1 October 2010
(Sent via email)

Carlos Corcostegui
CEBS Secretariat
Tower 42 (level 18)
25 Old Broad Street
London EC2N1HQ

Cc Paul Rich – CEBS
Cc Gerald Breen – CEBS

Dear Mr. Corcostegui,

**Response to the CEBS CP-40 Consultation Paper on Guidelines to Article 122a of the Capital Markets Directive**

The Loan Syndications and Trading Association (LSTA) is a U.S. trade organization representing over 300 firms that engage in loan syndication and trading activities. The LSTA's membership includes buy- and sell-side organizations, law firms, consultants, accounting firms and vendors. The LSTA's objective is to promote a fair, orderly, efficient and growing loan market and provide leadership in advancing and balancing the interests of all market participants.

The LSTA has been involved in discussions with regulators on risk retention to the extent that it affects Collateralized Loan Obligations (CLOs) and hence impacts the syndicated loan market. While it may be unusual for a U.S. trade organization to comment on a European Commission proposal, we believe that Article 122a of the Capital Requirements Directive could have serious negative consequences for both the U.S. and European CLO markets, as European Credit Institutions have historically – and successfully – invested in CLOs. Because Article 122a is not aligned with the risk retention provisions envisioned in the Dodd-Frank Wall Street Reform and Consumer Protection Act – and because it does not conceive of an actively managed third-party CLO in its architecture – we believe that it may significantly reduce the ability of European Credit Institutions to invest in U.S. CLOs. This could materially impact the syndicated loan market; it could reduce the availability of growth capital to companies; it could also close an avenue of investment for European Credit Institutions that performed well during the downturn.

In light of our interest, the LSTA welcomes the opportunity to comment on CP-40. However, rather than comment at great length, we refer you to the letter dated 30 October 2010 by the AFME, BBA and ISDA. That letter ably describes the impact of Article 122a on CLOs in Annex 3. We echo concerns of those trade organizations about the difficulty that CLOs will face in complying with 122a. In turn, the LSTA supports their proposal to develop an Originator SPV to acquire the portfolio of assets, sell the assets to the CLO issuer and retain a material portion of the credit risk as laid out in 122a
.

We would also like to provide additional commentary on the importance of the syndicated loan and CLO market to U.S. borrowers. Finally, in the interest of quantifying the affects of regulation, we are providing the results of a survey we performed on the impact of different forms of risk retention on future CLO formation.

**Background on the U.S. syndicated loan market**

The U.S. Shared National Credit Review (which is conducted jointly by the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the FDIC) defines a syndicated loan as a loan that is at least $20 million and has at least three bank lenders. There are more than $1.2 trillion syndicated loans outstanding and another $1.3 trillion of commitments to lend; this financing supports thousands of large and small companies in the U.S. Syndicated loans have been used by companies for at least 50 years; they are not new, but rather are a tried and true way of providing large amounts of financing to companies. Over $500 billion of these loans are held by non-bank lenders.

Essentially, in a syndicated credit facility, each lender, severally, makes the loan or commits to make loans. Each lender does its own credit analysis of the borrower and assessment of the facility or loan, with the opportunity to review and comment on proposed terms, conditions and documentation. An agent provides administrative functions to enable the group of lenders to lend and be repaid in a coordinated and seamless manner for the convenience of the borrower and the lender group. Borrowers also provide financial information on an on-going basis to the lender group, which is distributed by the agent to the lenders.

**Background on CLOs**

CLOs participate in these loans; indeed, they provide nearly $250 billion of financing to U.S. non-investment grade borrowers. However, as the AFME, BBA and ISDA letter has noted, CLOs are just one of a number of participants in these loans; instead of the loans being offloaded from a bank's balance sheet via a balance sheet CLO (the originate-to-distribute model), managed CLOs are more akin to managed funds where investors are seeking to invest in loan assets. In fact, managed CLOs are unique in many facets, including:

- Managed CLOs are not created to facilitate "originate to distribute" activities by the banks.While banks do organize CLOs, these banks generally are not securitizing their own assets. Instead banks that structure CLOs ("structuring banks") actually work as agents for asset managers such as PIMCO and Eaton Vance. When a CLO is being put together, an asset manager will engage a structuring bank to arrange the CLO, and provide short term financing so that the manager can build a portfolio. A portion of these loans might have been originated by the structuring bank, but most of them are originated by other banks. *Most importantly, the asset manager tells the structuring bank which loans to buy.* The asset manager is the driving force, not the structuring bank, and the asset manager continues to have discretion over asset purchase and disposition in the portfolio after closing. In turn, the banks are not the "sponsors" or "originators" of the CLOs.

