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# DODD-FRANK'S REQUIREMENT OF "SKIN IN THE GAME" FOR ASSET-BACKED SECURITIES MAY SCALP CORPORATE LOAN LIQUIDITY

DAVID LINE BATTY\*

"The law of unintended consequences, often cited but rarely defined, is that actions of people—and especially of government—always have effects that are unanticipated or unintended."<sup>1</sup>

## I. INTRODUCTION

The economic devastation of the past three years (and counting) has come to be known as the Great Recession because it has had far-reaching economic and societal effects not felt since the Great Depression which inspired its name.<sup>2</sup> Like its namesake, the Great Recession started with a collapse in the financial markets which quickly spread throughout the economy as a whole. Not surprisingly, just as the Great Depression aroused widespread calls for a comprehensive governmental response, the severity of the current economic crisis made government action all but inevitable. At first, the government's response consisted of economic triage to prevent complete economic catastrophe. Only after the economy had been stabilized did policy makers turn their

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1. Rob Norton, *Unintended Consequences*, THE CONCISE ENCYCLOPEDIA OF ECON., <http://www.econlib.org/library/Enc/UnintendedConsequences.html> (last visited Jan. 12, 2010).

2. See Paul Taylor et al., *A Balance Sheet at 30 Months: How the Great Recession Has Changed Life in America*, PEW RES. CTR. (June 30, 2010), available at <http://pewsocialtrends.org/files/2010/11/759-recession.pdf>. The study states the following: "[m]ore than half (55%) of all adults in the labor force say that since the Great Recession began 30 months ago, they have suffered a spell of unemployment, a cut in pay, a reduction in hours or have become involuntary part-time workers . . . ." The survey also finds that the recession has led to a new frugality in Americans' spending and borrowing habits; a diminished set of expectations about their retirements and their children's future; and a concern that it will take several years, at a minimum, for their family finances and house values to recover. *Id.*

attention to long-term solutions intended to avoid a repeat of the collapse. To date, the most comprehensive federal governmental response is the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) which became law on July 21, 2010. Commensurate with its scope and breadth,<sup>3</sup> the stated purpose of the 2,300-plus page new law is “[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail’, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.”<sup>4</sup> Despite the sense of urgency which led to the passage of Dodd-Frank, many of the law’s provisions will not take effect for several years. In fact, the full content of the law will not be known until the various regulatory agencies created or otherwise empowered with new responsibilities complete the rule-making process mandated by Dodd-Frank. This rule-making process will last for at least eighteen months following enactment of Dodd-Frank and even longer if efforts to delay implementation of Dodd-Frank are successful.

To assist the applicable regulatory agencies in preparing implementing regulations, Dodd-Frank calls for over sixty different reports to study the effects of the multitude of regulations required pursuant to the comprehensive reform law. In particular, Section 941(c) of Dodd-Frank requires the Board of Governors of the Federal Reserve System (FRB) to conduct a study on the effect of the risk retention requirements for Dodd-Frank.<sup>5</sup> The FRB’s Report to the Congress on Risk Retention

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3. See FIN. REG. REFORM WORKING GRP. (WEIL, GOTSHAL, & MANGES LLP, NEW YORK, NY), FINANCIAL REGULATORY REFORM: AN OVERVIEW OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 1 (2010), *available at* <http://www.weil.com/files/upload/Weil%20Dodd-Frank%20Overview.pdf> [hereinafter WEIL OVERVIEW] (noting that the legislation (i) includes 15 major parts with 14 stand-alone statutes and numerous amendments to the current array of banking, securities, derivatives, and consumer finance laws, (ii) is intended to restructure significantly the regulatory framework for the United States financial system and (iii) will have broad and deep implications for the financial services industry as well as parts of the economy beyond the financial sector).

4. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified in scattered sections of U.S.C.).

5. *Id.* at sec. 941(b), § 15G.

(Risk Retention Report) was issued on October 19, 2010.<sup>6</sup> In addition to asset-backed commercial paper, the Risk Retention Report focused on “eight loan categories” including collateralized loan obligations (CLOs).<sup>7</sup> Although the Risk Retention Report contains a detailed analysis of existing “risk retention and incentive alignment practices” for these various loan categories, the FRB notes that because the implementing regulations are not yet final, it is impossible to fully analyze the effect of Dodd-Frank’s risk retention requirements at this time.<sup>8</sup> Additionally, Section 946 of Dodd-Frank requires the Chairman of the Financial Stability Oversight Council (FSOC) to conduct a study of the macroeconomic effects of Dodd-Frank’s risk retention requirements.<sup>9</sup> The FSOC Chairman’s report on the Macroeconomic Effects of Risk Retention Requirements was delivered to Congress on January 18, 2011.<sup>10</sup> As a general matter, the report notes that the primary potential benefit of a mandatory risk retention framework is to improve underwriting standards.<sup>11</sup> Balanced against that perceived benefit, however, is the warning that overly restrictive risk retention requirements “could constrain the formation of credit, which could adversely impact economic

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6. BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO THE CONGRESS ON RISK RETENTION 1 (2010), *available at* <http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf> [hereinafter RISK RETENTION REPORT].

7. *Id.*

8. *Id.*

9. Dodd-Frank Act § 111 (to be codified at 12 U.S.C. § 5321). The Financial Stability Oversight Counsel (FSOC) is created pursuant to Section 111 of Dodd-Frank. *Id.* The FSOC is chaired by the Treasury Secretary and is composed of the following additional nine voting members: Chairman of the Federal Reserve Board, Comptroller of the Currency, Chairman of the Federal Deposit Insurance Corporation, Chairman of the Securities and Exchange Commission, Chairman of the Commodities Futures Trading Commission, Chairman of the National Credit Union Administration, Director of Federal Housing Agency, Director of the Bureau of Consumer Financial Protection and an independent Presidential appointee (subject to Senate-confirmation) with insurance expertise. *Id.*

10. See FINANCIAL SERVICES OVERSIGHT COUNSEL, FSOC CHAIRMAN’S REPORT ON THE MACROECONOMIC EFFECTS OF RISK RETENTION REQUIREMENTS 1 (Jan. 18, 2011), *available at* <http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20%28FINAL%29.pdf>. [hereinafter FSOC CHAIRMAN’S REPORT].

11. *See id.* at 3-4.

growth.”<sup>12</sup> Unfortunately, because Section 946 of Dodd-Frank requires the FSOC Chairman’s Report to place an emphasis “on potential beneficial effects [of the risk retention requirements] with respect to stabilizing the real estate market,” the report contains scant reference to the effect of the risk-retention requirements on CLOs or syndicated loans.<sup>13</sup> In fact, one of the few references to syndicated loans implies that the goal of the risk retention requirement is to cause the asset-backed securitization market to manage the risk of information asymmetry<sup>14</sup> in the way such risk is currently managed in the existing syndicated loan market.<sup>15</sup>

This article identifies and analyzes the potential unintended impact that the risk retention requirements of Title IX of Dodd-Frank could have on the syndicated loan market.<sup>16</sup> Part II of this article provides a general overview of the syndicated lending market, identifies the basic structure of a typical CLO, and discusses the importance of CLOs to the syndicated loan market.<sup>17</sup> Part III analyzes the potential impact of the risk retention requirements of Dodd-Frank on the syndicated loan market and concludes that the risk retention requirements of Dodd-Frank will negatively impact the syndicated loan market by disrupting the secondary loan trading market and restricting the formation of new CLOs.<sup>18</sup> Next, Part IV evaluates the performance of CLOs and syndicated loans during the credit crisis.<sup>19</sup> Finally, Part V proposes an alternative to the risk retention requirements of Dodd-Frank for improving risk management in the syndicated loan market.<sup>20</sup>

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12. *See id.* at 4.

13. *See* Dodd-Frank Act § 946(a).

14. The disparity in information between the packager-seller of a securitized asset and the buyer of such securitized asset is referred to as “information asymmetry.” *See* Sanjeev Arora et al., *Computational Complexity and Information Asymmetry in Financial Products* (Princeton Univ., Working Paper, 2009), available at <http://www.cs.princeton.edu/~rongge/derivative.pdf>.

15. *See* FSOC CHAIRMAN’S REPORT, *supra* note 10, at 17.

16. *See infra* pp. 25-33.

17. *See infra* Part II.

18. *See infra* Part III.

19. *See infra* Part IV.

20. *See infra* Part V.

