdles to the securitization process and fallen short of what Congress intended.

Moreover, it is not clear what distinction the regulators were trying to draw by allowing banking entities to invest in CLOs backed solely by loans but treating investments in CLOs with a permitted bond bucket, typically in the range of 10% of total assets, as prohibited hedge fund investments. While the loans in legacy CLOs are often secured and the bond bucket often includes high-yield bonds, there is nothing in the loan securitization exclusion in the final Volcker Rule regulations that would prohibit future CLOs from including high-yield instruments, as long as they are in the form of loans and not bonds. As a result, the credit risk a banking entity would be exposed to would be no different whether the high-yield instruments are structured as loans instead of bonds.

Whatever their reasons for doing so, by adding a last minute surprise ban on banking entities' ability to own investments in CLOs that have a bond bucket, and by defining ownership in an unnecessarily expansive way, regulators may actually end up exposing banking entities to *greater* risks. One community banker **warns** in a letter to regulators quoted by lawmakers last Wednesday that divesting its CLOs — at presumably fire-sale prices, if it can do so at all — would have a "material negative impact" on the bank's capital. In addition, to the extent that CLO collateral managers sell all bonds to fit within the covered fund exclusion for loan-only CLOs, they may seek to shore up returns by acquiring higher yielding second-lien loans, **according** to **market analysts**, which are often made to borrowers deemed **too risky** to access the high-yield bond market. Finally, by precluding the rights of CLO investors to remove managers for cause, such as fraud, the regulators have made these investments more risky.

Where Do We Go From Here?

Regulators **appear** inclined to offer solutions but have so far declined to commit themselves to any course of action. Potential alternatives include the following.

- ***Exclude CLOs from the Definition of Covered Fund:*** The most sensible solution would be to recognize that CLOs are not hedge funds and exclude *all* CLOs from the definition of covered fund in the Volcker Rule final regulations. To the extent that the regulators believe that CLOs are risky investments, they can calibrate investments via their safety and soundness powers, as the FDIC has already done in the treatment of CLOs in calculating risk-based insurance premiums and the OCC has done with leveraged loans.
- ***Grandfather Legacy CLOs:*** One option regulators should consider is a grandfathering of all CLOs that were established before December 10, 2013, the date the final Volcker Rule regulations were published.
- ***Clarify the Definition of Ownership Interest:*** As **urged** by some industry groups, regulators could also clarify that certain rights regarding the removal/selection of a collateral manager should not convert debt interests in CLOs into ownership interests for purposes of the Volcker Rule. This solution would provide relief for banking entities that hold only senior-tranche debt securities in CLO vehicles.
- ***Waiver of Ownership-Interest Rights:*** Another potential solution for debt tranches of CLO vehicles that include collateral manager removal rights is for a banking entity to waive such rights by committing to its regulators not to exercise them without regulatory consent.

Without any of the above regulatory actions, banking entities holding CLOs have a choice between two unattractive options.

- ***Bond Sell Off and Contractual Amendments:*** Without regulatory action, if banking entities are to continue to hold interests in CLOs that are deemed to be ownership interests under the final Volcker Rule regulations and be confident of not violating the Volcker Rule, CLOs that currently hold bonds will need to sell off their bond portfolios and amend their governing documents to prohibit purchases of bonds in the future. As noted above, this is significantly easier said than done.

- ***Banking Entities Divest CLOs:*** If all else fails, banking entities will be required to divest their interests in CLOs that hold bonds by the end of the Volcker Rule conformance period, if the interests would be characterized as ownership interests under the final Volcker Rule regulations. Whether markets can absorb the magnitude of sales of these CLO interests by banking entities without disruptions in the lending and securitization channels remains to be seen.

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