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# Collateralized Loan Obligations (CLOs), Structure, Use, and Implementation of the Volcker Rule

## Overview

A collateralized loan obligation (CLO) is one way to fund debt through a trust that issues securities. Recent rulemaking to implement Section 619 (the Volcker Rule) of the Dodd-Frank Act focused attention on bank participation in CLOs. This article provides a general overview of the CLO structure; with a particular focus on CLOs that have been used by banks to fund commercial debt, and discusses regulatory policies of CLOs in relation to the Volcker Rule. Some policymakers are concerned that the December 2013 final regulation for the Volcker Rule may create unintended hardship for banks that own interests in CLOs originated prior to the issuance of the rule. There is proposed legislation (H.R. 4167) designed to address these concerns.

## General Definition and Structure of a CLO

CLOs are a subset of the more general category of collateralized debt obligations (CDOs). In a CDO, a trust is formed to hold debt. The debt might be loans or bonds, and thus there are CLOs for loans and CBOs for bonds. The difference between a CLO and a CBO is that bonds are generally more easily transferrable than loans because bonds are designed to be marketable securities whereas most loans are not. However, there can be robust secondary markets for some forms of loans, such as mortgages, although the liquidity of such secondary markets is sensitive to market conditions. A second potential difference between CLOs and CBOs is that several banks may use the CLO structure to coordinate combined lending to a single borrower (such as loan participations or loan syndicates), which can complicate the transfer of loans to the trust or the decoupling of the loan from the lender. Because of this potential coordinating role, CLOs are often associated with commercial lending.

CDOs can be funded by issuing obligations (securities) that are collateralized by the debts (loans or bonds) held in the trust. This is the basic structure of many classes of securities, including such CLOs as asset-backed securities (ABS), mortgage-backed securities (MBS), student loan asset-backed securities (SLABS), and commercial mortgage-backed securities (CMBS). For more information, see CRS Report R43345, *Shadow Banking: Background and Policy Issues*, by Edward V. Murphy. Although lenders might use the trust structure to fund loans by selling securities to third parties through securities markets, the structure can also be used to coordinate loans among several lenders that then buy back some or all of the securities from the transaction.

## Types of CLOs of Immediate Concern

Although the term CLO is a broad term that includes many kinds of asset-backed securities, the current policy discussion is focused on a narrower class. Banking regulation in the United States had historically limited the geographic reach of depository banks, and thus the trust structure has been a common structure to coordinate commercial lending in a growing economy and to facilitate the use of securities markets to supplement depository lending. The next two sections will illustrate these two (of many) uses of collateralized lending.

First, the use of the trust structure as a bank coordinating mechanism can be illustrated with a hypothetical example. A regional business, such as a food truck, might have a line of credit and other relationships with a regional bank. As the business grows, it may desire to expand to additional cities not served by its current lender. A regional bank might offer to coordinate with other regional banks, rather than surrender the food truck company to a larger bank. One convenient coordinating device for such a loan package is a trust, in which the loans from various banks are pooled, yet the banks themselves retain much of the interest in the loan pool by retaining most of the securities issued by the trust. Technically, such securities would be obligations of the trust collateralized by the loans held by the trust (CLO). The food truck example is a caricature, but it is a useful reminder that the trust structure is neither particularly innovative, nor the exclusive territory of the largest banks.

Second, the CLO structure can be used to allow securities markets to supplement bank lending (so-called leveraged loans). A lead bank can form a trust to pool loans. The trust can issue debt and equity securities (obligations) to fund the loans, which are collateralized by the loans in the pool (CLO). In some areas of finance, the term CLO is industry jargon for business loans funded in this fashion. Banks might retain some of the interest in the loans, but mutual funds, hedge funds, insurance companies, and other investors may also participate. **Figure 1** shows recent trends in the share of CLOs as investors in commercial loans.[1] Other investor groups include mutual funds, hedge funds, insurance companies, and other investors.

[1] See page 6 of "Risk Retention for CLOs," November 2013, by Oliver Wyman, available at http://www.fdic.gov/regulations/laws/federal/2013/2013-credit_risk_retention-c_149.pdf.

Banks retain interest in the CLO arrangement in both the food truck example and in the leveraged lending example. However, if the trusts that are used as coordinating devices for CLOs are considered risky investment funds, then banks may have to divest themselves of such assets because of the Volcker Rule.

## The Volcker Rule and CLOs

In addition to prohibiting proprietary trading by banking organizations, the Volcker Rule also prohibits certain relationships between banks and risky investment firms. Financial regulators issued a final regulation in December 2013 that included definitions for the prohibited business relationships and for the class of prohibited investment funds. For more information, see CRS Report R43440, *The Volcker Rule: A Legal Analysis*, by David H. Carpenter and M. Maureen Murphy.

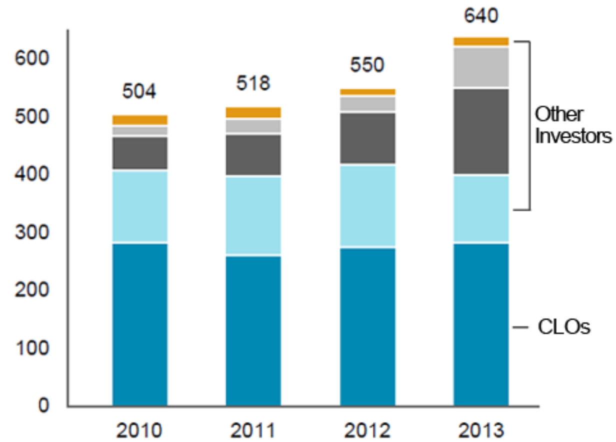
The final Volcker Rule prohibits bank ownership of many kinds of CLO securities because the trusts in the CLO structure are defined as prohibited investment funds. The December 13 rule prohibits bank ownership of obligations from CLOs if the security includes rights similar to ownership rights (elements of equity rather than pure debt). Intended or not, the rule generally requires banks to divest themselves of CLOs that they used to coordinate commercial lending with other banks, not just CLOs that are used to finance third-party lending.

The final Volcker Rule affects current and future CLO structures. Going forward, banks may be able to construct CLO structures to comply with the Volcker Rule by not retaining the kinds of equity interests prohibited by the December rule. However, the regulation also requires banks to divest themselves of CLO interests that they already possess by the conformance date. Banks that have used the CLO structure as a coordinating device have argued that they should be exempt from the general CLO rule, or have their current interests grandfathered, or the time they have to conform extended.

## Active CLO Legislation

There is current legislation, H.R. 4167, to exempt from the Volcker Rule bank ownership of certain debt interests in CLOs originated before January 31, 2014. The bill defines a CLO as an asset-backed security secured primarily by commercial loans. The bill states that participation in removal of the trustee for cause cannot be the lone indicator of ownership interest to designate a security as an ownership interest rather than debt. The bill effectively would extend the conformance period of many existing CLO structures. H.R. 4167 passed the House but has not been acted upon by the Senate.

**Figure 1: Share of CLOs as Investors in Leveraged Commercial Loans**




**Source: "Risk Retention for CLOs," November 2013, by Oliver Wyman, available at http://www.fdic.gov/regulations/laws/federal/2013/2013-credit_risk_retention-c_149.pdf.**

## More Information

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For more information, see CRS Report R43440, *The Volcker Rule: A Legal Analysis*, by David H. Carpenter and M. Maureen Murphy , CRS Report R43345, *Shadow Banking: Background and Policy Issues*, by Edward V. Murphy.

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