## II. COLLATERALIZED LOAN OBLIGATIONS AND THE SYNDICATED LOAN MARKET

Since the mid-1990s, the syndicated loan market and the CLO market have enjoyed a symbiotic relationship. The syndicated loan market provided a steady stream of new assets to CLOs in exchange for the necessary liquidity to make new loans to corporate borrowers.<sup>21</sup>

### A. The Syndicated Loan Market

Syndicated loans are large commercial loans provided to corporate borrowers by a group, or syndicate, of lenders.<sup>22</sup> Although the federal government classifies any loan or loan commitment of at least \$20 million shared by three or more supervised financial institutions as a “syndicated loan,”<sup>23</sup> it is not unusual for a syndicated loan to involve twenty or more separate lenders loaning hundreds of millions of dollars to a borrower or group of borrowers. Multi-billion dollar syndicated loans may have hundreds of lenders in the syndicate, or bank group. One unfamiliar with syndicated loans may conclude that a loan transaction of the size and scope of a typical syndicated loan is unwieldy and complex. However, quite the opposite is true.

The structure of a syndicated loan transaction facilitates financial dealings by and among the borrower, its bank group, and the broader capital markets.<sup>24</sup> Syndicated loans are usually

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21. See Press Release, Deerfield Capital Corp., Have CLO structures performed as designed? (May 5, 2010), available at [http://www.deerfieldcapital.com/announcements\\_sa/05/10/2010.-have-clo-structures-performed-as-designed](http://www.deerfieldcapital.com/announcements_sa/05/10/2010.-have-clo-structures-performed-as-designed) [hereinafter *Deerfield*].

22. See William Chew et al., *A Guide to the Loan Market*, Standard & Poor's (Sept. 2010), <https://www.lcdcomps.com/d/pdf/LoanMarketguide.pdf> [hereinafter *S&P Guide*].

23. See generally *The Shared National Credit Program*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., <http://www.federalreserve.gov/econresdata/releases/snc/snc.htm> (last visited Jan. 12, 2011). “The Shared National Credit Program [(“Shared National Credit Review”)] was established in 1977 by the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency to review and classify large syndicated loans.” *Id.*

24. See *S&P Guide*, *supra* note 22.

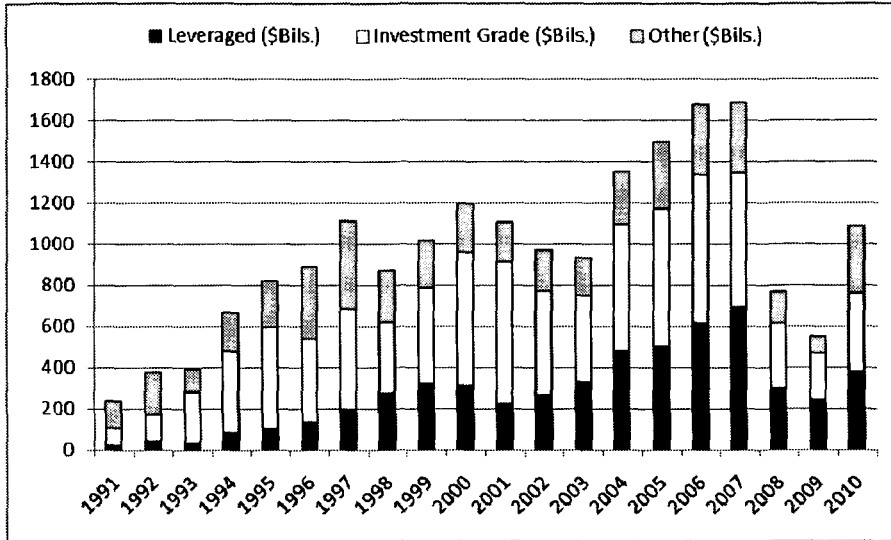
structured and arranged by one of the lenders in the bank group called the arranger. The structuring and arranging service provided by the arranger frees corporate borrowers from the time-consuming and costly task of identifying multiple lenders willing to finance the corporate borrower's operations and then negotiating separate loan agreements with each lender. The arranger often holds a larger percentage of the syndicated loan than any of the other individual lenders and frequently acts as the administrative agent for the bank group. The administrative agent facilitates the operation of a syndicated loan transaction by acting as the primary administrative point of contact for both the borrower and the lenders with respect to the syndicated credit agreement. The administrative agent also assists trading of loan commitments in the secondary market by administering assignments of loans and loan commitments among lenders who are party to the syndicated loan transaction as well as between current lenders and new lenders seeking to join an existing bank group.

Thus, syndicated loans effectively allow a borrower to obtain larger loans than it could typically obtain from a single lender, but without requiring the borrower to sacrifice the ease of dealing with a single point of contact (in the case of a syndicated loan, the administrative agent), rather than a number of individual lenders through separate loan agreements. Lenders benefit from syndicated lending by spreading loan commitments and obligations among multiple syndicated loans to different borrowers which allows lenders to better manage default risks by diversifying their loan portfolios. Because of these advantages, syndicated loans are the preferred way for corporate borrowers to obtain loans from banks and institutional lenders. Domestic syndicated loans currently provide \$2.5 trillion of credit to domestic companies.<sup>25</sup> Figure 1 below shows the dynamic growth of the overall syndicated loan market since 1991.

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25. See generally Press Release, Fed. Reserve Bd., Credit Quality of the Shared National Credit Portfolio Improved in 2010 (Sept. 28, 2011), available at <http://www.federalreserve.gov/newsevents/press/bcreg/20100928a.htm>.

Figure 1  
Annual Syndicated Loan Volume by Loan Type<sup>26</sup>



### B. Basic Structure of a Collateralized Loan Obligation

A CLO is a special purpose vehicle formed for the purpose of purchasing and holding bank loans, including syndicated loans, as assets.<sup>27</sup> CLOs finance the purchase of loans by issuing debt and equity to investors seeking to obtain an interest in the cash flow generated by the borrowers' payments of the loans held in the CLO's diversified portfolio. The manager of the CLO typically retains a portion of the CLO's equity, with the amount of such

26. Thompson Reuters LPC, Annual Syndicated Loan Volume by Loan Type (2010) (unpublished) (on file with author). Investment grade loans are loans made to corporate borrowers with a rating of at least Baa3 from Moody's and BBB- from each of Standard & Poor's and Fitch. Leveraged loans refer to loans made to unrated corporate borrowers or corporate borrowers with a rating lower than investment grade.

27. See BABSON CAPITAL MGMT, LLC., THE BABSON CAPITAL WHITE PAPER 6-7 (2009), available at [http://www.babsoncapital.com/BabsonCapital/http/bcstaticfiles/Research/file/CLO%20White%20Paper\\_CLOWP4309\\_Jun09.pdf](http://www.babsoncapital.com/BabsonCapital/http/bcstaticfiles/Research/file/CLO%20White%20Paper_CLOWP4309_Jun09.pdf) [hereinafter BABSON WHITE PAPER]; Deerfield, *supra* note 21, at 2. For an additional discussion of CLO structures see RISK RETENTION REPORT, *supra* note 5, at 22–23.



equity retention depending on the size of the CLO. Most CLOs have a term of between twelve and fifteen years.<sup>28</sup> The first five to seven years of the CLO's term is called the reinvestment period and the proceeds of early loan payments can be reinvested by the CLO's asset manager in other syndicated loans.<sup>29</sup> Thereafter, the CLO enters an amortization period and eventually liquidates as the loan assets reach maturity and are repaid.<sup>30</sup> CLOs are a subset of the broader class of collateralized debt obligations (CDOs) and, like structured assets, the formation of new CLOs came to a virtual standstill in 2009 as a result of the credit crisis that precipitated the Great Recession. Although the market for new CLO issuance has begun to recover,<sup>31</sup> CLO structures are still evolving in response to the credit crisis. CLO market participants expect that new CLOs will be held by different types of investors and will have simpler structures with both shorter reinvestment periods and lower leverage when compared to CLOs pre-dating the credit crisis.<sup>32</sup> Because it is premature to state conclusively what form the CLO market will take over the next few quarters, this overview of the basic structure of CLOs is based on CLO structures that existed prior to 2007.

The debt issued by a CLO to finance its purchase of loan assets is allocated into separate classes or "tranches" with different priority claims on the cash flow generated by the underlying loans held by the CLO. The issuance of different tranches of debt allows CLO investors to purchase the type of debt that matches the investor's risk appetite. Investors seeking less risky investments purchase the senior tranches of debt which are more highly rated than the subordinated, or mezzanine, tranches. Investors willing to tolerate increased risk in exchange for a higher return are attracted to the mezzanine tranches of CLO debt. In this regard,

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28. RISK RETENTION REPORT, *supra* note 6, at 22.

29. *See id.*; Kenneth Kohler, *Collateralized Loan Obligations: A Powerful New Portfolio Management Tool for Banks*, SECURITIZATION.NET (Jan. 1, 1998), available at [http://www.securitization.net/knowledge/transactions/coll\\_loan\\_obl.asp](http://www.securitization.net/knowledge/transactions/coll_loan_obl.asp) [hereinafter Kohler].

30. Kohler, *supra* note 29.

31. *See infra* Figure 3.

