Risk-retention vehicle restructurings expected

Appetite for European CLO risk-retention and warehouse investments is strong. Uncertainty post-Brexit around third-country provisions is proving a threat to the nascent development of CLO risk-retention vehicles, however.

"Brexit is a live issue because it is occurring at the same time that any number of CLO risk-retention sponsor vehicles (as well as the CLOs they are holding risk-retention investments in) are going through their fundraising phase. For risk-retention vehicles that have already been launched, the hope is that some kind of grandfathering will be provided for existing transactions. In any event, the industry needs a credible plan B, C and D, including various tax analyses and assumptions," says Will Normand, partner, investment funds at Travers Smith.

Ares Management, Apollo, Napier Park and CVC Credit Partners among others are understood to have recently established CLO sponsor vehicles to comply with risk retention requirements. The vehicles provide an alternative approach to originator entities, such as those established by Blackstone/GSO (SCI passim), whereby a new standalone CLO manager is established to hold the required 5% horizontal retention piece. The new manager is funded by third-party capital, as well as investment from the sponsor, with investors benefitting from the returns attributable to the risk-retention investments held.

Normand suggests that such vehicles are a product of broader acceptance of sponsor/manager structures. "From an investor perspective, they provide a guaranteed allocation for CLO equity from the relevant manager's CLOs on defined terms. From a manager's perspective, they provide an efficient structure by which it can continue its CLO management business in a manner that complies with both EU and US risk retention regulation."

The vehicles take around 12 months to set up and have a natural draw-down period over two years. Normand says that the calculation of how much capital is necessary to raise via the vehicle depends on a manager's pipeline.

"The vehicles typically acquire horizontal tranches, broadly equating to 50% of the equity, so another 50% needs to be sold. Between five and 15 investors participate in the vehicle, with the manager's level of investment varying from vehicle to vehicle," he adds.

Investor capital is locked in the vehicle until the deals are called. This gives rise to a potential conflict of interest: while a manager is incentivised to keep a CLO going for as long as possible, investors might want to exercise the call.

"Many traditional fund investor protections aren't relevant with these vehicles, so investors negotiate different protections to mitigate such risks within the confines of what is possible under applicable risk retention regulation," Normand observes.

For European CLO sponsor/manager vehicles to be compliant with risk retention requirements, the sponsor needs to be a regulated entity in the EU. In terms of dealing with the post-Brexit landscape, Normand confirms that it is currently expected that the EU will permit non-EU originator vehicles to hold risk-retention investments in EU CLOs, while the sponsor regime will continue to require an EU member state regulated entity.

"Ireland and Luxembourg, for example, don't have equivalent regimes to the UK for the existing UK sponsor/manager vehicle, so post-Brexit the existing risk-retention vehicles are likely to remain outside of the EU - unless there is a change of approach in EU member states that allows an equivalent structure to be established," he notes.

He concludes: "Other jurisdictions may make the required changes in time, but there seems to be little appetite to uproot existing CLO managers and most of them are based in London. As such, we would currently expect most of the existing UK sponsor vehicles to restructure as third-country manager originators (namely, vehicles that qualify as originators for risk retention purposes, but also manage the underlying CLOs) in due course."

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