ALTIS Flash Report

Moral hazard in the high yield market: Risk Retention and implications for Leveraged Loans

High Yield Bonds and Leveraged Loans are core components of institutional investors Fixed Income exposure to sub-investment grade companies. Regulation in response to the Great Financial Crisis has had important implications for the functioning of these markets. In this note we review 'Risk Retention', which is the most recent such regulation to come to force across the US and Europe. This development has important implications for the supply & demand technicals of the market for Leveraged Loans.

Box 1. Leveraged Loans - main characteristics

Leveraged Loans are loans to sub-investment grade rated companies. Features of Leveraged Loans include:

- Broad syndication → whereby the loan is provided by a group of lenders rather than a single lender
- Seniority in the capital structure → so in case of default, lenders get paid ahead of bond investors
- Secured status → whereby lenders have a legal claim to borrows' assets
- Floating rate → interest payments to lenders are reset periodically to a spread over a predetermined reference rate

Background

Risk Retention is one of a series of regulations that aim to reduce the occurrence of moral hazard in the credit markets by better delineating activities and re-shaping incentives[1].
The main philosophy behind Risk Retention is that originators of loan securitizations should retain some economic interest in the securitizations they bring to the Leveraged Loans market and thereby share in the fortunes of those products, alongside investors. By forcing originators/sponsors of securitizations to have 'skin in the game', Risk Retention brings about an alignment of interest between entities that engage in structuring or repackaging of corporate loans and investors in such structures. In Europe, Risk Retention has been in effect since January 2011. In the US, Risk Retention has been in place since December 2015 for securitizations backed by residential mortgage loans, whilst it became applicable for all other asset backed securities, including Collateralized Loan Obligations (CLOs), from the 24th of December 2016.

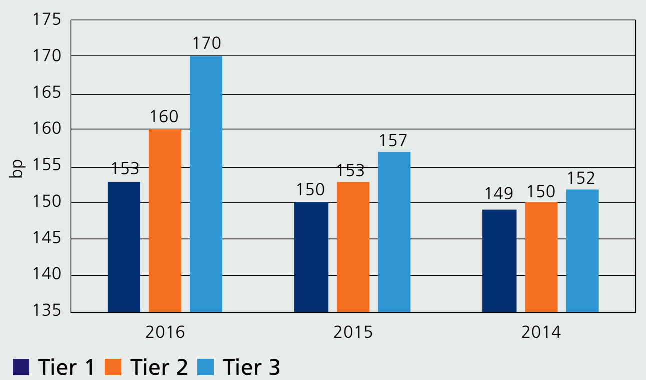
[1] Other regulatory developments have included the leveraged lending guidance and the Volcker Rule. The leveraged lending guidance was brought into force in May 2013 to bolster under-writing standards and curb loans to the most risky companies, for example companies with a low ability to pay down debt or a high debt load relative to earnings. The Volcker Rule was brought into force in 2014 to focus the activities of banks on lending and away from securities-trading for their own account. The Volcker Rule prohibited proprietary trading by banks and restricted their ownership interest in hedge funds, private equity funds and other 'covered funds', including CLOs, that hold securities.

Implications

Risk Retention will be mainly felt in the CLO market. CLOs are a form of securitization, whereby the underlying pool of assets are Leveraged Loans. In other words, CLOs are essentially funds of Leveraged Loans, the purchase of which is financed by the fund investors. Risk Retention requires that CLO managers effectively retain a minimum of 5% interest in their funds, alongside external investors[2].

The most direct implication of Risk Retention is that it requires a capital commitment by the CLO managers. Whilst the largest players[3] will have the balance sheet to shoulder this capital commitment, for many smaller players this will not be an option[4]. The result is likely to be consolidation amongst the smaller providers. In anticipation of potential issues that smaller managers will face in implementing Risk Retention, investors are already requiring a larger spread on the liabilities of smaller managers (Tier 2 and 3 managers in Figure 1).

