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IN FOCUS

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Collateralized Loan Obligations (CLOs) and the Volcker Rule

Recent rulemaking to implement Section 619 (the Volcker Rule) of the Dodd-Frank Act focused attention on bank participation in collateralized loan obligations (CLOs). Loans can be pooled and funded via a CLO trust structure, which subsequently creates and issues securities. This In Focus provides background discussions on loan funding, distinguishing between types of functionally equivalent transactions, and how the structure of bank CLOs is used to fund loans. On December 10, 2013, the federal financial regulations issued final rules for the Volcker Rule, but its effects on CLO markets may be inconclusive. H.R. 10, a broad financial reform bill that passed the House, would repeal the Volcker Rule.

Funding Loans: Background Concepts

Lenders generally fund their longer-term assets (e.g., consumer and business loans) via a continuous series of shorter-term borrowings. Lenders profit from the spreads between the loan prices (interest rates), or the difference between the rates charged on longer-term loans, and the rates paid to savers (e.g., depositors, short-term creditors) on successive sequences of shorter-term loans. Specifically, depository institutions (i.e., banks and credit unions) may fund their loans via recurring deposits, which are short-term loan obligations to depositors. Depositors expect to be repaid their principal and receive interest at regular intervals; each interval represents a short-term loan by depositors to the institution holding their deposits.

Depositories are not limited to funding loans solely with deposits. For example, suppose a regional merchant, wanting to expand to additional cities, goes to a local bank for a loan. If the small bank is unable to offer the loan, rather than surrender the merchant to a larger bank, it may offer to coordinate with other local banks to jointly provide the loan using a loan *participation* structure. The local bank would originate the loan, thus acting as the *sponsor* or lead bank of the participation arrangement. The sponsor typically retains the largest portion of the loan and sells smaller portions (shares) of the loan to other institutions. This structure allows the sponsor to maintain control of the customer relationship and overcome funding limitations. The other banks in the participation may use their shares to diversify geographical concentration risks in their lending portfolios, meaning that this funding structure can also serve as a prudential financial risk management tool.

CLO Structures and Distinctions

A collateralized debt obligation (CDO) is another type of funding structure. A CDO is a trust formed to hold debt, which can be in the form of loans or bonds. CLOs are a subset of the more general category of CDOs; CLOs are for loans and collateralized bond obligations (CBOs) are for bonds. One difference between a CLO and a CBO is that bonds are generally more easily transferrable than loans because bonds (unlike loans) are designed to be marketable securities. (Note: Robust secondary markets exist for some forms of loans, e.g., mortgages, and market liquidity varies with market conditions.) Despite some idiosyncratic differences, the CDO trust structure is applied to 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). In some areas of finance, the term CLO is industry jargon for business loans (specifically, loans for highly leveraged businesses) funded in this manner. A sponsor may form a CLO (i.e., trust) that subsequently issues securities to fund (and are collateralized by) the pool of longer-term loans in the CLO. Banks may decide to retain some of the securities; additionally, mutual funds, hedge funds, insurance companies, and other investors may purchase securities issued by the CLOs. Hence, the CLO structure serves as another mechanism to obtain funding for loans originated by the banking system.

CLOs have features similar to loan participations. For example, repayment to CLO shareholders is typically stated upfront (e.g., specific dates, rates, and maturity) rather than expressed as a share of the revenues generated by the trust. CLOs and holders of loan participations receive a specified return, which is considered less risky relative to holding an equity position. (Investors with equity or ownership interests, by contrast, may receive an unspecified return linked to the fluctuating value of the firm.)

CLO issuances may have features analogous to ownership interests in a hedge fund. For example, a hedge fund manager manages the fund assets for the equity investors; banks that hold CLO issuances may have little or no direct familiarity (customer relationships) with the numerous borrowers who have loans in the trust. The performance of the trust arguably would depend upon the selected loans (entrepreneurial decisions) by a third party CLO manager rather than the underwriting requirements (entrepreneurial decisions) of the holders of CLO issuances. Furthermore, shareholders may have voting rights and can subsequently select a CLO trust manager. Such features provide the basis for interpreting CLO shareholders as having analogous equity ownership interests in a hedge fund instrument.

The Volcker Rule Applied to CLOs

The Volcker Rule is designed to prohibit banking entities from engaging in propriety trading, (i.e., making investments for their own trading accounts) and having certain relationships with hedge and similar funds covered under the rule, which arguably may increase banking entities' exposures to downside loss risk. 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 such as hedge funds. For more information, see CRS Report R43440, *The Volcker Rule: A Legal Analysis*, by David H. Carpenter and M. Maureen Murphy.

