June 18, 2015

SPECIAL EDITION Thursday

ABS Barcelona DAILY

GlobalCapital
The new EUROWEEK

CLO ROUNDTABLE
Managers get creative to run the regulatory gauntlet

OPINION
Securitization keeping its head above water

HEARD IN THE HALLS
Quotes and gossip from GC's very own special purpose vehicle

One STC rule to rule them all, says Rule

Will Caiger-Smith

DAVID RULE, the Bank of England's executive director of prudential policy, used his keynote address at Global ABS on Wednesday to call for the construction of a sustainable securitization market in Europe, rather than measures to revive it in the short term.

He also pledged to distil the alphabet soup of securitization quality labels into a single set of criteria to be applied across different sectors.

Rule poked holes in market participants' focus on issuance numbers, saying it ignored significant changes in market dynamics since the financial crisis.

"Comparing current issuance with pre-crisis levels misses the point that the pre-crisis market was fragile, based on investment by leveraged PAGE 4 »

Rule: building for the long term

ECB says HQS rules must match up

Graham Bippart

THE EUROSYSTEM should prioritise harmonising different regulatory frameworks for securitizations to meet standards of high quality, said the European Central Bank's head of risk strategy in a keynote address at Global ABS on Wednesday.

The criteria for qualifying ABS should be applied across regulatory frameworks including Solvency II, the liquidity coverage ratio, capital requirements regulation and elsewhere, said Fernando González during his speech during the conference's first morning slot on Wednesday.

"For example, at the moment, the criteria for Solvency II are different than they are for LCR, which PAGE 4 »

Monster mortgage sales drive market

Owen Sanderson

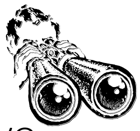
THE SALE of more than £26bn in mortgage portfolios could drive the UK RMBS business for the rest of the year — but the anticipated supply is already weighing on UK non-conforming spreads.

Co-Op's £6bn Optimum portfolio, GE Capital's UK home lending book (£7.7bn) and Northern Rock Asset Management's £13bn Granite portfolio could all find new owners by the end of the year, with securitization likely to provide the funding.

Market participants say that smaller portfolios are also trading actively, and finding homes in the non-bank sector.

The precedent for the jumbo size deals is NRAM's Slate portfolio, PAGE 5 »

THE GC VIEW



The ECJ ace up the Troika's sleeve

Greece's imminent cash shortage might be grabbing most sovereign bond watchers' attention, but the European Court of Justice has handed its creditors an extra bargaining chip in negotiations.

With talks going down to the wire before Greece has to repay the International Monetary Fund €1.5bn at the end of the month and the talk from both sides becoming ever tougher, it's hard to imagine anything more than a short term deal being agreed on structural reform to release much needed bail-out cash before time is up.

If that does happen — and it's a big if — then we can expect many more months of the cycle of rising and falling hopes of a resolution being reached.

But thanks to a decision by the European Court of Justice on Tuesday, Greece's creditors will have a stronger hand in those talks.

The ECJ ruled that the European Central Bank's outright monetary transactions programme — first announced back in 2012 as part of the central bank's efforts to drive down eurozone periphery yields — was legal under European Union law.

So far, so boring — the ruling barely registered on bankers' risk barometers this week, given ECJ advocate general Cruz Villalón already opined in January that OMT was compatible, in principle, with the Treaty on the Functioning of the European Union.

But crucially, the January opinion warned that a feature of OMT whereby a beneficiary country must adhere to a financial assistance programme of the European Financial Stability Facility or European Stability Mechanism or lose OMT support could smudge the border between the ECB's mandate for setting monetary policy and the entirely separate domain of economic policy.

However, in Tuesday's ruling, the ECJ did not force the ECB to drop this condition. The ECJ said instead that, while OMT conditionality may PAGE 5 »

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08:45 Registration and Breakfast

09:30
The Investors' Roundtable

- What are other asset managers focusing on and why (if not ABS)?
- Where does structured credit fit in the wider investment portfolio?
- Looking across the ABS landscape globally, where are the opportunities?
- How can we create a broader base of capital market investors and more effectively distribute risk?
- What is the roadmap for incentivizing broader investor participation?
- Will we ever see a robust private placement market in Europe?

Moderator:
Gareth Davies, Managing Director, J.P. MORGAN

Panelists:
Neil Calder, Head of Investments – Credit, Treasury, EBRD
Eric H. Havard-Duclos, Managing Director, AXA INVESTMENT MANAGERS
Ope Agbaje, Executive Director, NEUBERGER BERMAN EUROPE LIMITED
Ramesh Kumar Kumar Ramiah, Principal Portfolio Manager, WORLD BANK
Markus Herrmann, Managing Director, LANDESBANK BADEN-WüRTTEMBERG

10:30 – Refreshment Break in Exhibit

11:00 – Keynote Address

Introduction:
Conference Co-Chair Jo Keighley, Executive Chairman, SFM EUROPE AND MEMBER OF AFME SECURITISATION BOARD

Speaker:
Raoul Ruparel, Co-Director, OPEN EUROPE

11:30 – Track A
Overview of the Dutch and UK RMBS Markets

Moderator:
John Milward, Director, HSBC

11:30 – Track B
Traders' Roundtable: Impact of ABS PP on Liquidity and the Secondary Market

Moderator:
Mark Hale, Owner, PRYTANIA INVESTMENT ADVISORS

11:30 – Track C
The Outlook Across Europe for Alternative Finance

Moderator:
Prashanth Satyadeva, Partner, Structured Debt and Capital Markets, BERWIN LEIGHTON PAISNER

11:30 – Track D
The CLO Investor Roundtable

- Do investors feel this sector can deliver the yield they may be searching for?
- Pricing expectations
- Profiling the investors and where are they active in the capital structure?
- What impact has regulation and structural enhancements had on investor appetite for CLOs?
- Differentiating fund managers
- Investor opinion on the refi option
- Relative value of US$ CLO paper; ease of cross border investing with new U.S. risk retention in place

Moderator:
Matthew Jones, Senior Director, STANDARD & POOR'S RATINGS SERVICES

Panelists:
Ian Robinson, Principal, KINSON CAPITAL
Chandrajit Chakraborty, Principal, PEARL DIVER CAPITAL
Sharif Anbar-Colas, Head of European CLO/CDO Trading, JEFFERIES INTERNATIONAL
Steve Baker, Managing Director, APOLLO MANAGEMENT

12:20 Track A
Australian ABS Market Update

Moderator:
Chris Dalton, Chief Executive Officer, AUSTRALIAN SECURITISATION FORUM

12:20 – Track B
Eligibility of ABS for Open Market Operations at the ECB and BoE – Criteria Update

Moderator:
Federico del Monte, Partner, HOGAN LOVELLS INTERNATIONAL

12:20 – Track C
European Marketplace/Online Lending (P2P)

Moderator:
Jeremiah Wagner, Partner, CADWALADER, WICKERSHAM & TAFT

12:20 – Track D
Infrastructure Finance - Plugging The Funding Gap

Moderator:
Tim Conduit, Partner, ALLEN & OVERY

13:10 – Delegate Luncheon

14:15 – Track A
Investing in Asian ABS 101: Market Overview and Outlook for China, Singapore and Korea

- Why are the Asian issuers looking to securitization?
- How do the structures look compared with international issuances?
- Rating levels and the rating agency approach
- Investment opportunities for Asian ABS

Moderator:
Ian Bell, Head of the PCS Secretariat, PRIME COLLATERALISED SECURITIES

Panelists:
Borong Liu, Chairman and Partner, CHINA SECURITIZATION FORUM / BEIJING ZHONGLUN LAW FIRM
Maggie Zhao, Partner, CLIFFORD CHANCE
Ben McCarthy, Managing Director, FITCH RATINGS
Chia Nam Toon, ACEO, Corporate Services, Group CFO, ASCENDAS
Colin Chen, Managing Director, Head of Structured Debt Solutions, DBS
Kyson Ho, MD, Head of Structured Capital Markets, Asia-Pacific, HSBC

14:15 – Track B
Loan Portfolio Sales: It's All About the Collateral

Moderator:
Arne Kluwer, Partner, CLIFFORD CHANCE

14:15 – Track C
The European Private Placement Market

Moderator:
Reza Taylor, Counsel, LINKLATERS

14:15 – Track D
Financing Short Term Receivables/ Warehouse Financing

Moderator:
Mark O'Keefe, Global Head of Asset Based Finance, RABOBANK

15:05 – Track A
U.S. ABS Market: Cross Border Issuing and Investing Challenges

Moderator:
Patrick Tadie, Group Vice President of Global Capital Markets, WILMINGTON TRUST

15:05 – Track B
Trustees and Investors - Friends or Foes?