32. *See* BABSON WHITE PAPER, *supra* note 27, at 6-7; Deerfield, *supra* note 21, at 2.

the structure of a CLO closely resembles the structure of other types of CDOs.

However, there are many important differences between CLOs and CDOs. The most important of these differences is that most CLOs are actively managed by well-known and experienced third party asset managers (CLO Managers) like Babson Capital Management LLC, Eaton Vance Investment Managers, PIMCO, and INVESCO Ltd. Many CDOs, particularly the mortgaged backed securities widely criticized in the aftermath of the credit crisis are not managed at all after the original asset pool is created. Another critical difference relates to the manner in which CLOs are formed. Although banks that originate the loans purchased by CLOs often assist in structuring CLOs, these banks are acting as agents for CLO Managers rather than on their own behalf as either sponsors or originators of the CLO. The agent bank (in this agent capacity, the Structuring Bank) purchases loans selected by the CLO Manager.<sup>33</sup> Unlike other more passive CDO structures, CLOs include objective financial tests to monitor the overall credit quality of the CLO's loan portfolio.<sup>34</sup> Finally, the underlying loans purchased by CLOs are much more transparent assets than the types of assets that backed the complex CDOs, now known as "toxic assets."<sup>35</sup> For example, many of the syndicated loans purchased by CLOs are issued by large public corporations, which are required to comply with the reporting requirements of the

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33. For an overview of the types of credit factors typically considered by a CLO Manager in evaluating a potential loan purchase see BABSON WHITE PAPER, *supra* note 27.

34. Typical financial tests are the interest coverage test and overcollateralization. See BABSON WHITE PAPER, *supra* note 27. For a more detailed discussion of each test and how they act as self-correcting mechanisms for a CLO's loan portfolio see *id.*

35. A toxic asset is "[a]n asset that becomes illiquid when its secondary market disappears. Toxic assets cannot be sold, as they are often guaranteed to lose money. The term 'toxic asset' was coined in the financial crisis of 2008/09, in regards to mortgage-backed securities, collateralized debt obligations and credit default swaps, all of which could not be sold after they exposed their holders to massive losses." *Toxic Asset*, INVESTOPEDIA, <http://www.investopedia.com/terms/t/toxic-assets.asp> (last visited Feb. 2, 2011); see also, FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT, THE FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xvi, xxiii (Jan. 2011), available at <http://www.fcic.gov/report> [hereinafter FCIC REPORT].

Securities and Exchange Act of 1934. Further, according to the Loan Syndications and Trading Association (LSTA), the large corporate loans typically purchased by CLOs “are publicly rated by Standard & Poor’s, Moody’s or Fitch; they are liquid and trade in the secondary loan market; and they are valued daily by third party pricing services.”<sup>36</sup>

### *C. The Importance of Collateralized Loan Obligations to the Syndicated Loan Market*

The growth of the syndicated loan market financed the expansion of corporate America and the vitality of the national economy from the early 1990s and throughout the 2000s.<sup>37</sup> Moreover, unlike other financing alternatives such as equity issuances or asset-backed securitizations, the syndicated loan market continued to function and provide liquidity, albeit at a greatly reduced rate, throughout the Great Recession. In fact, syndicated loan market volume has already recovered to pre-2003 levels, showing that the syndicated loan market is on the vanguard of the economic recovery.<sup>38</sup>

Much of the growth in the syndicated loan market is due to the fact that the structure of syndicated loans allows for a vibrant and liquid secondary trading market in those loans. This secondary trading market permits non-bank institutional investors such as CLOs to participate in the syndicated loan market on a large scale. As demonstrated by Figure 2 below, since the mid-1990s, the most important non-bank institutional investors in the syndicated loan market are CLOs.

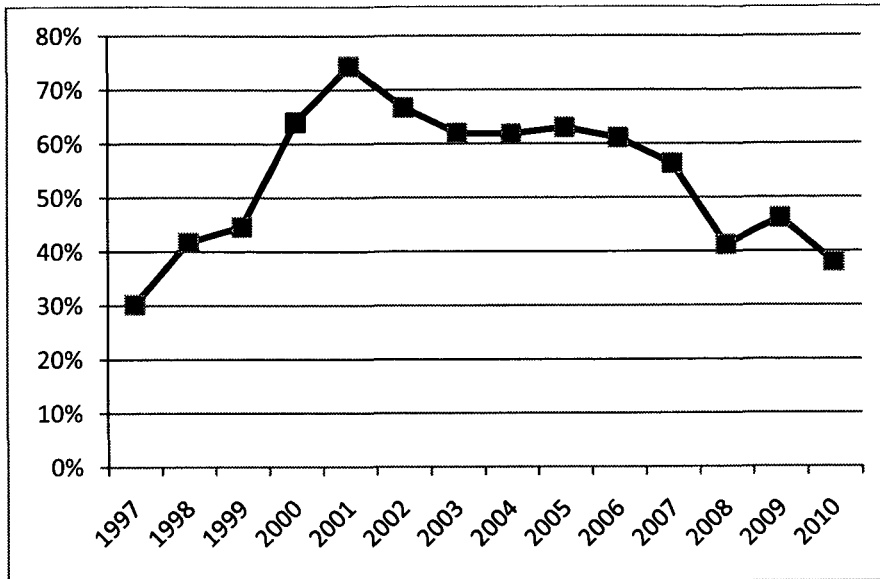
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36. LOAN SYNDICATIONS AND TRADING ASSOCIATION, THE IMPACT OF RISK RETENTION ON CLOS AND OTHER MEANS OF ALIGNING INCENTIVES 1-2 (2010), available at <http://www.lsta.org/WorkArea/showcontent.aspx?id=11904> (last visited Feb. 12, 2011) [hereinafter LSTA CLO RISK RETENTION SURVEY].

37. See, e.g., *id.*

38. See *supra* Figure 1.

Figure 2  
 Percentage of Syndicated Loan Market Held by CLOs<sup>39</sup>



Quite simply, just as the growth of the syndicated loan market drove the economic growth since the early 1990s, the investment by CLOs in non-investment grade loans drove the growth of the syndicated loan market. Prior to the onset of the collapse of the credit markets in mid-2007, CLOs held over sixty percent of all outstanding term loan debt in the domestic loan market.<sup>40</sup> Since that time, CLO market share has dropped to below forty percent.<sup>41</sup> Because new CLO issuance was virtually non-existent during 2008 and 2009, CLO market share has been maintained at this level through reinvestment by existing CLOs.<sup>42</sup> Outstanding CLOs cannot support the non-investment grade segment of the syndicated loan market indefinitely. Unless new CLO formation continues to rebound, the LSTA predicts a \$100

39. Thompson Reuters LPC, Percentage of Syndicated Loan Market Held by CLOs (2010) (unpublished) (on file with author).

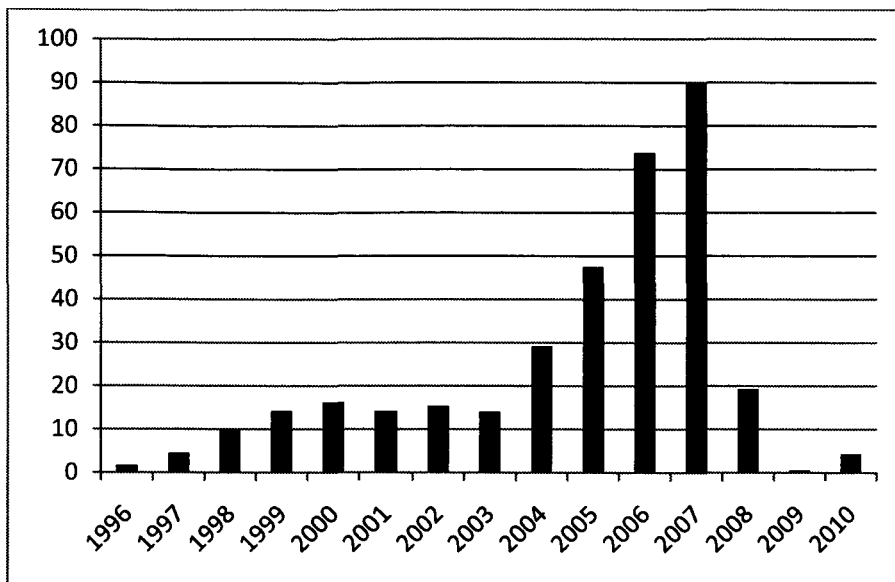
40. Meredith Coffey et al., LSTA 15th Annual Conference, Meet the New Investors 2 (Oct. 13, 2010), <http://www.lsta.org/WorkArea/showcontent.aspx?id=11568>.