The treatment of CLOs under the Volcker Rule has been a subject of debate. CLOs may be structured in a manner similar to loan participation shares, which generally are not considered covered funds under the Volcker Rule. CLOs, however, may also be structured in a manner such that banks' ownership interests appear similar to those associated with hedge funds; the Volcker Rule prohibits banking entities from having ownership interests in hedge funds.

A CLO is generally considered a covered fund, meaning that a bank may not sponsor or have ownership interests; however, the final rule establishes criteria that would be met for a CLO to qualify for an exemption from the Volcker Rule. For example, the permissible assets that may be included in CLO structures, which banks may sponsor or retain ownership interests, are defined as extensions of credit (i.e., consumer loans, business loans, loan participations, or certain other limited types of assets). In addition, the final rule provides guidance on how banks may construct CLO structures to avoid the retention of impermissible ownership or equity interests that resemble hedge funds. For example, a prohibited funding structure would include voting rights similar to ownership rights for shareholders.

The federal financial regulators did not grandfather existing CLO structures that predated the final rule. CLOs may have contained bonds or other assets that did not qualify for exemption from the Volcker Rule. Banks were initially given until July 2015 to comply with the requirements of the final rule via restructuring noncompliant CLOs or selling their ownership interests; but the conformance period was extended through July 2017. If noncompliant CLO securities are unloaded in a hasty manner such that the market consists of more sellers relative to buyers, the market value (price) of the slices could fall and translate into accounting (capital) losses on bank balance sheets.

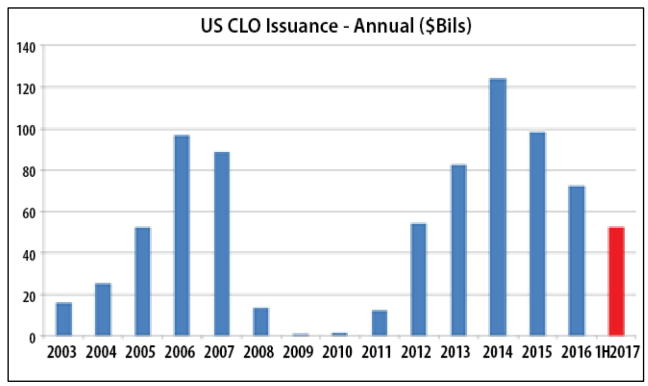
Understanding the effects of the final Volcker Rule on the CLO market is challenging. **Error! Reference source not found.** shows that U.S. bank CLO issuances (collateralized primarily by loans made to highly leveraged businesses) dropped off during the recent recession, but had since rebounded and now appears to be declining after 2014. The CLO issuances since 2014 are likely to reflect the more narrow definition of compliant CLOs, consisting solely of loans and excluding other financial instruments (e.g., bonds, derivatives unrelated to loans in the pool, commodity forward contracts). Hence, the volume of CLO issuances reflect changes in the composition of CLO trusts, meaning that it is difficult to disentangle how much of the recent decline reflects fewer loans, fewer impermissible financial instruments, or both. In addition, the federal banking regulators finalized higher risk-retention requirements for CLO sponsors. Finally, the CLO market depends upon the demand and supply for loans, which may be linked to current macroeconomic conditions, thus generating what appears to be a cyclical trend in CLO issuances.

Active Legislation

The Financial CHOICE Act of 2017 (FCA; H.R. 10) was introduced on April 26, 2017, and the bill passed the House on June 8, 2017. The FCA, which is a broad bill that would make many changes to financial regulation, would repeal the Volcker Rule requirements, thereby making it possible for banks to own CLO issuances that could include a wider assortment of financial instruments in addition to extensions of credit.

Figure 1. U.S. CLO Issuances of Leveraged Loans

Annual, Billions of Dollars



Source: S&P Global Market Intelligence, powered by Leveraged Commentary and Data (LCD), at LeveragedLoan.com; the graph may be found at http://www.leveragedloan.com/primer/#!clos.

Note: The red bar represents the first half of 2017.

For More Information

For more information, see CRS Report R43440, *The Volcker Rule: A Legal Analysis*, by David H. Carpenter and M. Maureen Murphy; David S. Krischer and Heath P. Tarbert, "CLOs and the Volcker Rule," *The Review of Banking & Financial Services*, vol. 31, no. 8 (August 2015), pp. 81-90; and Dennis Scholl and Ronald L. Weaver, "Loan Participations: Are They "Securities," *Florida State University Law Review*, vol. 10, no. 2 (Spring 1982), pp. 215-234.

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