Moderator:
Dominic Swan, Head of Team, HSBC BANK

15:05 – Track C
Investment Opportunities in US Single Family Rental Securitisation

Moderator:
Patricia A. Evans, Vice President, WILMINGTON TRUST

No more alphabet soup, says BoE exec

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funds and bank treasuries," he said. "Building a stable market will require a broader, real money investor base."

Whilst he advocated the sale of full capital stacks (subject to risk retention), he cautioned against structures at the more fanciful end of the risk transfer spectrum.

"The market also needs to be based on genuine risk transfer and not regulatory arbitrage such as synthetic sales of thin mezzanine tranches intended to maximise the reduction in regulatory capital at minimum cost," he said.

He also said a stronger RMBS market could help ensure the housing market was weighted properly.

"In the long run...we will need robust RMBS markets so that at least part of the risk on long-term housing lending is financed from long-term savings rather than short-term bank deposits," he said.

Simple, transparent labels

He promised that the "bewildering range of acronyms" for Simple, Transparent and Comparable (STC) securitizations would be homogenised by European policymakers.

"I can reassure you that these will be brought together into a single set of criteria in European legislation," he said. "I believe the intention is that they will then be applied consistently across different sectors — for example, banks, insurers and funds — and different regulations — for example, capital and liquidity."

Regulatory aid

In addition to helping investors analyse deals and issuers make deals more robust, STC should help regulators, added Rule.

"Setting risk sensitive capital requirements for securitization tranches is challenging," he said.

> "Building a stable market will require a broader, real money investor base"

"One solution is to use credit ratings, but the shortcomings of that approach were exposed during the crisis. Another is to use a regulatory formula capturing dimensions of risk such as the credit quality of the underlying pool, tranche seniority and maturity."

"In our view, including a differentiation based on STC in that capital calculation helps to capture other important dimensions of risk related to structure, transparency and governance."

In terms of capital requirements, Rule said the risk weightings set in December by the Basel Committee were "broadly right" but that STC deals could get lower risk weightings because of lower structural risk.

"A stronger argument can be made that Solvency 2 standardised capital requirements for EU insurers are still too high, especially at longer maturities," he said.

"For banks and insurers, part of the issue with securitisation capital requirements is the comparison with covered bonds, which tend to be treated favourably in EU regulation," he said.

"Issuers looking to raise secured funding may therefore see covered bonds as a more cost effective alternative to securitisation."

"Covered bonds have a legitimate role in the market as a source of stable long-term funding. But securitisation has the advantages of risk transfer and lower encumbrance of underlying assets. We would support moves to put securitisation and covered bonds on a more level playing field.

Phew

Policymakers handed another olive branch to securitization sponsors this week, scrapping a proposed amendment to a resolution on Capital Markets Union that aimed to double or triple the percentage of their own deals issuers must hold to satisfy risk retention rules.

Tim Conduit, a partner at Allen & Overy, said that showed that regulators were adopting a more "nuanced and educated" view of the securitization market.

"Risk retention was intended to disrupt originate-to-distribute, and that was a fair compromise in a new regulatory settlement," he told GlobalCapital. "But in reality, 5% retention has to be enough, because it amounts to a very significant part of a deal."

"If you were going to move it to 10% or 15% then it would put into question the rationale for doing securitization transactions at all, and that would really hurt the market." ■

HQS harmony a priority, says ECB

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are in turn different from the criteria developed by the European Banking Authority," he added.

The ECB's increasing involvement in the ABS market — and the view that regulation is lagging the central bank's pro-securitization stance — has been a key topic of debate at the conference, as the market continues to grapple with what many view as contradictory and overly restrictive rules.

Fast-track callGonzález added that he understands the European Commission will address this issue "in a comprehensive package for a renewed framework including qualifying securitizations, and I can only applaud this endeavour." He said he hoped the measures would be fast-tracked through the European Parliament and the Council.

His statements jived with industry participant's previous statements at the conference, with the central banker saying that "capital requirements for securitizations must accurately reflect their risks," and that the "risk sensitivity should be consistently applied across banks, insurers and other market participants who are relevant."

He added later that, while the ECB is not Europe's ABS regulator, it does, about seven months into the ABS purchase programme, feel it has gained a greater understanding of the asset class.

That may be the most significant outcome of the ABSPP in the long term, said Baker & McKenzie partner Vincent Keavey during the following session. Greater understanding should lead to a lifting of the negative stigma still tainting the sector in the eyes of many investors, he said.

"For example the eurosystem is now better able to contribute to regulatory discussions on simple, standard and transparent ABS," González said.

Residual valueGonzález, taking time out from his vacation to speak at the conference, briefly addressed the exclusion of auto ABS containing residual value receivables from eligibility for repo with the ECB, saying that the central bank felt such collateral exposed it not to credit risk, but to the market risk of having to sell cars at any given time.

He also urged issuers not yet taking part in loan-level data disclosure to begin doing so, saying that "for those that do not provide basic fields [of data requested], this creates more doubt about your ability to create healthy ABS," and adding that the resulting doubt would harm efficient execution more than the one-off cost of providing the data.

González called for issuers to make the jobs of investors easier by standardising documents and providing loan-level data, saying that the most affective way for regulations to be implemented is via the self-attestation of originators, combined with regulatory oversight and investor due diligence.

However, he added that investor diligence "should not translate into unnecessary burdens". ■

UK mortgage market on the make

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the sale of which closed last year. The UK bad bank said in its annual results on Tuesday that "the book was sold through a competitive sales process which saw a high level of interest and resulted in a sale price in excess of par. The proceeds included a premium of around £55m over the book value, representing good value for the taxpayer."

JP Morgan bought the £2.7bn book and securitized it in a pair of issues named Slate, with CarVal Investors in the equity of the deal.

GlobalCapital understands Morgan Stanley had teamed up with UK challenger OneSavings Bank and was the second placed bidder on Slate, with the recently spun-off TSB also in the final rounds. Morgan Stanley and OneSavings are said to be working together again on the upcoming deals.

JP Morgan is also likely sitting on a £2bn book of UK equity-release mortgages which it previously bought from NRAM. It began structuring a securitization of the book in 2013, but it never made it to market.

Granite bids

Goldman Sachs and Blackstone are reported to be working together on a bid for Granite, while TPG is also putting together a bid. Sky News recently reported that RBS was looking to buy the Granite book, but attendees at the Global ABS conference in Barcelona treated this prospect with derision.

"All the big banks and all the big private equity shops want a piece of this business," said a market participant. "The large private equity funds have a huge appetite, and will be very aggressively pushing this out in the market for funding."

Blackstone, which teamed up with TPG to buy Kensington Mortgages from Investec, added mortgage servicer Acenden to the package afterwards. The revamped mortgage platform has already issued two RMBS deals this year.

> "The large private equity funds have a huge appetite"

"A lot of non-conforming secondary portfolio trading has been done in the past 12 to 18 months, a lot will continue to happen, and I'd expect a lot to quickly find its way to the securitization market," said Simon Allsop, head of securitzation at Precise Mortgages, part of the Elliot Capital Management-backed Charter Court Financial Services, speaking in an afternoon panel.

Easy now...

Despite the hype around these UK mega-deals, private equity sponsors may need to tread carefully. Bob Paterson, head of ABS syndicate at Lloyds, said on the same panel that some investors viewed regular non-bank RMBS issuers, such Pepper Mortgages or Paragon, as more likely to call their deals than financial sponsors.

The Granite portfolio presents a particular challenge for aspiring bidders, because it is already securitized, at highly attractive pre-crisis levels. According to one investor, speaking on the sidelines of the conference, there is no way a bank could offer leverage to a private equity bidder at a cost close to the weighted cost of the Granite notes.

But leaving Granite in place means that the equity does not get any principal payments — all mortgage repayments go to paying the notes down. So a purchaser would either need to restructure the trust, or accept only interest payment cashflows until the notes paid down.

A London-based head of securitization said that banks would be unlikely to offer leverage against the equity in Granite, for credit control reasons.

Spread movement

In a different panel, Sriram Soundararajan, head of European ABS strategy at Jefferies, said that the potential supply coming down the pipe in non-conforming UK RMBS had pushed the bottom of the capital structure in existing deals tens of basis points wider.

"Once there is more clarity on the portfolio sales, I'd expect a few basis points to be shaved off," he said. "Any snapback from a successful Greece resolution would be more sluggish in UK non-conforming."

Granite is a prime portfolio, but the mortgages were high loan-to-value at origination and the bonds generally trade wider than the best UK shelves. ■

Could OMT opponents have cause for cheer?