41. *Id.*

42. *See infra* Figure 3.

billion shortfall by 2013 between the demand for liquidity to refinance maturing loans and the reinvestment capacity of the current universe of CLOs.<sup>43</sup>

Figure 3  
Annual Domestic CLO Issuance (\$Billions)<sup>44</sup>



Despite the absence of CLOs from the loan market for the past two and one-half years, the domestic loan market topped \$1 trillion in 2010, almost doubling the 2009 total of \$547 billion.<sup>45</sup> The nascent recovery of new CLO issuance in 2010 played an important role in this recovery and most loan market participants do not think that the loan market can continue to grow at a robust pace in 2011 in the absence of significant new liquidity from institutional investors including new CLO funds.<sup>46</sup> Without the

43. Coffey, *supra* note 40, at 2.

44. Thompson Reuters LPC, Annual Domestic CLO Issuance (2010) (unpublished) (on file with author).

45. Press Release, Thomas Reuters LPC, U.S. 4Q10 Loan Market Review: Running to stand still? Banks battle run-offs, broaden mandates, re-enter leveraged lending (Dec. 31, 2010), [http://www.loanpricing.com/pressdetail.php?yearValue=2010&press\\_release\\_info\\_id=8](http://www.loanpricing.com/pressdetail.php?yearValue=2010&press_release_info_id=8). [hereinafter *Reuters Press Release*].

46. *Id.*

liquidity from CLOs, “capital-constrained arrangers are required to retain a large loan portion, they are able to syndicate fewer loans and the supply of syndicated credit is reduced.”<sup>47</sup> The companies most likely to be scalped by this reduction in credit supply will be companies attempting to access the syndicated loan market for the first time. This is because the loan market is less familiar with such new borrowers, and as a result, arrangers have a more difficult time selling such loans even when the secondary loan market is not constrained by a lack of liquidity.<sup>48</sup> Unfortunately, borrowers accessing the syndicated loan market for the first time tend to be growing companies that are most likely to create new jobs. If financing is not available to finance these growing companies they will be forced to curtail or cancel their expansion plans. Therefore, regulations that adversely affect the CLO market will impair the ability of the syndicated loan market to meet the credit demands of corporate America which could, in the words of the FSOC Chairman, “adversely impact economic growth.”<sup>49</sup>

### III. POTENTIAL UNINTENDED IMPACT OF THE RISK RETENTION REQUIREMENTS OF TITLE IX OF DODD-FRANK ON THE SYNDICATED LOAN MARKET

Because many capital markets products share characteristics and structures, it is almost inevitable that laws and regulations targeted at one product or structure will have unintended effects on other unrelated capital markets products. The only way to avoid these unintended effects is to carefully refine the broad scope of omnibus legislation like Dodd-Frank through well-crafted regulations implementing such laws. The FRB specifically acknowledged this fact, noting in the Risk Retention Report:

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47. Ralph De Haas & Neeltje van Horen, *The crisis as a wake-up call*, VOXEU.ORG (Aug. 25, 2010) <http://www.voxeu.org/index.php?q=node/5435> [hereinafter *Haas & van Horen*].

48. *See id.*

49. *See* FSOC CHAIRMAN’S REPORT, *supra* note 10, at 4.

In light of the heterogeneity of asset classes and securitization structures, practices and performance, the Board recommends that rulemakers consider crafting credit risk retention requirements that are tailored to each major class of securitized assets. This approach is consistent with the flexibility provided in the statute and would recognize differences in market practices and conventions, which in many instances exist for sound reasons related to the inherent nature of the type of asset being securitized. Asset-class specific requirements could also more directly address differences in the fundamental incentive problems characteristic of securitizations of each asset type, some of which became evident only during the crisis.<sup>50</sup>

Syndicated loans and CLOs should be excluded from the risk retention requirements of Title IX of Dodd-Frank. The justification for this recommendation begins with an examination of the statutory language.

#### *A. Applicable Definitions*

Section 941, Regulation of Credit Risk Retention, of Dodd-Frank comprises several amendments to the Securities and Exchange Act of 1934 which create the framework and minimum standards of the risk retention requirements to asset-backed securities.<sup>51</sup> According to Section 941(a), the term “asset-backed security” is defined as

a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the

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50. RISK RETENTION REPORT, *supra* note 6, at 83.

51. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 941(b), 124 Stat. 1376, 1891-96 (2010) (to be codified at 15 U.S.C. § 78o-11).

security to receive payments that depend primarily on cash flow from the asset, including (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section.<sup>52</sup>

CLOs fall squarely within the definition of “asset-backed security” under Dodd-Frank because, as discussed in Part II above, CLOs are a type of collateralized debt obligation which are collateralized by a loan.<sup>53</sup> This conclusion is supported by the inclusion of CLOs as one of the eight loan categories analyzed by the FRB in the Risk Retention Report.<sup>54</sup>

Under Dodd-Frank, Section 941(b) defines the term “securitizer” as “(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.”<sup>55</sup> Based on this definition, a CLO, the CLO Manager, and the CLO’s Structuring Bank could all be classified as “securitizers.”<sup>56</sup> As noted by the LSTA, because the Structuring Bank is simply working as an agent for the CLO Manager, “it is unfair to require structuring banks to hold on to risk in a portfolio *they are simply sourcing* at the direction of another party.”<sup>57</sup>

Finally, the term “originator” means a person who (i) through the extension of credit or otherwise, creates a financial

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52. Dodd-Frank Act, sec. 941(b), § 15G(a)(4) (to be codified at 15 U.S.C. § 78o-11).

53. *See infra* Part II.

54. *See* RISK RETENTION REPORT, *supra* note 6, at 1.

55. Dodd-Frank Act, sec. 941(b), § 15G(a)(3) (to be codified at 15 U.S.C. § 78o-11).

56. *See id.*

57. LOAN SYNDICATION AND TRADING ASSOCIATION, LSTA WHITE PAPER 4 (2010), *available at* <http://www.lsta.org/WorkArea/showcontent.aspx?id=10976> (emphasis in original) [hereinafter LSTA WHITE PAPER].



asset that collateralizes an asset-backed security; and (ii) sells an asset directly or indirectly to a securitizer.<sup>58</sup> As discussed in Part II above, many syndicated loans are structured and arranged by a lead bank which acts as an arranger on behalf of the borrower.<sup>59</sup> Large leveraged syndicated loans, especially those used to finance leveraged buy-outs, frequently have several co-lead arrangers that collectively structure and arrange the loan. In either case, arrangers syndicate their loans by selling a portion of their loan commitment to an initial bank group prior to the closing. On the closing date of the loan, the arrangers and the original bank group each own a portion of the syndicated loan. Loans typically begin trading in the secondary market as soon as they are closed.<sup>60</sup> If a portion of the loan is purchased by a CLO, which is likely, that loan has been sold to a “securitizer” and becomes “a financial asset that collateralizes an asset-backed security.”<sup>61</sup> Therefore, the arrangers and any other lender party to a syndicated loan on the closing date could be deemed to be “originators” under Dodd-Frank’s expansive definition of that term.<sup>62</sup>

### *B. The Risk Retention Requirements*

Pursuant to new Section 15G (Credit Risk Retention) of the Securities and Exchange Act of 1934 added by the Dodd-Frank Act, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, “Federal banking agencies”) together with the Securities and Exchange Commission (the SEC) are required to “jointly prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security,

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58. Dodd-Frank Act, sec. 941(b), § 15G(a)(4) (to be codified at 15 U.S.C. § 78o-11).

59. *See infra* Part II.

60. Loan commitments are often traded prior to the closing date of the loan as well.

61. *See* LSTA WHITE PAPER, *supra* note 57, at 5.

62. Dodd-Frank Act, sec. 941(b), § 15G(a)(4) (to be codified at 15 U.S.C. § 78o-11).

transfers, sells, or conveys to a third party” within 270 days following the effective date of Section 941(b).<sup>63</sup> According to the FRB website, during the period of January 2011 through March 2011, the FRB will develop jointly with the other Federal banking agencies and the SEC a Notice of Proposed Rulemaking to implement the credit risk retention requirements of Dodd-Frank.<sup>64</sup> Under the applicable standards of Dodd-Frank, such regulations shall “require a securitizer to retain . . . not less than 5 percent of the credit risk for any asset” other than certain qualified residential mortgages.<sup>65</sup> Finally, pursuant to Section 941(b), the risk retention regulations shall “provide for . . . the allocation of risk retention obligations between a securitizer and an originator in the case of a securitizer that purchases assets from an originator, as the Federal banking agencies and the Commission jointly determine appropriate.”<sup>66</sup> Although Dodd-Frank does not prescribe the specific form of risk retention that is required under Section 941, the FSOC Chairman’s Report notes that “the general forms include: a vertical slice (a pro rata piece of every tranche), a horizontal slice (a first loss interest in the securitization structure), or an equivalent exposure of the securitized pool (retaining a random selection of assets from the pool).”<sup>67</sup>

The five percent minimum may be reduced for any asset so long as the originator of such asset complies with the applicable “underwriting standards established by the Federal banking agencies that specify the terms, conditions, and characteristics of a loan within the asset class that indicate a low credit risk with respect to the loan” pursuant to Section 15G(c)(2)(B).<sup>68</sup>

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63. Dodd-Frank Act, sec. 941(b), § 15G(b)(1) (to be codified at 15 U.S.C. § 78o-11).