Figure 1: Median new issue AAA spread by manager tier



Note: Tiering based on post-crisis deal volume

Source: S&P LCD, Barclays

Whilst, CLOs issued post the 24th of December 2016 when the Risk Retention requirement became effective must be compliant, several CLO managers had brought to market CLOs that are already Risk Retention compliant, prior to this effective date. This is partly to assure market participants that compliance does not pose a major hurdle. Moreover, for CLOs issued post-December 24th of 2014, refinancing of the liabilities can trigger a retention requirement, making Risk Retention compliance more important for these structures.

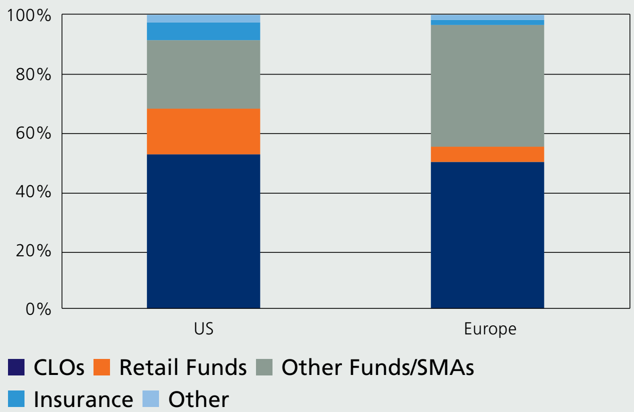
Figure 2: In Jan-Sep 2016, nearly half of the Managers have priced US Risk Retention-Compliant CLOs

Source: J.P. Morgan

CLO managers, especially the once that will be hard pressed to issue Risk Retention compliant CLOs, have also sought to extend the life of their funds[5], which may partly explain the recent wave of refinancing activity observed in the market.

Longer-term, Risk Retention may reduce the issuance of CLOs given the related capital requirement. On the other hand, consolidation is likely to counter as the increased market share of the largest managers bolsters revenues. We will be watching very closely the issuance of CLOs into 2017 to gage the impact of Risk Retention on CLO creation. A substantial decline of CLOs would have an importance effect to the market for (direct) Leveraged Loans given that CLOs are the single largest source of demand for this market across the US and Europe.

Figure 3: Breakdown of Investor Base for Leveraged Loans



Source: Source: Lipper, EPFR, CEF Connect, Credit Flux, HRF, Federal Reserve, S&P LCD, Bloomberg, Barclays Research

[2] CLO investors can purchase the equity of CLOs or one of several debt tranches providing them different exposures to the underlying pool of Leveraged Loans.

[3] According to 'Creditflux' the largest 10 CLO managers as of end of Q3 2016 were: GSO Capital Partners, Carlyle Group, Credit Suisse Asset Management, Ares Management, Apollo Global Management, PGIM, CIFC Asset Management, 3i Debt Management, Alcentra and CVC Credit Partners (http://creditflux.com/Data).

[4] According to an article on the Financial Times, the number of CLO providers went from around 180 pre-crisis to 160 in 2015 (Rennison, 2015). From interaction with multiple investment managers active in this space, we know this number to have declined further to below 100 in 2016.

[5] According to an article from Reuters, several refinancing deals of CLOs that took place in 2016, included a 'reset' feature whereby the main features of the CLO transaction remained in place but its duration was extended (Haunss, 2016).

Conclusion

Since the great financial crisis, regulation has been introduced to safeguard the stability of the financial system. One focus of regulators has been the alignment of the interests of originators/sponsors of securitizations and the investors, through measures such as the Risk Retention rule, which since December 2016 became applicable across the major developed markets. In this note we provided an overview of Risk Retention and its implications. Risk Retention may reduce the issuance of CLOs, which would provide a negative technical for Leveraged Loans. On the other hand, there is scope for consolidation amongst investment managers to counter this. Taking also into consideration the better alignment of interests which Risk Retention has the potential to introduce between different stake-holders, we view this new regulation positively on a long-term structural basis and neutral to modestly negative over the medium term.

References

- Rennison, J. (2015, September 2). Rule change puts pressure on CLO managers. The Financial Times.
- Haunss, K. (2016, August 25). LPC: Firms rush to extend life of CLOs as risk-retention looms. Reuters.
- http://creditflux.com/Data