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have indirect effects on the implementation of economic policy objectives, "such indirect effects do not mean that such a programme must be regarded as an economic policy measure".

Without the power of conditionality, it would not be hard to imagine a situation where Greece has exited its bail-out, regained access to the capital markets — a far-off possibility, but don't forget the country sold two bonds a year ago — then the ruling Syriza party decides to renege on its reforms. After all, it is, and always will be, an anti-austerity party.

In this scenario Greece would be able to demand OMT assistance with seemingly no responsibility on it to take measures to ensure it doesn't need future ones. In short, it has a free option.

That may seem a long way of but if a short term solution can be found to Greece's looming redemption pile, its European creditors will be in a much stronger bargaining position in the longer term thanks to the ECJ.

And with Tuesday's ruling strengthening Europe's hand in any future negotiations, the many — largely German — opponents of OMT might start thinking it's not such a bad idea after all. ■

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Redwood raises brows

A PLANNED US jumbo RMBS issuance by Redwood Trust has some investors sitting on the sidelines – and not because the transaction is backed by the highest portion yet of mortgages with litigation and regulatory risk.

The issuance includes both senior and junior triple-A rated notes, with the junior notes carrying credit enhancement of 5%, lower than the credit enhancement for junior triple-A rated slices of most other jumbo RMBS deals.

"The collateral looks good, but there is a lot less subordination for the deal compared to most others," a New York hedge fund manager told GlobalCapital.

A recent jumbo RMBS issuance by JP Morgan for instance provides credit enhancement of 7% for its junior triple-A rated bonds.

Redwood's planned deal, Sequoia Mortgage Trust 2015-3, is the sponsor's second consecutive transaction to include 5% subordination for its junior bonds. The jumbo mortgage aggregator's first deal this year, however, included subordination of 7.25%.

While junior bonds in Redwood's new deals have received lower credit enhancement than earlier transactions, market participants said they expect the transaction to launch smoothly. The issuance is expected to price next week.

In addition to the subordination floors for the top tranche, and the reduced subordination for less senior notes, the new transaction includes the highest share of non-qualified mortgages (QMs) to date. QMs provide safe harbour from regulatory enforcement and litigation, discouraging lenders from originating mortgages that do not qualify for the treatment.

An RMBS head at a global investment adviser told GlobalCapital that the non-QMs Redwood includes in its deals tend to be of very high credit quality. "Non-QM is a red herring. There's no credit risk in these deals," he added.

Morgan Stanley is the sole lead bookrunner on the deal, which is expected to price next week. ■

Wanted: CLO assets, will take sterling

MANAGERS OF European CLOs don't foresee a near term solution to a long-standing problem — an extremely thin pool of assets.

But participants at Wednesday afternoon's panel of CLO managers at Global ABS said that many would like to see easier access to the sterling market.

That could help ease the problem managers face with scarcity of assets, as well as boosting the yield to equity. Credit Suisse Asset Management recently priced a CLO with both sterling and euro tranches, taking a vertical sterling slice itself to comply with risk retention.

"Using the sterling strip of retention is one way of accessing the sterling market, which has some very attractive assets in it. It also overcomes the relative inflexibility that a manager has on perfect asset swaps, where if a credit starts to trade down, not only do you take a hit on the asset, but you also have to pay any break costs on the swap," said Alan Kelly, senior investment analyst at Apollo Global Management.

But ratings agencies' recovery ratings on sterling loans can detract from the benefit, said Jonathan Bowers, partner at CVC Credit Partners.

"Every time we try to structure a deal with a significant sterling tranche it seems to haircut the equity by two or three points," he said.

"The irony is that the recovery rate on sterling loans is far greater than the rest of Europe combined. And you also get a spread pickup for the illiquidity premium of 50bp-75bp, generally, so that's also helpful. This is something we need to try and solve with the rating methodology."

Ramping problem

But without easier access to the sterling market, it will remain difficult for managers to ramp and manage portfolios. Colin Atkins, managing director at Carlyle Group, said his firm would typically warehouse assets for three months, but that has lengthened to about five months lately.

Risk retention will also slow down the entry of new managers into the space, with regulations generally favouring operations of scale.

Sam DeRosa-Farag, managing director at Kingsland Capital Management, said that there was a further irony in risk retention, in that by forcing managers to hold a piece of their own equity, regulators were actually encouraging risky behaviour by incentivising managers to boost their own returns.

"The regulators are under the impression that [risk retention] will lower the risk — I think it's going to be the exact opposite," he said. ■

European CMBS: a matter of short supply

THE REFINANCING of a recent European commercial real estate purchase showed that CMBS spreads could tighten enough to support more issuance in the dwindling — yet performing — market.

The transaction was an all-cash purchase of HSBC Tower by the Qatar Investment Authority from the National Pension Service of Korea. The purchase was financed through a syndicated loan from Lloyds Bank, Qatar National Bank and Deka Bank. The banks earned a spread of 135bp over Libor for the deal, not far off best execution for CMBS when the financing closed in April.

"First you would have had to have a bank write a check for €750m and then take the risk of securitizing it, and you wouldn't have expected them to make much profit," said Bank of American Merrill Lynch CMBS research analyst Mark Nichol during a panel discussion on Europe's CMBS market at Global ABS on Wednesday.

"You would have hoped to break even, and in the meantime you would have taken a massive risk with a very large loan on your balance sheet," he added.

Not enough

While loan prices suggest a larger CMBS market can exist in Europe, transaction sponsors are having a difficult time creating loans themselves or finding enough from other sources to supply collateral pools.

Issuance has been far below pre-crisis levels and the market's current volumes have been dwarfed by a booming market in the US which benefits from more commercial loan production and strong demand from institutional investors.

BAML expects that trend to continue with new CMBS issuance totaling between $5bn and $10bn over the next three to five years, Nichol said. He compared that to the $150bn a year pace in the US market.

"It's probably a good thing that CMBS is such a small fraction of the market for a while," Nichol said. "It's not big enough to cause the next downturn. It can't be blamed for causing the price of debt to get so cheap and for leverage levels to get so high as to become unsustainable."

Another factor hurting CMBS issuance is the negative regulatory treatment banks get for holding CMBS portfolios compared to loans which might otherwise back deals, according to Euan Gatfield, a managing director at Fitch Ratings.

"CMBS gets treated much worse than the underlying loan," Gatfield said.

Few and different

Fewer deals means investors are spending more time analysing transactions before they buy, said the panellists. But a lack of commercial loan supply means a lot of deals are backed by loans with different credit profiles.

That means the credit pools of individual deals are usually more diversified, but portfolio managers might prefer to diversify their funds with a mix of more uniform collateral pools.

"You have a lot of diversification in one deal, but I like to diversify over different bonds," said Stijn Stortelder, a portfolio manager at Aegon. ■

Senior regulators: quality label drive will strengthen market long-term

THE LABEL schemes for high quality securitization are supposed to attract new investors to the market and strengthen it in the long term, according to two senior policymakers speaking at the Global ABS conference in Barcelona.

"I'm not going to engage in a discussion about whether single jurisdiction, multi-jurisdiction, single currency or multi-currency deals count or not," said Ashley Kibblewhite, head of structured finance at the Prudential Regulatory Authority, and the former head of Merrill Lynch's European structured finance business.

"We're thinking here of new investors in the market, and of building a market where investors can come in with greater certainty."

> "There's no confidence in whether bonds are actually eligible"

David Rule, executive director, prudential policy at the Bank of England, said in his keynote address: "Because one of our objectives is to broaden the investor base, it is important that the Simple Transferable Comparable designation makes things simpler for investors, particularly non-banks."

Rule continued: "They should be able to place greater reliance on it when conducting their own due diligence on matters covered by the STC criteria, such as risk retention. Investors would thus be in a position to concentrate with more confidence on other existing due diligence requirements, such as in relation to the creditworthiness of the underlying assets and cash flows characteristics."

The industry itself argues that any new label scheme — and there are several under discussion, with separate proposals from the European Banking Authority, Basel and IOSCO, and the European Commission — should be based on principles, not on crude asset class divisions.

Ian Bell, head of the Prime Collateralised Securities secretariat (a voluntary industry scheme to designate simplicity and transparency) said that a regulatory label should not be "stamp collecting regulation" — meaning a series of detailed specifications of asset classes, with some in the label and some outside.

Fabrice Susini, global head of securitization at BNP Paribas, and chairman of Afme's securitization board, said: "What we have tried to push is a principles approach, where something is eligible for the label if it ticks the box. A deal should not be excluded just because it is branded a CLO or a CMBS."

However, he did note that large loan CMBS usually had embedded maturity transformation and refinancing risk — if the loans cannot get refinanced, the bonds will not pay back. More granular deals usually have a long tail period, and the assets behind them usually amortise.