64. *See Initiatives Planned: January to March 2011*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, [http://www.federalreserve.gov/newsevents/reform\\_milestones201101.htm](http://www.federalreserve.gov/newsevents/reform_milestones201101.htm) (Feb. 11, 2011). This Notice of Proposed Rulemaking was not released as of the date of publication of this article.

65. Dodd-Frank Act, sec. 941(b), § 15G(c)(1)(B)(i) (to be codified at 15 U.S.C. § 78o-11).

66. Dodd-Frank Act, sec. 941(b), § 15G(c)(1)(G)(iv) (to be codified at 15 U.S.C. § 78o-11).

67. *See* FSOC CHAIRMAN’S REPORT *supra* note 10, at 19.

68. Dodd-Frank Act, sec. 941(b), § 15G(c)(1)(B)(ii) & (c)(2)(B) (to be codified at 15 U.S.C. § 78o-11).

Moreover, pursuant to Section 15G(e) of the Securities and Exchange Act of 1934, “[t]he Federal banking agencies and the Commission may jointly adopt or issue . . . exemptions, exceptions, or adjustments for classes of institutions or assets relating to the risk retention requirement . . . under subsection (c)(1)” of Section 15G.<sup>69</sup> According to the FSOC Chairman’s Report, “[s]uch exemptions, in combination with risk retention requirements, may further incent strong underwriting practices.”<sup>70</sup>

### *C. The Potential Unintended Negative Effect of the Risk Retention Provisions on CLOs*

The risk retention requirements of Dodd-Frank will negatively impact the syndicated loan market by disrupting the secondary loan trading market and restricting the formation of new CLOs.

#### 1. The Effect on The Secondary Loan Market Caused By Treating Lenders As “Originators”<sup>71</sup>

The LSTA uses the following example to illustrate the problem of treating the arranger and original lenders as “originators” for purposes of Dodd-Frank. Assume that Bank A receives a larger allocation of a syndicated loan at closing than it can hold long term in accordance with its internal risk management policies. To reduce its exposure, Bank A sells a portion of its loan to Bank B. Thereafter, Bank B sells a portion of the loan it purchased from Bank A to a CLO. As a result of Bank B’s sale to the CLO, Bank A has indirectly sold that asset to a securitizer (the CLO that purchased a portion of the loan from

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69. Dodd-Frank Act, sec. 941(b), § 15G(e) (to be codified at 15 U.S.C. § 78o-11).

70. See FSOC CHAIRMAN’S REPORT, *supra* note 10, at 25 (“Exemptions could take into account a borrower’s history of debt repayment, the borrower’s current and anticipated capacity to make debt payments, and the quality and value of the collateral securing repayment.”).

71. For ease of reference, under Dodd-Frank, the term “originator” means a person who (i) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and (ii) sells an asset directly or indirectly to a securitizer. Dodd-Frank Act, sec. 941(b), § 15G(a)(4) (to be codified at 15 U.S.C. § 78o-11).

Bank B). Moreover, once the loan becomes part of the CLOs portfolio, Bank A has effectively created a “financial asset” through the extension of credit (the original loan) that is collateral for an asset-backed security (the CLO’s debt). The end result is that upon the sale to the CLO by Bank B of a portion of the loan that Bank A originally sold to Bank B, Bank A has become an “originator” within the meaning of Dodd-Frank.<sup>72</sup> This result holds true even if the transaction between Bank B and the CLO occurs several years after the Bank A sale to Bank B. If Bank A no longer held five percent of its original loan at the time that it became an originator as a result of the sale from Bank B to the CLO, Bank A would have to purchase loans in the secondary market to achieve compliance with Dodd-Frank. Forcing Bank A to enter into a trade purely for regulatory compliance purposes long after the original syndicated loan had closed and its terms had been finalized does not mitigate any risk whatsoever. Moreover, to be able to monitor compliance with Dodd-Frank, Bank A would need to track all subsequent sales and assignments of the loan it sold to Bank B until the date that the underlying loan had been paid off in full.<sup>73</sup> It is even possible that Bank A would need to continue to track the loan beyond that date if the underlying loan was repaid with the proceeds of an amended and restated loan agreement to which Bank A was a party. This sort of tracing is not feasible and according to the LSTA such “capability does not exist in the secondary loan market.”<sup>74</sup> The likely result of such an onerous requirement would be that banks would prohibit sales of loans to CLOs thereby eliminating the tracing problem as well as all of the market liquidity provided by CLOs.<sup>75</sup>

## 2. The Effect on New CLO Formation Caused by Classifying Structuring Banks and CLO Managers as “Securitizers”

The effect of classifying Structuring Banks and CLO managers as “securitizers” would have a similar chilling effect on

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72. LSTA WHITE PAPER, *supra* note 57, at 5.

73. *Id.*

74. *Id.*

75. *Id.*

overall market liquidity. Structuring Banks are not currently compensated to hold a portion of the assets they are purchasing at the direction of a CLO Manager and it is not economically feasible for CLO Managers to compensate Structuring Banks for that risk.<sup>76</sup> As a result, banks would be unwilling to act as Structuring Banks and that would significantly increase the difficulty of forming new CLOs.

To evaluate the potential impact of the Dodd-Frank's risk retention requirements on the CLO market, the LSTA recently completed a study of existing CLO funds holding \$99 billion in assets under management (AUM).<sup>77</sup> The results of this survey show that if Dodd-Frank's risk retention requirements are applicable to CLOs there will likely be a drastic impact on new CLO formation. First, eighty-seven percent of the CLO Managers surveyed indicated they could not retain a five percent vertical slice<sup>78</sup> of their CLOs to satisfy Dodd-Frank's risk retention requirements, with a majority of CLO Managers surveyed stating that they lacked the necessary capital to retain a five percent vertical slice.<sup>79</sup> Although only thirteen percent of survey respondents indicated that they could retain some risk in the form of a horizontal slice,<sup>80</sup> a majority of respondents indicated that they lacked sufficient capital to hold a five percent horizontal slice.<sup>81</sup> Survey participants were also asked to predict whether or not they could successfully form new CLOs based on risk retention requirements ranging from one percent to five percent. As illustrated by Figure 4 below, a five percent risk retention requirement that takes the form of a required equity contribution has the potential to reduced new CLO formation by up to eighty percent. The loss of that much potential liquidity in the form of new CLO funds will have a devastating effect on a syndicated loan market facing a potential \$100 billion refinancing shortfall in the next two years.

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76. *Id.*

77. *See generally* LSTA CLO RISK RETENTION SURVEY, *supra* note 36, at 1-2.

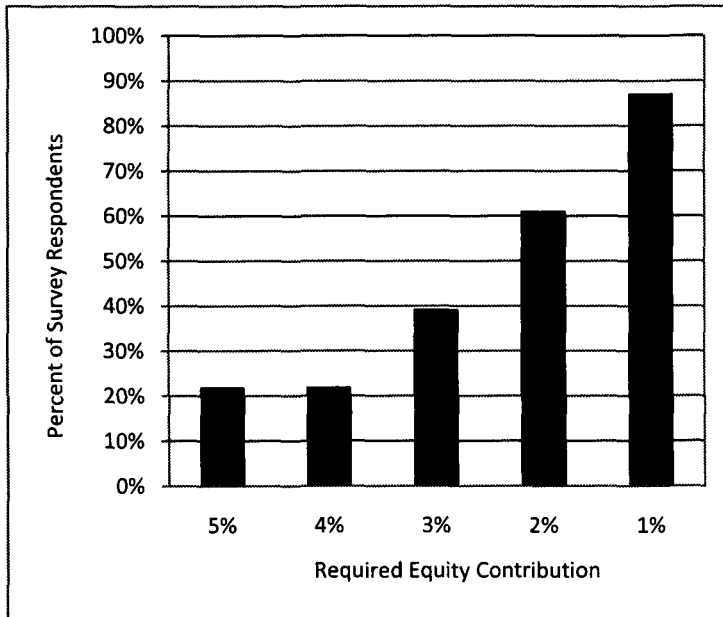
78. *See supra* note 67 and accompanying text for a description of a vertical slice.

79. *See generally* LSTA CLO RISK RETENTION SURVEY, *supra* note 36, at 3.

80. *See supra* note 67 and accompanying text for a description of a vertical slice.