- The vast majority of CLO portfolios are *actively* managed by experienced third party asset managers such as Eaton Vance, PIMCO and INVESCO.

- Most CLOs own portions of just 150-200 large corporate loans; the CLO managers know each of the loans, and make daily decisions on whether to buy or sell these loans.

- The underlying corporate loans are large (usually over $100 million) and transparent: Most of the U.S. loans are individually and publicly rated by Standard & Poor's, Moody's or Fitch, they are liquid and trade in the secondary loan market, and they are valued daily by third party pricing services.

- CLOs have many tests that require managers to maintain the quality and diversity of their loan portfolios. These tests, which include overcollateralization tests, weighted average ratings factor tests, interest coverage tests, and weighted average life tests among others, are mandated by the CLOs' indentures and an independent trustee verifies the tests.

- Investors in CLOs receive monthly trustee reports that detail all the tests, the performance of the portfolio, and the performance of each individual loan.

- CLOs have structures to align the interest of managers and investors. The CLO manager has the majority of his/her management fees paid at the same time as or just prior to the equity receiving payments. In addition, some CLO managers are able to hold equity in their CLOs.

The unique nature of CLOs has allowed them to perform well during the worst financial crisis since the Great Depression: 85% of CLO AAA notes remain rated AA or better. Moreover, of the 500 CLOs that Moody's rates, only five triggered any form of an event of default (EOD) since October 2008; importantly, even in the less than 1% that triggered (and often cured) an EOD, there were no credit losses that impaired the AAA tranche.

**Impact of risk retention on future CLO formation**

Recognizing that risk retention was being legislated, the LSTA surveyed its members to assess the potential impact of risk retention on future CLO formation. The LSTA gathered survey responses from 22 CLO managers, who collectively manage more than $97 billion in CLO AUM (assets under management). This represents nearly 40% of the outstanding U.S. CLO universe.

The LSTA first asked CLO managers whether they could retain risk in the form of a 5% vertical pro rata strip. Only 14% of the respondents (by count) said they could retain risk in a vertical pro rata strip. The majority of respondents said that they did not have sufficient capital to retain a 5% vertical pro rata strip. The LSTA then asked managers whether they could retain risk in the form of equity/first loss position (in any amount); 86% of the CLO managers said they could retain some amount of equity/first loss position. However, most could *not* retain equity/first loss position of at least 5% of the face value of the securitized exposures. When asked how much equity/first loss position they could retain, just 23% of respondents said they could raise new CLOs if they were required to retain 4 or 5% equity as a share of face value of the CLO. At 3% equity retention, 43% said they could raise a new CLO. At 2% equity retention, 59% said they could raise a new CLO. At 1% equity retention, 86% said they could raise a new CLO. (Even so, the amount of new CLO formation would be reduced materially.) This aligns with the AFME, BBA and ISDA letter that noted that many investment managers do not have the capital to be able to hold the retention itself, which is conceived to be 5% under Article 122a.

**The LSTA supports the CLO proposals set forth by AFME, the BBA and ISDA**

While the LSTA is concerned about the impact Article 122a will have on CLO formation, we recognize that the market has moved to the implementation process. So while we echo the concerns enumerated by AFME, the BBA and ISDA in Annex 3 of their comment letter, we also support their proposal to develop an Originator SPV to acquire the portfolio of assets, sell the assets to the CLO issuer and retain a material portion of the credit risk as laid out in 122a.

We welcome an opportunity to discuss the impact that 122a may have on CLOs – and the ability of EU institutions to safely invest in them.

Sincerely,

R. Bram Smith
Executive Director
Loan Syndications and Trading Association