Kibblewhite speaking at Global ABS today

The PRA's Kibblewhite indicated that he was sensitive to concerns about different and overlapping regulatory regimes.

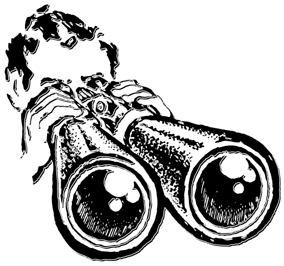
"Whether we call it SST (Simple, Standardised and Transparent) or STC (Simple, Transparent and Comparable), it all points in the same direction...it allows traders, investors and regulators to identify which securitisations act in a consistent and predictable manner," said Kibblewhite. "It is not a quick fix initiative."

He continued: "Where we see real value in the designation is something that works on a harmonised basis across frameworks to allow us to figure out which bonds get a differentiated treatment, in the liquidity coverage ratio."

The difficulty of gaining clarity on exactly what happens in every circumstance for every deal has been amply illustrated in the ECB's purchase programme, according to research analysts on a panel on Wednesday morning.

Conor O'Toole, head of European ABS strategy at Deutsche Bank, said that some Spanish RMBS deals had initially been eligible for the ECB's purchase programme, but that when the asset managers mandated by the ECB did their due diligence, they found wrinkles in the post-event of default waterfall language — meaning the bonds dropped off the list and widened.

"There's no confidence in whether bonds are actually eligible," he said. ■



THE GLOBALCAPITAL VIEW

Securitization is still running on the spot

More than five years of intense lobbying later, and the securitization market still has the same set of complaints. Maybe next year things will be better.

Since the crisis, the European securitization market has been pleading unfair treatment. Being tarred with the same brush as US subprime meant the product has had to fight against a huge tide of regulation — and it still hasn't made much difference.

As the European market gathers for its annual Global ABS conference, the bugbears of the conference are eerily familiar.

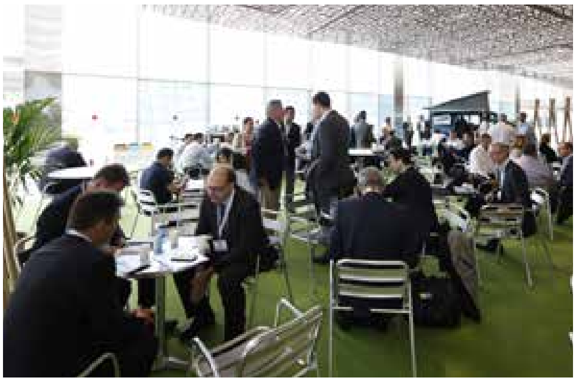
Basel capital charges, Solvency II capital charges, investor due diligence, the structure of risk retention, and credit rating regulations are all troubling the market — for more or less the fifth year running.

There has been progress. Instead of trying to kill the market, policymakers are looking for ways to revive it. Instead of toughening up collateral rules for ABS repo, as it did in 2011, the European Central Bank is now trying, slowly and haltingly, to buy up the market.

And there is a new set of buzzwords to add to the litany of regulatory precepts. As central bankers and policymakers keep saying, securitization must be standardised, simple, transparent, and comparable.

Issues meeting these criteria get a bit of a regulatory reprieve. But issuers that don't, in the words of one panellist at Global ABS, are "thrown to the wolves".

The market will roll with the punches — as it is doing with risk retention and loan level data requirements — but it is one more item for the long laundry list of lobbying topics, and it isn't going away. Panel after panel can call for regulators to avoid cliff effects, or to tweak the details, and if they're lucky, a sympathetic policymaker will be in the audience.



The busiest Global ABS in recent memory – could the next year bring the regulatory relief everyone is hoping for?

But the big, nasty, market busting regulations probably aren't going away. Solvency II is widely despised across the capital markets, and has taken more than seven years to be firmed up. It won't be officially reviewed until 2018, and until then, it will unavoidably continue squashing insurance company investments in securitization.

But ever optimistic, this year Global ABS has something new to pin its hopes on. The European Commission's Capital Markets Union project has securitization as its centrepiece, and the Commission is due to produce a Green Paper setting out its approach to the market in September.

Hopes are high that this could produce another round of regulatory easing, or at least a more consistent approach stitching together CRD IV, Solvency II, AIFMD, CRA III and any other random collection of letters and numbers into a harmonised package.

Just like every year, Global ABS is hoping that next year, the market can meet and talk about doing deals, not coping with regulation. This time it really could be different. ■

Citi and Renew plan more energy efficiency ABS

US SECURITIZATION

CITIGROUP AND Renew Financial plan to partner on more securitizations of energy efficiency loans following their market-opening deal, which closed earlier this month.

The first transaction totaled just \$12.58m, smaller than the \$50m deal that Renew was hoping for originally. But the hope is that new transactions could help create more liquidity for the asset class and support larger deal volumes going forward.

"Citi and Renew expect to execute additional transactions over the next several years, firmly establishing a secondary market for these loans to make more capital available for homeowners to fund energy efficiency improvements to their homes," Citi said in a press release.

More buyers will have to enter the space for that to happen though. Just one firm, Calvert Investment Management, purchased all of the first deal, which was arranged by Citi.

WHEELer dealers

The loans that backed the first deal were originated under the Warehouse for Energy Efficiency Loans (WHEEL) program, a public-private partnership between states, local governments, utilities and lenders to finance cheap home energy loans.

AFC First Financial Corporation originated the loans backing the deal, before they were aggregated by Renew Financial. Future transactions are expected to utilize the same structure.

The WHEEL program was based on a similar project called the Keystone Home Energy Loan Program (HELP) which the Pennsylvania Treasury Department began developing in 2010. Loan originations under the HELP program became too much for state government to finance though.

Ford, the Surdna Foundation and energy foundations provided initial funding for WHEEL along with the Department of Energy. Renew and Citi joined the effort in 2011.

Pennsylvania is one of three states to help finance WHEEL loans. Kentucky and Ohio have joined WHEEL and more states are expected to opt into the initiative, which provides loans as large as \$20,000 for energy efficient home improvements.

"[The new issuance] allows us to work with Renew to bring other states into the fold now that there is no restriction on capital," AFC chief executive Peter Krajsa said of the first WHEEL securitization.

"We have warehouse lines and things, but to really grow you need to be able to tap into the larger secondary market and that is what this is going to allow us to do, to really expand our product base further." ■

HEARD IN THE HALLS

Deals! Actual deals!!

"This year the feeling is much more positive. Deals are being launched here. It's not just marketing deals or having meetings, but actual launches.

For the past few years [at Global ABS], there has seemed to be a preponderance of service providers: analytics, trustees, and lawyers. Now it feels like there are more people issuing, originating and investing in deals here."

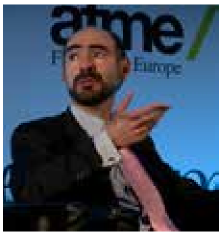
Simon Hill, partner and head of international capital markets, Allen & Overy

Blood on the ground

"Spreads are gapping out in the US too, just like they have in Europe. They've affected a few new issues and it's been a bit of a bloodbath. Everyone thinks rates are going to rise, so people want extra spread to compensate for that, and sometimes they don't think there's enough."

Head of structured products at a US investment bank

Alignment of interests



"Covered bonds have the advantage of aligned incentives for both the issuer and the investor, because the issuer retains all the risk of the lender. The challenge for ABS is to achieve a level of risk transfer while maintaining the alignment of interests between the issuer and the investor.

The reason that alignment matters is that the originator will always have better information on the quality of the loan than the investor. So knowing that the originator is retaining some of the risk is in and of itself part of the credit decision."

Dmitri Rabin, senior securitized analyst at Loomis Sayles

If the shoes don't fit...

"The concern that some of the market has around limiting the standards to PCS type frameworks [for Qualifying Securitizations] is that there are certain sectors of the market that performed fine throughout the crisis that would by definition be excluded.

So anything that involves refinancing collateral, including CLOs, they won't be QS. Neither would residual value auto ABS, which is a growing segment of auto sales in Europe. They want fully amortising, level-pay, standard product. There's not much that fits into that box in the securitization market."

Jim Ahern, managing director, Moody's Investors Service.

Under the influence

Further developments from the lonely coalface of the **European Central Bank**'s ABS Purchase Programme.

GlobalCapital's intrepid conference drinkers spotted a throng of ECB-ers at JP Morgan's W Hotel drinks reception on Tuesday night and was initially surprised after reporting yesterday that the central bank's ABSPP portfolio managers were prohibited from partying.

Compliance officers can relax, though – it appears that none of the ECB throng were PMs. In central banking, it would seem, the more money you control, the fewer free drinks you consume...

