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How Risk Retention Created Opportunity for Bank Spinoff Trinitas

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By Glen Fest

Four years ago, Gibran Mahmud took a chance on the little guy.

At the time, he was head of structured products and a senior portfolio manager at Dallas-based Highland Capital Management, then, as now, the largest U.S. manager of collateralized loan obligations in terms of assets. But in March 2013, he moved to a much smaller Big D firm, Triumph Bancorp. With Mahmud's help, the community bank launched a CLO business, Triumph Capital Advisors, issuing three deals from its Trinitas shelf platform in 2014 and 2015. Then, in March 2015, the company more than doubled its assets under management by acquiring two existing CLOs in an FDIC auction from the failed Doral Bank of Puerto Rico.

But while risk retention created some opportunities, both Gibran and Triumph Chairman Aaron Graft also saw a problem with their original strategy to diversify the small commercial lender with a supplemental, fixed-income business. There was no practical means for a $2.6 billion-asset community bank to retain a 5% capital stake in any new TCA CLO. So in 2015 they established a separately run capitalized vehicle — Trinitas Capital Management — through which TCA management launched its fourth and fifth CLOs.

Even as an off-balance-sheet business, running CLOs through a third-party entity outside the bank structure was "unpredictable at best and impractical at worst," Graft told analysts in a first-quarter earnings call in April. That's what drove TCA and bank company management to seek out a private-equity buyer, the New York investment firm Pine Brook Partners.

The spinoff closed in June, with Mahmud moving over as chief executive and Pine Brook supplying a $250 million line of equity. Simultaneous to the acquisition was the launch of the $717 million Trinitas VI, the largest deal to date on the platform.

Mahmud sat down with Asset Securitization Report to share his views on regulation and how it is playing out in the CLO market.

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What led Triumph Bancorp to spin off Trinitas, and to team up with Pine Brook?

GIBRAN MAHMUD: We were a subsidiary of a bank holding company, which, given all of the regulation and capital requirements, is not great for an asset management company. There are a ton of banking rules that do not necessarily apply to an asset manager or a CLO manager, and that makes capital spending from the bank difficult.

Overlaying all of that are the risk retention rules. If we stayed underneath the bank holding company and used any bank or bank holding company capital, each CLO would have had to be consolidated on to the holding company’s balance sheet. For example, in this last transaction [closed in June], we put on $700 million in assets and $630 million in liabilities, which would have thrown the bank holding company ratios all out of whack and make the balance sheet of the bank holding company worthless. So a long story short, it didn't make sense to be underneath a bank holding company anymore.

The way we got in touch with Pine Brook is that they are a very well-known, well-renowned private equity firm with a very specific focus on energy, oil and gas and financials, so as we were surveying potential partners out there, their stellar reputation along with the fact they are very focused on financials, understand our markets, and connections to potential investors to us and our LPs, was extremely attractive.

Are there any new strategies or plans for CLO formation that will change under Pine Brook vs. Triumph?

Not really any changes that come to mind. The CLOs we put together are the standard cookie-cutter, down the middle of the fairway-type of CLOs where you have 12 years of locked-in financing and floating risk on both sides. The only way to mess them up is stretch for yield, which you don't need to do in a CLO because the structure is a 10-times levered vehicle. The return is built in it for you as long as you don't mess it up.

We have a warehouse open and may price a deal if market conditions are viable.

In forthcoming new-issuance deals, are you accounting for potential spread volatility of the underlying loans, given the amount of refinancing that have already taken place in the leveraged loan space?

The loan market has periods of volatility like any other market, and has its ups and downs. But currently, what we're presuming is we are in a tightening environment. That's what we did in this last deal [Trinitas VI]. We priced it in May [closed in June] and assumed loans would tighten up.

We'll take that into account on a forecasting basis. The fact you're buying this loan today, it's a known issue, and it's a Libor plus 350 [basis points] coupon — but in six months it's going to drop to 325, that doesn't really change our credit decision.

On regulation, what would be the primary impact for CLOs if the CHOICE act were to be enacted, or if regulators were to relax risk retention standards for CLOs?

For the CHOICE Act [which would repeal Volcker], the biggest benefit is probably indirect, in that it expands the buyer universe for CLOs and allows banks to go down further in the capital structure to invest in the mezz and potentially the equity.