81. LSTA CLO RISK RETENTION SURVEY, *supra* note 36, at 3.

*Figure 4*  
*Percent of Survey Respondents That Could Raise New CLO Funds*  
*Under Various Equity Contribution Requirements*<sup>82</sup>



#### IV. PERFORMANCE OF CLOS AND SYNDICATED LOANS DURING THE ULTIMATE STRESS TEST

Concern that the risk retention requirements proposed by Dodd-Frank will severely limit the formation of new CLO funds and thereby reduce the amount of credit available to finance an economic recovery is not, in and of itself, a reason for the syndicated loan market to reject the risk retention requirements. After all, if the risk retention requirements achieve the stated goal of promoting financial stability and ending bailouts, then perhaps the adverse “side effects” of Dodd-Frank’s strong medicine are tolerable. To answer this question, we need to determine how the CLO market and the syndicated loan market responded to the credit crisis of the past three years – the ultimate bank “stress test.”

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82. LSTA CLO RISK RETENTION SURVEY, *supra* note 36, at 5.

The Risk Retention Report evaluated the performance during the credit crisis of each of the asset classes, including CLOs, subject to the report. With respect to CLOs, the Risk Retention Report focused on the period from December 2008 to December 2009 and observed that although sixty-five percent of CLO tranches rated Aaa were downgraded during this period, three-quarters of those downgraded tranches retained an investment grade rating of Aa.<sup>83</sup> Moreover, the FRB noted that “estimates suggest that 15 percent of outstanding CLO deals have had at least one tranche upgraded since mid-2009 despite the toughening of rating standards. Mezzanine tranches have reportedly accounted for most of the recent upgrades.”<sup>84</sup> With respect to syndicated loans, the FRB recognized that “[d]espite fairly widespread downgrades, there were only a few actual defaults. Defaults in the underlying collateral – syndicated corporate loans – were limited, with CLO collateral defaults peaking at 6.5 percent in June 2009.”<sup>85</sup> According to the FRB, “[t]he relative transparency of the asset pool and the relative simplicity of the structures may also have played a role, in addition to the credit enhancements and incentive alignment mechanisms discussed earlier [in the Risk Retention Report].”<sup>86</sup> Finally, the FRB concluded that “[b]reaches of overcollateralization triggers peaked in June 2009, with 57 percent of CLOs failing minimum OC [overcollateralization] tests. Since then, most deals have cured and only 10 percent are still in breach of minimum OC levels as of September 2010.”<sup>87</sup>

Participants in the capital markets concurred with the FRB, concluding that during the credit crisis “CLOs performed the way they were designed to perform”<sup>88</sup> and noting that despite “the magnitude of the financial crisis, CLOs have performed remarkably well” during the Great Recession.<sup>89</sup> These conclusions are supported by an econometric<sup>90</sup> analysis of the syndicated loan

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83. RISK RETENTION REPORT, *supra* note 6, at 62.

84. *Id.* at 63.

85. *Id.* at 62.

86. *Id.*

87. *Id.* at 63.

88. See Deerfield, *supra* note 21.

89. See LSTA CLO RISK RETENTION SURVEY, *supra* note 36, at 5.

90. Econometrics is defined as “the application of statistical methods to the study

market in the aftermath of the credit crisis as well. More specifically, a study accepted by VoxEU.org, a policy portal set up by the Centre for Economic Policy Research, found that “the outbreak of the crisis led to a significant and robust increase in arrangers’ retention rates.”<sup>91</sup> “This increase materialised during the early phase of the crisis – before the collapse of Lehman Brothers and the ensuing sharp output decline – and persisted over time.”<sup>92</sup> Finally, managers of CLOs that were adversely impacted by the credit crisis saw their management fees partially or fully blocked in accordance with the terms of their management agreements.<sup>93</sup> This blockage of fees ensured that the managers of downgraded CLOs suffered immediate and negative economic consequences at the same time as the investors in the CLOs managed by such managers.

In short, the syndicated loan market weathered the financial “perfect storm” better than the broader securitization market.<sup>94</sup> Lest advocates of the syndicated loan market become too self-congratulatory, they should note that outperforming the securitization market over the past few years is a low bar to clear. The credit crisis laid bare many shortcomings in the syndicated loan market which I will address in greater detail in Part V.<sup>95</sup> Nevertheless, the comparatively successful reaction and response of both the CLO market and the syndicated loan market to the credit crisis are clearly relevant to evaluating the appropriateness of risk retention requirements for the syndicated loan market. For example, in evaluating the response of the syndicated loan market to the credit crisis, the Haas and van Doren econometric analysis documented

a strong, broad-based but market-driven increase in retention rates among syndicate arrangers.

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of economic data and problems.” *Econometrics Definition*, MERRIAM-WEBSTER.COM, <http://www.merriam-webster.com/dictionary/econometric> (Last visited Jan. 20, 2011).

91. Haas & van Horen, *supra* note 47.

92. *See id.*

93. *See* LSTA CLO RISK RETENTION SURVEY, *supra* note 36, at 5.

94. *See* Haas & van Horen, *supra* note 47.

95. *See infra* Part IV.



Participant lenders, concerned about arrangers' lax screening and monitoring, were in many cases able to take corrective action without regulatory intervention. ***Although syndicated lending declined sharply, the market did not break down.*** This stands in contrast to the securitization market, where the link between the originator and the ultimate investors was too severed to make any corrective (and collective) action possible.<sup>96</sup>

Although Haas and van Doren acknowledge that “this market-driven self-regulation may not last forever,” they suggest that a market-based response, whereby loan participants such as CLOs require originators of syndicated loans to maintain a meaningful position in their loans is superior to a regulatory response.<sup>97</sup> Echoing this conclusion, the Risk Retention Report observes that “the arranging bank’s ownership of part of the loan could be considered originator’s risk retention” with respect to a syndicated loan purchased by CLOs.<sup>98</sup> In addition to the self-regulation observed by Haas and van Doren, the syndicated loan market self-corrected the lax underwriting standards that prevailed in the period preceding the credit crisis by significantly tightening underwriting standards in the aftermath of the crisis.<sup>99</sup> According to the most recent Annual Survey of Credit Underwriting Practices prepared by the Office of the Comptroller of the Currency, this tightening of underwriting standards continued into early 2010.<sup>100</sup>

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96. See Haas & van Horen, *supra* note 47 (emphasis added).

97. See *id.*

98. RISK RETENTION REPORT, *supra* note 6, at 47.

99. OFFICE OF THE COMPTROLLER OF THE CURRENCY’S 15TH ANNUAL SURVEY OF CREDIT UNDERWRITING PRACTICES 2 (July 2009), available at <http://www.occ.gov/publications/publications-by-type/survey-credit-underwriting/pub-survey-credit-under-2009.html>.

100. *Id.*

## V. A MODEST PROPOSAL

Although the syndicated loan market survived the worst financial crisis since the Great Depression, it is obvious that syndicated loan investment bankers took far too many unjustified and excessive risks in the pursuit of short-term gains prior to the onset of the credit crisis. In the words of Ken Lewis, former Chief Executive Officer of Bank of America and himself a casualty of the credit crisis, “[w]e are close to a time when we will look back and say we did some stupid things.”<sup>101</sup> Robert Kindler of Morgan Stanley put an even finer point on things when he stated, “[w]hen you net out all the profit versus all the losses, Wall Street hasn’t made money, it’s lost money.”<sup>102</sup> Notably, Lehman Brothers and Wachovia were both ten months away from failing and the economic crisis had at least several more years to run at the time Kindler made that statement. In fact, the value of large-cap domestic banks, as measured by the Dow Jones U.S. Banks Index, fell almost sixty percent from June 1, 2007 to December 27, 2010.<sup>103</sup> During the first quarter of 2009, the index declined over eighty percent.<sup>104</sup> Obviously, the decline in banks’ market capitalization and the devastation of their balance sheets was not attributable solely to problems in the syndicated loan market. Nevertheless, uncontrolled risk-taking in the syndicated loan market certainly contributed to the overall problem. When one considers that loans are the most basic business of a bank, the fact that syndicated loans caused so much trouble is particularly shocking.

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101. Francesco Guerrera, *On Wall Street Something’s Gotta Give waiting for the last reel to unwind*, FIN. TIMES (May 11, 2007, 5:16 PM), <http://www.ft.com/cms/s/1/1feb4af2-ffda-11db-8c98-000b5df10621.html#axzz1ALOGNrx>.