BNY MELLON Cortland

CLOs get creative to navigate European regulation gauntlet

Just over two years into its revival, the European CLO market is facing major hurdles. Despite the relative value it offers to investors in a world of ever-declining yields, an intimidating combination of low loan supply, high collateral prices, and complex regulation is keeping some prospective managers out of the market entirely and forcing others to innovate.

All of this has caused managers to look into creative ways to satisfy new rules while minimising cost and maximising the arbitrage that fuels CLO securities. Innovation isn't new to the European CLO market — the first round of deals in 2013 included a spate of notable structures and strategies, such as Credit Suisse Asset Management's recent sterling and euro combination CLO, which allowed it to fulfil risk retention requirements in sterling while tapping euro investor interest.

But are these developments helping to cure, or just alleviate, the issues challenging the European CLO market? What is in store for those managers willing to risk coming to market before regulations have fully taken shape?

GlobalCapital assembled some of the European market's most well-known participants to give their views on how far the market has come, and how far it still has to go.

Participants in the roundtable were:

Arlene Allen, group manager, sales and relationship management, BNY Mellon

Chandrajit Chakraborty, chief investment officer and co-founder, Pearl Diver Capital

Mark Hale, chief investment officer, Prytania Investment Advisors

Tim Houghton, managing director and principal, Cortland Capital Markets Services

Hernan Quipildor, head of CLO origination Europe, Natixis

Franz Ranero, partner, Allen & Overy

Guillaume Tarneaud, director and assistant portfolio manager, CVC Credit Partners

Graham Bippart, fixed income editor, GlobalCapital (moderator)

GlobalCapital: Let's begin with risk retention. How have originator structures evolved since risk retention was first introduced, and is regulatory scrutiny in this area a major concern for the market?

Franz Ranero, Allen & Overy: Yes they have, and the evolution is ongoing. The model of a substantive standalone origination business, with its own business model, investment strategy, capital, financing, decision-making and resources, is an area where there is continued development. Originator platform structures are also developing in order to address the US risk retention rules, and there are also a number of market participants developing multi-manager platforms. We'll see a lot of further development in these areas over the coming year. Regulatory scrutiny is an ongoing focus, but I do think the market now better understands the concerns of the regulators and is trying to do the right thing by them.

Chandrajit Chakraborty, Pearl Diver Capital: Yes, the evolving and changing regulatory landscape does lead to uncertainty, and it definitely has an impact on the volume of issuance. We're expecting issuance in both the US and Europe to be lower this year as a result of it.

But having said that, ultimately people should reflect on the spirit of the regulation. There needs to be true risk retention. Regulators have been concerned about originator vehicles that are structured to hold loans only temporarily and thus do not satisfy the spirit of true risk retention. How long should they need to hold it — a day, a month?

My main concern around risk retention, and many of the other regulations, has been structures that have been designed to get around the true spirit of the regulation. In the instance of regulation around skin-in-the-game, many of the structures developed has been designed to minimise the actual investment required to comply with the regulation and, thus, miss out on achieving true alignment of interest.

The changes regulators have made have been to try to plug these loopholes. If we can move away from those structural innovations and start to think about how we can create a structure that is actually offers true risk retention and true alignment of interests, that will result in much more certainty and provide a solid base for the CLO market, whatever the regulations might be going forward. We can always adapt structures that can deal with those regulations as they evolve further.

Hernan Quipildor, Natixis: But there have also been market reactions that represent new forward-looking developments. Franz mentioned structures that allow for providing retention on a multi-manager basis. These are structures that can permit competent managers who could have found it hard to manage the weight of the retention investment otherwise to participate in the market.

These structures are also able to provide other services, like warehouse equity, more broadly for market participants or potentially retention financing. So regulation could be a concern at some levels but there is also a new breed of entities that could provide a new landscape for the CLO market.

Franz Ranero
ALLEN & OVERY

Ranero, A&O: I agree, that's certainly a very attractive proposition for the market. A dedicated pool of capital available for CLO-related deployment of capital, whether in the form of debt, equity or both. So it can act as originator, it can lend against retention, it can lend against warehouses or it can provide warehouse or CLO equity.

Quipildor, Natixis: And they can consequently help managers to sort out a big piece of the puzzle. You can imagine these structures helping finance the equity — or sort of pre-place equity, if you like — particularly for dedicated single-manager originator structures. That provides certainty of execution at that level when you're coming to market. To do a deal, you need the assets, the equity, and the debt, and equity could be sorted up front using these structures.
Also, some managers have been able to benefit from well-established originator companies that have been part of their owned subsidiary setup for many years, and use this to bring compliant deals to the European market — like Black Diamond, for example.

GlobalCapital: What are the next things regulators are looking to do to close loopholes? Are there any clear deadlines managers, or investors, have to meet? And what are the key things regulators are focusing on?

Ranero, A&O: There isn't a deadline as such. The most recent example of loophole-blocking was in December, when the European Banking Authority (EBA) reported to the European Commission (EC) that there were concerns around some of the activities in the market around 'originator-for-a-day' structures. We don't have a clear picture of timing for the EC's response or for the form it will take, but it is very likely that at some point we'll see an amendment to the current definition of originator. We also saw the central banks, the European Central Bank (ECB) and the Bank of England (BoE), reiterating the same concerns a couple of months ago.

There is also a lot of ongoing work by regulators around the concept of 'high quality securitisation' or 'qualifying securitisation' as a method of distinguishing segments of the market which would receive beneficial treatment for a number of purposes, such as liquidity and capital ratio requirements. We are likely to see concrete proposals in this area over the coming year. It's not so directly relevant to CLOs in that CLO paper is unlikely to fall within the preferential categorisation — that ship has all but sailed. But it does mean that there is still an element of change and progress in the regulatory landscape, which translates to a level of uncertainty. For instance, it is very possible that the EC's response on the originator definition may be wrapped up within that body of proposals.

And on top of that, we have the US risk retention rules. In terms of regulatory evolution, it is important to note that US rules are on the horizon. They come into force in December 2016 for CLOs. If one is setting up an originator today, they should be future-proofing it. So there will be a lot of developments to try to cater for compliance with both regimes, which will change the way these vehicles look.

Chakraborty, Pearl Diver: One of the key elements of the rule regarding originators is that regulators want these originators to have substance. There needs to be a real business behind it. As Franz said, we've been seeing a lot of vehicles that are set up as shell structures. Regulators want the originators to be more than SPVs. They want them to be credit funds that are in the business of managing credit, businesses with actual substance, with people on the payroll, a system in place — a real fund. Those structures are on much more solid ground than those seen in the early days when we had just shell SPV structures which had no real purpose or substance in them.

I do think there's going to be some degree of convergence between US and Europe. In that respect many of the newer structures that are being contemplated are an attempt to future-proof deals, as Franz said, in order to comply with both regimes. GSO Blackstone's recent deal is an example, and there are a few others, of US CLOs being issued in European risk retention-compliant format so they can be sold to European investors. I think we'll see convergence, both in terms of spread and in regulation like risk retention.

Mark Hale, Prytania Investment Advisors: It's important to distinguish between what we'd like to see happen and what has happened to date. We had the US rules in October, and there are significant differences from the European regime. That's made it complex and very difficult for people to solve the simultaneous equation for both sides of the Atlantic.

Quite a few people we've spoken to have said that they are attempting to solve for both, including what they think will be the ultimate US rules as they evolve. Others have concluded that it's too difficult or not economic to do so at present and the large majority seem to have not made a decision. They don't know how the existing regulations will be implemented in full or how they may change in future. Some of that uncertainty has to do with how rules on accounting treatment will be interpreted around SPVs for US issuance.

In the medium term, many are hoping to see a convergence of the regulations so that it is easier to solve for both but there are many other examples of different regulatory regimes where we haven't seen the desirable convergence over time. So the broad mass of people are waiting to see what the first movers do and hoping that we have a clearer outlook by the end of 2016.

Ranero, A&O: It is true that there are significant and important differences between the two regimes. However, at their heart they pose the same fundamental question which is, as Chandrajit said, about substance. Even though we may have 700 pages of US rules and only 30 pages of European rules, they try to achieve the same end. But common to both is the question: 'Is there sufficient substance in the vehicle?'

In this respect, there was a view previously held in some segments of the market that there would be no regulatory scrutiny of structures involving only manager-group money. Now most understand that that is not, and never was, the case. The question is: is it a real company? Is it a blue-blooded origination business? If so, it can raise capital and financing like any other company. That is the key threshold question.