Potentially, you'd be able to add things like securities, bond baskets or structured product baskets within CLOs, but likely a very small portion given that you still have a rating agency construct on top of it. So maybe a 5% to 7.5% [securities] basket comes back into CLOs. I don't see that as a huge benefit or detriment; it will just be manager-by-manager who decides that this particular bond is a good value, or better than some loans out there. Likely, if it were us, we would like the flexibility of having the basket but wouldn't use it unless the market changed.

As it relates to risk retention rules, I foresee a repeal of the risk retention rules as unlikely. If they were to happen, they would not go all the way back to zero. I think it just gets scaled back on perhaps the percentage that's required to be held, how you can finance it or where the recourse can go.

Would investors prefer managers take on risk retention, regardless of any law or rule changes?

From the mid-'90s through the early 2000s, even through 2014, we lived without even the concept of any retention [for CLOs]. So I think the market has already accepted a nonretention environment. Going forward, newer, smaller managers could get somewhat of a benefit by saying "I have my skin in the game with you as well." But if retention were to be repealed, I don't think that would be something CLO market investors would then force without the regulation on the market. Or at least I don't think it would be broad-based.

As a dual-compliant manager, how do you read the European Parliament's decision to maintain 5% retention levels (versus a proposed 20%), as well as the ECB's recent adoption of leveraged lending guidelines?

The regulators in Europe said 5% is fine, but they left open also the ability to change that in the future. So it's not a ton of comfort that it's going to stick at 5. But if the U.S. rules get pulled back, if and when they do, that we'll likely see Europe not pushing much beyond.

What we have seen in the market is a bunch of U.S. managers have decided they aren't necessarily going to try to do dual compliant deals. Because if the U.S. rules are pulled back, you don't need to have as much capital deployed as the rules currently stand today.

We on the other hand, like to take majority equity pieces of our CLOs — one, for the control, two, to have the retention as well. It doesn't really affect us; we're going to be dual-compliant regardless because we are already taking the requisite amount of equity. We have the ability to do vertical, but we just like the horizontal better.

How do you see the international investor mix evolving for CLOs?

We've seen an expansion of the buyer universe. Japan has always been a player, but it used to be concentrated in a handful of people. We've seen that expand from five buyers to 20 for example, with a number that can do between $25 million to $50 million in each transaction. We've seen Korea become active again. They are usually in and out of the market, but they've been active in the last couple of months and hopefully they continue. We've seen China specifically come on line at the end of last year. There's a ton of capital in China, and they're just learning about the CLO and the product. There are a few guys that came on at the end of last year, and a number that are becoming active for the first time. I think once that ball gets rolling, that will be a significant investor group for us and for everybody in the market.

In Europe, investors in Germany, France, the U.K., and a little bit out of Spain, have been very active. If you can come with a dual compliant CLO and the basis of the exchange rates is not a hindrance, they can be pretty active and sizable as well. Investors who have raised separate account money, where they can invest in AAAs but also invest in equities and across the capital structure, we've seen a handful of those out of Europe.

What about domestically?

The BDCs [business development corporations] have broadly pulled back from equity — there are still a handful that are active. But there has been a significant amount of capital raised for risk retention solutions, just for being a pure minority equity investor but also investing in the rest of capital structure — we're seeing more and more coming online. That's going to be more specific to money managers and asset managers and hedge funds. At the top of the capital structure, we've seen an expansion from a handful of AAA buyers being the largest banks to more insurance companies, who have also been creating their own CLO platforms. [AAA] is also expanding into midsize investors, beyond the monster banks as well.

What is your outlook for the market for rest of the year?

We believe borrowers are still performing, the structures look good, and the checks from private equity sponsors are sizable. So that’s all very good. The worse thing out there is that spreads are pretty tight.

Issuancewise, I don’t see any slowdown outside of the usual August/Labor Day slowdown period we usually have. Everybody’s pipelines are full and the ratings agencies are pretty busy. We have been in a time where a lot of 2014 deals are refinancing, where no new capital is necessarily needed by managers in order to do those with the carve-outs that are in the regulations for those deals.

But now you’re rolling into the time frame where the 2015 transactions are coming up, and those will require retention or some sort of capital outlay if you’re trying to refinance or reset those. So I think from that perspective you’ll see a little bit of a slowdown from the extreme amount of volume we saw in the first half of this year.

The biggest factor for new issue in my opinion will be the access to the underlying loans. I think liability spreads will be tight, and we’ll see a healthy amount of issuance throughout the rest of the year, but it won’t be at the levels we’ve been seeing from the first half.

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