102. Dennis K. Berman, *The Private Equity Boom: A Net Loser for Wall Street?*, WSJ BLOGS: DEAL JOURNAL (Oct. 16, 2007, 8:30 AM) (on file with author); see also Les Leopold, *Why Do People Who Work in Finance Earn So Much More Than the Rest of Us?*, ALTERNET (Jan. 11, 2011), [http://www.alternet.org/story/149634/why\\_do\\_people\\_who\\_work\\_in\\_finance\\_earn\\_so\\_much\\_more\\_than\\_the\\_rest\\_of\\_us/](http://www.alternet.org/story/149634/why_do_people_who_work_in_finance_earn_so_much_more_than_the_rest_of_us/) (estimating that “[f]or every dollar ‘earned’ on Wall Street” during the past five years “about 8 dollars were destroyed” as a result of the economic crisis).

103. See *Dow Jones U.S. Bank Index*, MSN MONEY (Jan. 12, 2011, 10:10 PM), <http://moneycentral.msn.com/investor/charts/chartdl.aspx?symbol=%24DJUSBK>.

104. See *id.*

It is doubtful that the risk retention requirements of Dodd-Frank would have mitigated risks in the syndicated loan market had they been in force prior to 2007. First, as Haas and van Doren have shown, the syndicated loan market responded on its own with *de facto* originator risk retention requirements at the outset of the credit crisis.<sup>105</sup> Unfortunately, the market response was insufficient to staunch the crisis. For example, one of the most problematic deals of the credit crisis was the financing of the \$24 billion leveraged buy-out of Clear Channel Communications Inc. by Thomas H. Lee Partners and Bain Capital.<sup>106</sup> The syndication of the financing for the Clear Channel leveraged buy-out was a complete failure and the loan's originators ended up holding one hundred percent of the loan.<sup>107</sup> This transaction, like many others during 2007-2008, was the subject of protracted and acrimonious litigation which finally settled in early May 2008.<sup>108</sup>

The losses from deals like Clear Channel were not caused by the failure of the borrower to repay the loan. Rather, it was the punishment meted out by the secondary loan trading market that did the damage. Historically, syndicated loans have been a stable asset class trading at or near par in the secondary market.<sup>109</sup> The credit crisis changed all that. Prices for loans in the secondary market collapsed with leveraged loans being hardest hit, and the secondary market for leveraged loans with deal terms structured before the crash in mid-2007 that dropped between forty percent and sixty percent below par during 2008.<sup>110</sup>

A simple example illustrates the devastating effect of this pricing collapse on a multi-billion dollar leveraged buy-out

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105. See Haas & van Horen, *supra* note 47.

106. See *Clear Channel: Lessons Learned*, N.Y. TIMES DEALBOOK (May 14, 2008, 11:02 AM), <http://dealbook.nytimes.com/2008/05/14/clear-channel-lessons-learned/> (*hereinafter* Clear Channel). The Clear Channel leveraged buy-out came to be known as one of the "Four Buy-outs of the Apocalypse", along with the proposed leveraged buy-outs of BCE, Huntsman and Penn National Gaming. See *The Four Buyouts of the Apocalypse*, N.Y. TIMES DEALBOOK (Apr. 8, 2008, 10:28 PM), <http://dealbook.nytimes.com/2008/04/09/the-four-horsemen-of-the-apocalypse/>.

107. See *Clear Channel*, *supra* note 106.

108. See *id.*

109. Meredith Coffey et al., *State of the U.S. loan market 6* (Jan. 7, 2009), [http://www.pcbe.org/pcbe.nsf/0/032c37afb934a03a85257537005962f2/\\$file/COFFEY\\_PCBE\\_2009\\_01\\_07.pdf](http://www.pcbe.org/pcbe.nsf/0/032c37afb934a03a85257537005962f2/$file/COFFEY_PCBE_2009_01_07.pdf) [*hereinafter* 2009 *State of the Loan Market Presentation*].

110. *Id.*

structured and underwritten in 2007 before the crash, but closed in 2008 after the crash. Assume that a group of arrangers are unable to syndicate a \$4 billion syndicated loan backing a large leveraged buy-out and the value to the arrangers of that syndicated loan financing drops sixty percent – or \$2.4 billion – on the day the syndicated loan closes. Even if the arrangers earned a sizeable underwriting fee of two percent, or \$80 million, on the loan, they still suffer a loss of \$2.32 billion. Regardless of whether the loan is sold in the secondary market (thus monetizing the loss) or held in the hopes of a rebound in the price, the mark-to-market rules in effect in 2008 caused the arranger to book a significant loss.

If the risk retention requirements of Dodd-Frank are not the right medicine for excessive risk in the syndicated loan market, what is? Answering this question is particularly timely as the syndicated loan market has once again topped \$1 trillion. A recent survey of syndicated loan participants by Thomson Reuters identified “maintaining discipline in underwriting” as one of the “biggest concerns heading into 2011.”<sup>111</sup>

To answer this question, it is necessary to revisit how the syndicated loan market became so risky in the first place. The biggest single factor driving risk in the syndicated loan market was record liquidity. William E. Conway, Jr., founding partner, managing director, and chairman of the investment committee of The Carlyle Group summed up the issue in his 2007 annual review memorandum when he stated, “[f]rankly, there is so much liquidity in the world financial system, that lenders (even ‘our’ lenders) are making very risky credit decisions.”<sup>112</sup> According to Mr. Conway, this accommodating credit market allowed The Carlyle Group to generate “fabulous profits.”<sup>113</sup> A properly functioning credit market depends on robust competition between borrowers and lenders for the best deal terms. When this competition is missing, a credit market ceases to function properly. You do not need an

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111. *Reuters Press Release*, *supra* note 45.

112. Memorandum from William E. Conway, Jr. to All Investment Professionals, Conway Worldwide 1 (Jan. 31, 2007), *available at* <http://media.washingtonpost.com/wp-srv/business/documents/conwaymemo.pdf> [hereinafter *Conway Memorandum*].

113. *Id.*

advanced economics degree to recognize that a credit market that enables borrowers' financial sponsors to make "fabulous profits" at the expense of lenders who are doing "stupid things" is broken.

At the height of the credit boom, assertive financial sponsors played their role and aggressively pushed for the best deal terms for the borrowers they controlled. Until the bubble finally burst, there was so much excess liquidity in the credit markets that financial sponsors could afford to make every point a "deal breaker" because they were virtually assured that some other lender somewhere would "hit the bid" and take the offered terms.<sup>114</sup> Lenders effectively abdicated their role in a properly functioning market for the least common denominator. If a financial sponsor could secure a concession from any syndicated loan arranger in any deal, that concession was immediately foisted on all lenders as a "market term" regardless of the context of the original deal in which such term was negotiated. This market imbalance allowed risk to flood into the syndicated loan market.

As the boom continued, financial sponsors were able "to do transactions that were previously unimaginable."<sup>115</sup> Effectively, lenders ended up accepting, without much objection, whatever terms the financial sponsors requested. In the final years of the credit boom, all pretense of a negotiated deal was abandoned as the lawyers representing financial sponsors drafted the loan documents and presented them to the lenders and their counsel for execution. Despite efforts by lender's counsel to dissuade their clients from acquiescing to the worst of the sponsor's demands – such as covenant lite structures, broad equity cure rights, payment-in-kind and token amortization payments until maturity<sup>116</sup>–

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114. See FCIC REPORT, *supra* note 35, at 175.

115. Conway Memorandum, *supra* note 112.

116. See FCIC REPORT, *supra* note 35, at 175. The term "covenant lite" refers to loan agreements with incurrence covenants rather than maintenance covenants. Incurrence covenants are only tested when a borrower takes an action that is limited by the covenant. If the borrower can demonstrate compliance with the covenant both before and after giving *pro forma* effect to the proposed action, then the action is permitted and the covenant is not tested again unless the borrower engages in another action in the future that is subject to the covenant. Maintenance covenants are tested on a regular basis, most often at the end of each fiscal quarter of the borrower. Maintenance covenants are considered to be more restrictive than incurrence tests because a maintenance covenant can be breached as a result of a deterioration of the borrower's financial performance. Conversely, as long as a

anything but the most superficial negotiation of the financial sponsor's documents was strongly discouraged. As the Clear Channel transaction discussed above illustrates, risk retention requirements do nothing to solve this problem. Those requirements are based on the idea that the "securitizer" is selling assets that it would never buy itself to a market that lacks the securitizer's knowledge about the quality of the underlying asset backing the security.<sup>117</sup> In the syndicated loan market, the arrangers are active market participants that will have to live with

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borrower is able to avoid taking any action subject to an incurrence covenant, the borrower never has to demonstrate compliance with the covenant even if the borrower's financial performance has declined. See S&P Guide, *supra* note 22, at 17-18. An equity cure right permits, but does not require, the borrower's shareholders to cure breaches of financial maintenance covenants by investing additional equity in the borrower. The funds that are invested are typically treated as additional EBITDA earned in the quarter immediately preceding the cured breach for purposes of calculating financial covenant compliance. Because financial covenants are typically tested quarterly, the borrower will not have to demonstrate financial covenant compliance until another three months have passed. Although the lenders may benefit indirectly in the short term from the equity cure funds invested in the borrower, the equity cure may have significant negative effects in the long term if the borrower's financial performance is declining rapidly. See S&P Guide, *supra* note 22, at 24-25. Payment-in-kind rights allow a borrower to make regularly scheduled interest payments in the form of additional debt on the same terms as the existing debt. For example, a paid-in-kind option would permit a borrower to pay a \$700 interest payment on a \$10,000 promissory note by issuing another promissory note on the same terms in the amount of \$700. See JOHN DOWNES & JORDAN ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* (7th ed. 2006). At the height of the bull market preceding the credit crisis, it was not uncommon for loan agreements to limit quarterly amortization payments to 0.25 percent of the outstanding principal of the loan until the final year of the loan. This exposes the lenders to a greater risk of non-payment than if the loan agreement required larger amortization payments earlier in the term of the loan. S&P Guide, *supra* note 22, at 16.