Quipildor, Natixis: The CLO investor base has been becoming more global. Through time, collateral managers have also become more global with transatlantic consolidation. Having an originator structure that fits this global spectrum is quite logical. We would probably expect that in the future, regardless of the nuances of the regimes, they will be similar in substance overall. We would expect managers to create retention structures that aim to fit the bill across the spectrum.

GlobalCapital: How can managers adapt their existing originator structures to satisfy regulators, and what new structures have people come up with to avoid regulatory scrutiny? For example, what did the GSO structure look like and can others easily replicate it?

Chakraborty, Pearl Diver: The Blackstone structure is a single-manager structure, it's dedicated to CLOs that are sponsored and managed by Blackstone. They have done a number of deals through it. The vehicle buys the loans to later sell to the CLO and also holds the majority equity of the CLO in the form of a 5% horizontal piece, typically. So the majority control of equity goes into the same vehicle that also originates the loans, which satisfies risk retention. As I understand it, a large number of their key credit personnel, who do the credit analysis and originate the loans, are also a part of the same structure. That seems to satisfy the regulators with regard to substance and the 'real origination' that regulators are talking about, and it seems to work both for their European and US deals they've done through that structure.

The other structure we've seen, that a number of participants are talking about, is the third-party multi-manager originator structure. The participants looking at it are credit funds, looking to set up a similar structure that would be able to deal with multiple managers on an independent, arms-length basis, sponsoring and buying and holding the loans and taking a majority of the equity piece. These multi-manager structures seem to be much more robust compared to the single-manager ones and are likely to stand up to greater regulatory scrutiny.

Ranero, A&O: But there isn't a one size fits all approach. We work with managers setting up and banks financing these platforms. The ultimate shape of the platform depends on a lot of variables that are specific to the manager: how and from whom it wants to raise capital, the form of the debt, where the people are located and the tax consequences of that location. So we will see a lot of platforms launched over the coming months or year that have some shared features but will all look different in some or many respects.

Chakraborty, Pearl Diver: One of the fundamental differences between the two regimes is that in the US the onus is on the manager — they would be in violation for issuing a non-compliant deal. In Europe, the onus is on the investors. Now, there could be investors or funds that are based in jurisdictions that don't strictly fall within the European regime, and they can still participate and buy non-compliant deals. But overall there will be a shift towards the whole market being compliant, because that leads to liquidity, as the compliant deals would be able to appeal to the broadest segment of the investor base.

In the US context, we have the collateralised manager vehicle, which is something that works in Europe as well. We have manager or manager affiliate structures that take majority equity in their own deals, and we've seen people looking at various ways of funding those entities. To do that in a European context there are other qualifications that must be met. But, as Franz said, people are looking to set up the structures that are future-proof. That's where the convergence will come to.

GlobalCapital: Is the uncertainty and expense of future-proofing their structures going to impede the entrance of new managers into the European market?

Hale, Prytania: In recent times, the economics for many managers are such that there is not necessarily a clear benefit to issuing EU compliant deals that are large enough to warrant putting in the time and the effort and expense. There has been a rise in deals so far this year that have been EU compliant, but it's not a dominant feature of the market by any means. Broadly speaking, the benefit of doing so is not that material, if there is one at all. On the current compliant deal that we have just purchased, the triple-As priced at 150bp, above the level of some recent non-eligible US prints and a long way from the 120bp-125bp level that we've seen in recent European prints like PineBridge.

When we've spoken to managers about the kind of spread differential that would encourage them to go to the trouble of issuing a European compliant deal, the answers have varied over time. But broadly speaking, 20bp-25bp of net cost advantage would incentivise them to come to market, while 10bp-15bp would not. The grey area is around 15bp-20bp, where it's not completely clear whether or not it is worthwhile.

GlobalCapital: There has been a lot of talk from regulators about standardising documents to make it easier for inves-

tors to do due diligence and to restrict potentially harmful issuance strategies. How important is standardisation of documentation – can it help expand the European CLO market? Is standardisation an attractive proposition to all market participants?

Ranero, A&O: Yes, it's important for all market participants, but primarily for investors who need to compare across deals. I think the 2.0 market is already significantly more standardised than the market was pre-crisis in terms of documentation. When the market reopened in March 2013 there was very much a fundamental reset in documentation, notwithstanding the decade of pre-crisis deals. All the deals commenced with the same lineage of documentation. So we're already in a more standard and comparable market.

Chakraborty, Pearl Diver: As an equity investor in both the US and Europe, we see value in analysing the documentation. We spend a lot of time negotiating documentation away from standardisation. Standardisation does help in benchmarking and comparing across deals, but as a significant equity investor we're looking for opportunities for arbitrage as well as to give the manager the flexibility needed to produce additional alpha through the credit cycles. Those opportunities will go away if you have standardisation across deals. Every deal will perform similarly, at least from a documentation and flexibility perspective, if deal documents are standardised. There's a lot of different aspects you can tweak in the documentation, and the summation of those tweaks can create a significant difference in performance.

In the CLO 1.0 era, deals with essentially the same or similar loan portfolios, and with similar managers, but with different documentation, had completely different results in many cases. In CLO 2.0, yes, there's been a reset in the docs, and a lot of standardisation has been achieved, but much of our effort still goes into negotiating documentation. And as an equity investor looking for extra yield and alpha creation, standardisation is not our best bet.

Arlene Allen, BNY Mellon: We do have a greater degree of standardisation now, but each manager has their nuances as to what they want to see in the docs to be able to create alpha. From BNY Mellon's perspective, we have standardised our conditions in response to the direction of the market, but each transaction will have certain nuances due to key driver demands and we manage this through the document negotiation process. Standardisation allows investors to understand the product better, but I believe each manager will continue to have nuances in their documents, thus allowing differentiation.

Hale, Prytania: I agree with that approach. We can all see why standardisation may be attractive to a broad range of market participants but from our firm's perspective, it may be less appealing. We look at documents very carefully and model them in very fine detail to various scenarios. That level of analysis is how we create our alpha. To us, the documentation is a snapshot at the time of creation of the deal. Situations change over time, not just in fundamentals, but also in the way managers change their behaviour and the way trustees can interpret documents in different ways. This results in a finite limit to the degree to which a standardisation of documents can create a standardisation of outcomes.

Chakraborty, Pearl Diver: Yes, even with standardisation there is a divergence of outcomes, but what the trend towards standardisation leads to is commoditisation of the product, and we've seen that in other areas of fixed income as well. The extra yield is the reason why the broader investor community still finds CLOs so attractive, and it will definitely go away if you commoditise it with standardised documentation on deals getting rolled out one after the other. There is no meaningful alpha creation there. It will lead to a very narrow bid/offer with almost a flat curve.

For people who are looking for a quick trade in the secondary market, with a very short holding period, the issue is less important. But that's not the investor community that CLOs are mostly catering to. It's catering to those who are willing to do the more in-depth work, trying to create alpha on an ongoing basis.

Ranero, A&O: I'm glad you disagree with me, because standardisation means less work for lawyers!

Quipildor, Natixis: Managers prefer to be able to use their documents repeatedly because they can then manage a portfolio of transactions similarly and efficiently. On the other hand, the lower you go in the capital structure the more the details in the documentation have value in terms of flexibility and optionality. Of course that makes a difference and you can price that. A management style is expressed through the flexibility that the documents bring and how this flexibility is used.

Arlene Allen
BNY MELLON

Allen, BNY Mellon: Depending on the arranger and/or your triple-A investor, they sometimes drive a lot of the nuances within the documentation between transactions. Whilst you can get to a certain level of standardisation, you can't get to a full scope of it across all transactions. Each investor will drive different requirements depending on the market environment.

GlobalCapital: How well served are investors by the current trustee reporting infrastructure? Is the time lag between closing and effective date a potential blind spot for investors and what can managers/trustees do to solve this problem?

Guillaume Tarneaud, CVC: First CLO investors have to be comfortable with the manager on day one, do their due diligence and look at the model portfolio. But I agree that the lag between pricing and effective date is still an issue. The way to resolve that is quite tricky, but one possibility might be a high-level interim report provided to all investors, between pricing and effective date. Obviously you won't get

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Guillaume Tarneaud
CVC

the official test results until the effective date report, but this could help resolve the problem. The interim report could show some high-level metrics around weighted average spread, price, how much of the portfolio is triple-C, etc.

Allen, BNY Mellon: If your effective date is six months after issuance, then the lag is a real issue. But now with transactions coming to market more fully ramped at issuance, your effective date is around six weeks to two months after pricing. That narrows that gap and the risk for investors with respect to the trustee report.

Everything required to be in the trustee report is outlined in the documentation — including when the report is to be issued — and there's nothing much the trustee can do about that except deliver it as per the documentation.

