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Risk retention rules open opportunities for some credit managers

BY Arleen Jacobius APRIL 17, 2017

Bharath Srikrishnan sees CLO managers needing about $4.25 billion of additional equity this year.

Some credit managers see investment opportunities in helping managers of collateralized loan obligations cope with the new risk retention requirements. A rule ordered in December 2014 under the Dodd-Frank Wall Street Reform and Consumer Protection Act requires that sponsors of asset-backed securities keep some of the value of new securities, rather than offloading all the risk to investors.

Those risk retention rules for asset-backed securities, including collateralized loan obligations, requires that CLOs, commercial mortgage-backed securities and all other non-residential asset-backed securities managers retain 5% of the value of any new such issuance.

"The new risk retention requirements are increasing the CLO industry's capital requirements, and one place to get (the capital) is private equity," said Bharath Srikrishnan, a managing director of Pine Brook.

On March 30, Pine Brook announced it would acquire Triumph Capital Advisors, a $1.5 billion manager of syndicated bank loans with a focus on collateralized loan obligations, from its parent, Triumph Bancorp. The deal is expected to close in the first half of 2017. Triumph Bancorp was motivated to sell the business in part because of the risk retention rules, he said.

Pine Brook is not alone in moving in on the investment opportunity. Since Dec. 24, there have been 10 announced deals to sell companies or raise capital for risk retention. Pine Brook estimates the actual number is at least double that, for a total of about $8 billion of capital invested so far.

In December, Marble Point Credit Management LLC — a joint venture that includes Eagle Point Capital LLC, the credit subsidiary of private equity firm Stone Point Capital LLC — acquired American Capital CLO Management LLC, a manager with about $3.4 billion in assets under management across eight collateralized loan obligation vehicles as of the end of December.

Alternative investment firms Apollo Global Management and GoldenTree Asset Management have set up separate vehicles to raise capital to help them comply with the risk retention rules, Securities and Exchange Commission documents show. In January, GoldenTree closed GoldenTree Loan Management with $600 million to invest in the equity and junior mezzanine tranches of the CLOs the firm manages.

A 2016 J.P. Morgan Chase research report predicted $50 billion to $60 billion of CLOs would be issued this year. Based on $55 billion in CLO issuance, CLO managers could require some $4.25 billion of additional equity to comply with risk retention rules this year, Mr. Srikrishnan said.

Over the next two to three years, CLO managers could need $8 billion to $12 billion of equity, Pine Brook executives estimate.

“We think that 20 to 30 managers will ultimately raise risk retention capital,” from outside investors either on their own or from a private equity firm. However, the number of CLO managers is expected to shrink as the result of the risk retention rules.

A January report by Citigroup Global Markets Inc. estimates that 65 to 75 CLO managers will survive the risk retention rules, down from more than 120 before rules were announced in 2014, a December report from Bank of America Merrill Lynch states.

However, Daniel M. Spinner, a portfolio manager at Eagle Point in Greenwich, Conn., said the risk retention rules have added complexity, resulting in some CLO collateral managers exiting the market.

But the risk retention rules are not the only reason for the reduction in CLO managers. A lethal combination of dry powder and low deal flow has hurt CLO managers, Mr. Spinner said. Even so, there are still about 80 active CLO managers, including several firms new to the market, he said. Eagle Point expects CLO issuance to exceed last year's approximately $70 billion.

While investors had stayed away from any collateralized debt obligations and other types of securities after the financial crisis, an increasing number are starting to invest in CLOs, said Mr. Spinner, who was an investment analyst at the $9 billion 1199SEIU Benefit and Pension Funds, where he oversaw the private equity, special opportunities credit and real estate portfolios before joining Eagle Point in 2012.

The 1199SEIU, a Taft-Hartley plan, had invested in CLOs as part of its special opportunities investment allocation, he said.
He expects investors will continue to invest in CLOs in part because CLO equity and debt are floating rate, limiting interest rate risk. The other reason is for returns.

The equity tranche of CLOs launched before the financial crisis ultimately generated returns in the mid-teens if held to maturity, Mr. Spinner said.
Eagle Point manages more than $1.2 billion in its flagship majority CLO equity strategy.

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