117. The disparity in information between the packager-seller of a securitized asset and the buyer of such securitized asset is referred to as "information asymmetry." See Sanjeev Arora et al., *Computational Complexity and Information Asymmetry in Financial Products* (Princeton Univ., Working Paper, 2009), available at <http://www.cs.princeton.edu/~rongge/derivative.pdf>. At least one study has concluded that complex derivatives like CDOs and CDSs actually amplify the cost of information asymmetry rather than mitigate it. *Id.* According to this study, "[t]he practical downside of using derivatives is that they are complex assets that are difficult to price." *Id.* Further, the study concludes that even minor information asymmetry in complex derivatives may make such derivatives "computationally intractable to price derivatives." *Id.* Stated more simply, "derivative contracts could contain information that is in plain view yet cannot be understood with any foreseeable amount of computational effort." *Id.* If this paper's conclusions are correct, there is no way to quantify the risks associated with complex financial derivatives let alone manage or mitigate the risk.

the very deal terms that will become a problem in the future. The fact that arrangers held significant portions of the loans that had the worst terms in the prior market did nothing to improve the credit quality of those loans.

The solution to this problem is to allow lenders' lawyers to do the job they were hired to do, namely assist their clients in making informed, deliberate, and rational underwriting decisions and then negotiating loan documents that reflect those underwriting decisions. Deal terms should never be justified simply because they are "market terms."<sup>118</sup> At best, such justifications are lazy underwriting; at worst, they permit indefensible credit structures simply because "everybody else is doing it." During the credit boom that preceded the credit crisis, lending transactions included whatever terms the most experienced borrower's counsel could wring from the most junior associate representing the lead arranger. This is not an attempt to pass the buck or blame the least experienced lawyers for the prevalence of risky deal terms in syndicated loans. Certainly, experienced senior attorneys bear the responsibility for closely supervising less experienced attorneys on every deal. But not even the best lawyer and most experienced negotiator can win a battle his or her client is unwilling to fight. History has shown that when lenders hold their ground in negotiations they can permanently change the market. For example, although financial sponsors uniformly dislike market flex<sup>119</sup> provisions in loan commitments, those terms have remained a standard part of the syndicated loan market since the late 1990s. This is because lenders simply refuse to budge on this point. It is true that the scope and effectiveness of

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118. The deal terms of any specific deal are a product of the negotiations of the parties to that loan agreement and therefore are unique to that deal. Although the LSTA promulgates model credit agreement provisions for syndicated credit agreements, these provisions are primarily intended to facilitate the administration relationships among the members of the bank group and trading in the secondary loan market. The LSTA does not have any involvement in negotiating or drafting the substantive deal terms, such as pricing, repayment and covenants of any transaction.

119. Market-flex provisions allow syndicated loan arrangers to adjust, or "flex" pricing of the syndicated loan in response to investor demand for the syndicated loan. See S&P Guide, *supra* note 22. Often, pricing can only be adjusted within a set range. Market-flex provisions also typically allow for loan amounts to be re-allocated among the various loan tranches composing the overall syndicated loan. *Id.*

market flex terms move with the market, becoming more limited when liquidity is high and less so when underwriting standards tighten; but it is also true that market flex is here to stay.

Some deals must be turned down. If no deal is too aggressive, then there is no risk management. Though a bank only makes money if it earns fees on closed deals, not every deal is worth the fee paid. The cost of losing a deal, or even several deals, is ultimately far less than the risk of over-committing to a bad loan in a bad loan market. An indisputable lesson from the credit crisis is that the downside risk of a large underwritten commitment for a supersize leveraged buy-out can far exceed any fees that were earned or could have been earned.

So how can banks ensure that outside counsel engaged to protect the interests of the institution and its shareholders are not ignored by the investment bankers responsible for negotiating and closing syndicated loan transactions? First, in-house counsel must expressly be given the responsibility for protecting the institution from excessive underwriting risk. Investment bankers should not be allowed to have the final say on underwriting risk determinations, because their compensation is tied to the short-term fees generated by closing deals regardless of how those deals perform over time. This simple fact makes investment bankers too self-interested to be expected to exercise detached judgment in determining which deals cross the line between acceptable risk and excessive risk. To ensure that outside counsel are not forced to choose between the Scylla of acquiescing to a deal that is simply too risky and the Charybdis of being replaced with a more accommodating lawyer, the in-house legal department must have the sole authority to engage, and if necessary, replace outside counsel. Outside counsel and in-house counsel can then be held accountable for how effectively they protect the institution and its shareholders from excessive risk.

Not surprisingly, bank chief executive officers may resist such a solution because many bank executives are former investment bankers who probably view lawyers as more of an impediment to deal-making rather than protectors of the institution's balance sheet. Dodd-Frank provides the response to this objection. To justify an exemption for syndicated loans from



the risk retention requirements of Dodd-Frank, syndicated loans must comply with “underwriting standards established by the Federal banking agencies.”<sup>120</sup> Therefore, the Federal banking agencies have the authority under Section 941(b) of Dodd-Frank to require the risk management and underwriting responsibilities outlined above.<sup>121</sup> Although investment bankers accustomed to having the final say on underwriting decisions may find this approach difficult to accept, the reality is that Dodd-Frank requires improved risk management. Banks can either rely on their own lawyers to strengthen underwriting procedures to improve risk management, or the government will step in and attempt to do the job through a mandatory risk retention framework under Dodd-Frank. Because self-regulation is almost always less onerous than direct government regulation, the preferable choice for banks is obvious.

## VII. CONCLUSION

Because of the complexity of Dodd-Frank and the vast array of implementing regulations yet to come, it is nearly impossible to predict the consequences – intended and unintended – of the new law at this time. Nevertheless, it is important to identify obvious problems and shortcomings while there is still time to affect the final form of the implementing regulations. Dodd-Frank’s risk retention requirements were drafted in response to the view that asset-backed securities, especially subprime residential mortgage backed securities, were the prime culprit in the credit melt-down.<sup>122</sup> The risk retention requirements are intended to cause financial institutions that package and sell asset-backed securities to better manage risks relating to such securities by requiring those institutions to keep “some skin in the game” rather than selling the entire issuance to third parties.<sup>123</sup> In

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120. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 941(b), 124 Stat. 1376, 1891-96 (2010) (to be codified at 15 U.S.C. § 78o-11).

121. *Id.*

122. FSOB CHAIRMAN’S REPORT, *supra* note 10, at 3, 10-14; *see also* FCIC REPORT, *supra* note 35, at xxiii-xxiv, 101; WEIL OVERVIEW, *supra* note 3, at 17.

123. *See* FSOB CHAIRMAN’S REPORT, *supra* note 10, at 3, 15-17; WEIL OVERVIEW,

trying to achieve this goal, however, regulators must be mindful of the FRB's admonition that "simple credit risk retention rules, applied uniformly across assets of all types, are unlikely to achieve the stated objective of" Dodd-Frank.<sup>124</sup> CLOs are very different from the types of asset-backed securities that motivated the risk retention requirements. These differences enabled the syndicated loan market to bend but not break during the Great Recession, whereas the securitization market simply collapsed due to its inability to take any corrective action in response to the credit crisis. Forcing CLOs to comply with arbitrary risk retention requirements will have a chilling effect on the formation of new CLOs at a time when the liquidity that could be provided by CLOs is critical to the recovery of the credit markets. Without the liquidity provided by a robust CLO market, banks will simply not be able to provide all of the credit needed to fund and sustain a vigorous economic recovery. Rather than attempting to tackle the shortcomings of the syndicated loan market with strategies conceived for a different problem, lenders should empower their lawyers to police risk and prevent deal terms and structures that cannot be rationally justified on business grounds. After all, a lawyer's most basic responsibility is to protect his or her client's interests.

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*supra* note 3, at 17.

124. RISK RETENTION REPORT, *supra* note 6, at 3.