You could potentially have an interim report that gets issued to investors that is not the ultimate effective date report. What that would look like depends on what investors are looking for. Are they happy with that effective date lag? Are they okay with having two to three months between issuance and effective date?

Chakraborty, Pearl Diver: We get that information mostly through direct conversations with the manager. We typically have conversations on a regular basis before the deal gets priced, as the portfolio is being constructed, at both pricing and closing, as well as running up to the effective date, so we do not really rely on when the trustee report actually comes out.

It's vitally important, especially for significant equity investors in these deals, to have a clear understanding of how the ramp-up is going, not just in terms of the speed and quality of the ramp-up, but also of the type of assets being included and other metrics on which the portfolio will eventually be evaluated.

Hale, Prytania: Agreed. We have regular dialogues with managers for the same reason. Some of them are reluctant to produce something physical before the effective date, and that's a clear role a trustee could take on: to produce a report that can be distributed to all investors, to gather the information efficiently and to meet the concerns of all investors who need to have the same information at the same time.

In terms of monitoring the quality of the ramp up before the effective date, we often see the initial portfolio in warehouses, as they are marketed to investors, being relatively high-quality. Lower quality assets are then added in during the remainder of the ramp, and clearly at a time when credit standards are loosening and the arbitrage is getting tighter, there is the potential for deals to get significantly more risky between pricing and the effective date. I'm not saying it's like 2006 or 2007, but that has got to be a concern for risk. There are enough echoes of that era for investors to want to keep a very close eye on what's happening with manager ramp ups.

Quipildor, Natixis: Managers generally tend to be open to communication throughout the period from pricing or closing to effective date. They tend to have continuous communications with investors at different levels of the capital stack, and particularly with equity partners.

Regardless, when an investor buys a CLO they are buying into a management franchise and a credit profile. The portfolio will trade and change throughout the life of the transaction, so it's important to see the portfolio at various point in time, yes, but it's also important to acknowledge that the portfolio can and will change — but that change is limited to certain metrics. This makes the manager selection, understanding their skills and investment philosophy, key for the value profile of the investment in the longer term.

Tim Houghton, Cortland Capital Markets: You have this period of time between pricing and effective date that can be from two to four months. It's a difficult problem, because trustees can't just unilaterally produce an interim report that isn't called for in the documents. On the other hand, the manager has an incentive to put some information out to investors broadly.

One answer might be an interim report, pre-effective date, and we've seen that in deals where the effective date period can be lengthy. An alternative, consistent with Chandrajit's point, is investors reaching out to managers directly to get colour on the ramp-up. We help our managers answer those questions and provide reports and cashflow runs to demonstrate the impact to the first equity distribution from the most recently added assets. It's an ongoing process, and managers with first-rate operations have the ability to respond to these inquiries.

Chakraborty, Pearl Diver: The effective date is a date by which the portfolio needs to be at or above a certain threshold and it needs to be able to meet or exceed various portfolio metrics. The important question is whether the managers are able to beat the target spread. Are they able to ramp up the portfolio at a better than the target price? How much of the portfolio is triple-C rated? How much is second-lien — has the manager bought a ton of second-lien loans in order to meet the average spread requirement? These questions are vitally important in understanding what your return profile would be as a CLO equity investor. Does what the manager has ramped up as at the effective date match with what you modelled and what you bought into? Or is it going to be vastly different?

Typically we see the first coupons being significantly above what we modelled at the time of deal pricing, and that's really a function of how quickly and how well the portfolio's been ramped up.

GlobalCapital**: Arlene, you said that ramp-up periods are shortening, but as I understand it they are significantly longer now than when the market rebooted. In large part because of a lack of collateral in the market. Is that not the case?**

Allen, BNY Mellon: Well, the ramp-up is now happening more during the warehouse period rather than after issuance. Last year we would have seen managers warehousing loans for about two or three months tops. Since about the end of the third quarter of 2014, , we've been seeing the warehouses running out to six months, so managers are doing a lot of their ramp-up before they issue. That way they don't have to have that cash sitting on balance sheet or in a money market fund where they'll likely get charged, which would drain on their equity returns.

Chakraborty, Pearl Diver: Ramp up time is also a function of the landscape of the loan market. If you have a very active primary market in loans, you could probably get away with ramping up between CLO pricing and closing, because you can be confident that there will be enough volume to do it and still meet or beat the requirements before the effective date.

But in an environment like we have now, where the new issue pipeline is quite thin, you really need to make sure that you've given yourself enough time to build the portfolio that your investors wanted to buy into. What that means is a longer warehouse period, so you can pick your credits carefully. You don't have much visibility on the new issue pipeline beyond the near term, so you really need to give yourself that extra time.

Tarneaud, CVC: Yes, especially in this market where new issue loan pipeline is very thin, and given where secondary loan prices are today, managers can only ramp through secondary in a very limited way. This is an environment where the sourcing capability of a manager is key. CLO managers with long term relationships with arranging banks, private equity sponsors and so forth are better placed to have access to the loan market and ultimately better allocations on new credits which means that they don't have to buy the market and can select the right credits and decline the bad ones.

GlobalCapital: To what extent is the loan overlap in European CLOs a concern for investors, considering the relatively thin loan pool that's out there and the heavy pipeline of new CLOs?

Chakraborty, Pearl Diver: We have seen significant overlap across deals in Europe. But if you look across vintages and managers, there's always been a significantly higher overlap in Europe compared with the US CLOs. This is really a function of the European market being much smaller and with clubbier deals and chunkier positions compared to the US market.

It means that, especially if you're investing lower down in the capital structure, it's of paramount importance that you spend a lot of time understanding those large, clubbier, chunkier positions inside European CLOs, because there will be significant overlap across different holdings and individual defaults are likely to have significant impact on the overall portfolio returns. Our biggest loan exposure in our US portfolio is about 30 basis points and although we still do a significant amount of due diligence and analysis, the impact of any one of them going wrong is significantly less than in Europe.

Allen, BNY Mellon: I think if you were to compare the CLO 1.0 and 2.0 markets, you find that with the 2.0 managers, there is indeed less investor diversification, but the ones who are issuing have also been through the crisis have come out the other side. They have delivered to their investors.

This year will be interesting because we are for the first time seeing new entrants from the US coming to the European CLO 2.0 space. It probably won't be until 2016 that you could see any kind of greater market diversification in terms of managers and hopefully a pickup of the primary issuance to facilitate the new expanded market.

Chakraborty, Pearl Diver: Yes, the managers who are issuing now have come through the crisis, but not necessarily in the best way for investors. For some of the managers issuing now, I couldn't say that we are a happy investor in their 1.0 deals. In many aspects they could have done much better than they actually did. But that's the past. The market dynamic, going forward, will ultimately be the same for both US managers coming to issue in Europe and European managers issuing in Europe. It is a small market. You're going to have a lot of loan overlap, there's no getting away from that. What does help is bigger deals from bigger CLO manager platforms where you can get better allocations in selected better quality loans. Obviously, if it's a better platform, including many of the bigger managers, they are going to have fewer loan allocation issues as they have a better relationship with the street and with the loan arrangers.

Chandrajit Chakraborty,
PEARL DIVER CAPITAL

But it is a fine balance. If you're too small, it is difficult to get allocations in the loan market. But if you're too big, then you would have to buy probably almost every loan you can get because you have too many funds and portfolios to feed into, so there's not much selection — you become a forced buyer on everything available.

You have to make a decision about whether you think that manager will be able to balance between access and being a forced buyer in everything.

Larger managers, as we saw in the 1.0 era, also have significant enough positions to have a seat at the table through the restructuring process when things go bad. That does not necessarily always lead to a better outcome, but at least they have better visibility. But when things like Vivarte's default happen, it affects everybody, because every CLO had them in significantly large positions. There's no escaping it. It's a function of the European market.

Tarneaud, CVC: I would say that pretty much all CLO managers have been through restructuring processes in Europe since the crisis started in 2008, in all the major jurisdictions (UK, France, Spain, etc.) and so they are now experienced enough to drive the process, have a seat at the steering committee and take the keys of the company if they think they can achieve a better recovery that way. So I think they are now better equipped to drive better outcomes in restructurings.

On the manager size point, I think running different portfolios and funds formats can actually be an opportunity for large managers as they are able to cross-trade assets at mid-price to help ramp up new funds and CLOs.

But the key issue today is really the primary pipeline. It looks to me that every manager is chasing the same asset, which leads to primary loan books being multiple times oversubscribed. That is driving the pricing of loans down, as well as driving allocations down, which means that some managers will have to buy every credit. If you add the current repricing activity on top of that, this may impact the CLO equity story and arbitrage and CLO issuance volume in the mid-term. To increase the diversity and reduce loan overlap risk for investors, the European market badly needs increased M&A activity and bigger transactions — ideally new names — that would lead to larger allocations for everyone. The recent Douglas and Verallia large deals are a positive sign in that regard.

Hale, Prytania: It's very hard for investors to avoid this problem, when you think about the limited diversity of issuance in the CLO space in Europe. You've got one or two people that have different approaches — Prudential, for example, with the very large bond buckets they have in their CLOs. But even there, the European high yield bond markets have been a huge bull market, where relatively poor credits come with relatively tight spreads, and those deals are still getting a lot of demand.

There are some managers with a slightly more middle-market focus, like NIBC or IKB, but there isn't that diversity or opportunity that we are used to seeing in the US. Clearly adding bonds to a portfolio, for example, renders a deal Volcker non-compliant, which causes issues for US banks that want to be investors in the European CLO market.

But beyond a fundamental change where we have a mushrooming of supply in the European leverage loan market, clearly there needs to be some kind of increase in the alternatives for investors that could help to diminish the current squeezing of spreads for broadly-syndicated arbitrage CLOs.

There's clearly potential for a much more active SME CLO market in Europe. We seem to have recognition, finally, in the last two or three years, by both Brussels and Frankfurt, of the importance of this mechanism for the funding of small and medium-sized companies going forward. So perhaps that market will pick up.

A much more broadly-based, diversified market is within Europe's grasp. It just needs some slight adjustments on the part of the regulators, perhaps some more generosity by the ECB, and it could occur.

Quipildor, Natixis: Diversity can come in a few different ways. One, as Mark mentioned, could be SMEs or middle-market loans. And there is potential in Europe for transactions with more of a middle-market focus. A more specific middle-market related portfolio which would represent really different assets from the typical broadly-syndicated CLO space could bring that diversity appeal, together with manager diversity. There can also be a diversification of currencies. The bigger US dollar market or the sterling market could add diversity and reduce the natural overlap of assets in European CLO transactions. And from a structuring point of view, the constraints on building portfolios have provoked longer warehouse ramp-up times, which could then allow for more flexibility in portfolio construction, and mitigate the need for European managers to relay into every new issuance that comes to the market.

Hernan Quipildor
NATIXIS

Finally, and this is something that we've been doing at Natixis, CLO 1.0 transactions that can be refinanced could be a source of assets for new transactions. This also has a very interesting diversity angle, because they are effectively different assets to the ones that everybody else is looking into and also are more seasoned which can be an attractive positive credit feature. We did a transaction last December for Halcyon where the manager was able to source a good portion of the portfolio from a previous transaction being called, and that created a very interesting diversity profile. So we're constantly looking for such opportunities.

Tarneaud, CVC: I certainly agree on the sterling point. I think both investors and managers would welcome a long term solution to the problem of accessing the sterling market at a significant scale. This will provide additional collateral diversity, yield pick-up and exposure to probably the best jurisdiction in Europe when it comes to restructuring.

Regarding middle-market transactions, this would certainly add diversity and there is currently a very good pipeline of middle-market deals in Europe. The only downside here is liquidity. If the manager has to sell a middle-market name in a bad market to meet its tests or for whatever reason, this could prove very tricky. You would probably have to sell at a big discount to where the actual value is. On top of that these deals are usually not rated. But the biggest issue for us remains the liquidity point.

GlobalCapital: Tim, given the complexities and expense of compliance with new rules, is outsourcing ever an option for managers, and are there options for managers to build assets under management through outsourcing?

Tim Houghton, Cortland, Cortland: It's an important question, certainly in the CLO landscape, but equally in the credit fund space. It is getting more difficult for managers with all of the regulatory overhang and the different structures they have to adapt to. And we're seeing managers both large and small feeling like they don't quite have the operational leverage they want to have. It takes a substantial investment in people and systems and process to maintain the best operations.

So outsourcing has become an increasingly utilised solution in the 2.0 market. There are a handful of outsourcing solutions specifically targeted to CLO managers and loan managers alike. We're one of them obviously. We've seen more managers — at first it was smaller and mid-sized managers, and now larger managers — increasingly turning to outsourcing, expressing the view that this is going to continue be a difficult market and they are expected to put more at risk for their fees. Consequently they need to be even more efficient and timely in their operations, credit monitoring, and investor reporting.

Tarneaud, CVC: Outsourcing some of the operations could be indeed an efficiency opportunity if the price of doing so is attractive enough. I think managers will always keep control of the analysis and portfolio side of the business. That is very unlikely to change.

Allen, BNY Mellon: There is always an opportunity to drive efficiencies for managers. I think it depends on exactly what they are looking to outsource. The smaller mangers definitely are looking for the full outsourcing capability, while the bigger managers might look for more pieces of the loan life cycle to be outsourced, like loan closing and settlement, for example.

Big managers still want to have a good handle on their portfolio in-house, and for the most part, they have the systems that they require to be able to deliver that. If you're going to look to outsource totally, you are obviously looking for a trusted partner who understands your product, can deliver you the required information in a timely manner in order to facilitate making the relevant decisions. This is at the core of what we deliver to our clients on a day to day basis together with great clients services.

Houghton, Cortland: Yes, I would have argued that more strongly myself before, but now I see more managers who are willing to outsource more components. Traditional outsourcing was focused on some of the loan data, cash reconciliations and loan settlements, but we're seeing more managers who are saying: "All of my funds, whether they are credit funds or CLOs, have compliance requirements and so I need an outsourcing solution to provide me the input I need to make a decision on what's the maximum investment I can make in any given loan." So if you have twenty funds how much of any specific loan can you put into each of those different funds? Whether it's a credit fund, a mutual fund, an ETF or a CLO, they want an answer to the question of how much of any specific loan can fit into those different funds.

We're seeing more managers engage in full scale outsourcing, and that includes asset liability management or model management, as well.

GlobalCapital: Mark, you had said earlier that you felt there were echoes of pre-crisis in some of the deal structures. Do you think they will continue to get looser?

Hale, Prytania: Not specifically around CLO deal structures alone, but in general across credit markets. There are things that help to prevent the recurrence of that. First of all, the memories are still ripe and therefore there is a lot of investor caution — we haven't completely forgotten the last cycle. But it's the nature of banking: that it seems to repeat the same mistakes every economic cycle.

However there has been a lot of new regulation, and that regulation is still yet to be fully implemented. We've got new rules on both sides of the Atlantic, which will continue to bear down onto the forces that are leading to credit loosening — whether that's the leverage loan guidelines, in the US for example, or things like capital standards or the new regulations for insurance companies, like Solvency II coming in Europe. We are also bound to see a tightening of the regulations around pension funds, subsequent to that.

Mark Hale
PRYTANIA INVESTMENT ADVISORS

The second dimension is that we've got greater transparency, better reporting and better technology. So the gap between bad-quality underwriting and the consequences of bad-quality underwriting should be smaller, and the potential for the shock of a downturn translating into a significant rise in defaults or other indications of stress will be smaller.

That should make it easier for market participants than the last two or three downturns. We also haven't seen a great deal of innovation in the sector, and that's also meant that we're not seeing creative structuring in a way that's resulted in hidden risks that are hard for people to model and understand.

We talked about aspects of the 2.0 market being relatively standardised —the lack of that was a source of hidden risks in the past. That is much less likely this time around. So without a return to past sins, the risks of an exact repeat of past history are not high. We just need to be vigilant about any of these accumulating small risks at the margin translating to a much broader risk to portfolios overall.

Chakraborty, Pearl Diver: We also have seen some credit underwriting getting looser over the last few years. One aspect that gets a lot of focus from triple-A investors, as well as from other investors in the capital stack, is the amount of covenant-lite loans in new portfolios, especially in the US, but also in Europe. The proportion of cov-lite loans in the portfolio has been rising.

There's been different opinions and thoughts around cov-lite issues. One school of thought is that cov-lites are issued by companies that are much stronger, with better cash flows, so they can get away with it. Then it's not necessarily an indication of poor credit, and does not necessarily reflect a higher default rate. Historically, cov-lite loans have not always has worse default experiences.

But others would argue that what cov-lites really do is to push back the timing of potential defaults, which can really hit your recoveries hard, because it's further down the road when things have really gone bad with those companies.

What really caused the crisis was not CLOs. It was other market value-based leveraged structured products like SIVs — these were market value structures with fundamental mismatches in duration of assets and liabilities.

Those don't exist today. Nobody is saying that we will not see another cycle or a dip, or a slight rise in defaults, but as long as we do not have market value structures like SIVs, and so long as we do not have such fundamental asset/liability mismatches, then I think it's unlikely that we will see a recurrence of the magnitude that we saw in the past. ▲

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The big screen

Camper van discussions


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