WG8 (&WG4) A Legal Entity Relationship Use Case

Legal Entity Relationships for a CDO: An End User Perspective

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Overview of Use Case

It would be worthwhile to examine the configuration of legal entity relationships that arise with a Special Purpose Vehicle (SPV) such as a CLO. For example, how should each tranche of the CLO be considered (given the CLO is a legal entity but each tranche in the CLO is not a legal entity)? How much additional data describing the product terms of SPVs should (optionally?) supplement the standard LEI reference data?

Use Case Example: A hypothetical user friendly CLO (*LE-CLO*) is constructed that contains three tranches. A single sponsoring entity for the CLO (*LE-0*) is the parent of the *LE-CLO*.

Use Case Discussion

Collateralized Loan Obligations (CLOs) and Collateralized Bond Obligations (CBOs) are securities that are collateralized (say by means of high-yield bank loans and corporate bonds). CLOs and CBOs are referred to as CDOs or Collateralized Debt Obligations. These types of vehicles are financial products that are set up as separate legal entities (e.g., trusts) for several reasons (pooling investors and borrowers, liability considerations, and tax purposes.[1]

A special purpose vehicle (SPV) or trust is set up (*LE-CLO*) which issues three types of securities (reference Figure 1):

- Senior secured class A notes (say initially rated Aa3),
- Second senior secured class B notes (say initially rated Baa3), and
- Subordinated notes in the equity tranche.

The proceeds are used to buy high-yield notes (say with an average initial B1 rating) that are issued by entities with their own LEI. In practice, the asset pool for a CLO may also contain a small percentage of high-yield bonds (usually less than 10 percent). The reverse is true for CBOs (e.g. they may include up to 10 percent of high-yield loans)

A CLO (CBO) is an efficient securitization structure because it allows loans (or bonds) rated at say below investment grade to be pooled together and the cash flows prioritized to achieve an investment grade rating. This means that insurance companies and pension funds are able to invest in the “senior class” of notes. The main differences between CLOs and CBOs are the assumed recovery values for, and the average life of, the underlying assets. Recovery values on defaulted loans are assumed to be significantly higher than for corporate high-yield bonds. Rating agencies generally assume a recovery rate of 30% to 40% for unsecured corporate bonds, while the rate is around 70% for well-secured bank loans. Also, since loans amortize, they exhibit a shorter duration and thus present a lower risk than their high-yield bond counterpart. It is therefore easier to produce notes with investment grade ratings from CLOs than it is from CBOs.

[1] http://en.wikipedia.org/wiki/Collateralized_debt_obligation

Financial product attributes for the three tranches on the liability side (reference bottom part of Figure 1) of the CLO (say consisting of a pool of loan assets) might include the type of note (e.g. a senior secured note), initial amount in each tranche (say $840 million), initial yield (say LIBOR +38bp), initial rating (say Aa3) and Maturity (say a 12 year maturity).

Contractual terms of instances of CLO product tranches such as the seniority of the tranche are also useful since these terms describe important information for stakeholders (the investor, regulator, etc). In our Use Case example, the issued notes consist of two senior secured classes with an investment grade rating and an unrated subordinated class (the equity tranche). The equity tranche is in the first-loss position, and it will absorb default losses before they reach the senior investors and therefore do not pay any promised payment.

The rating enhancement for the two senior classes is obtained by prioritizing the cash flows. The credit enhancement of the senior secured class notes is obtained by simply shifting the default risk to the equity tranche. The equity tranche is often bought by investors such as "hedge funds"(each with their own LEI), either outright (or more often by means of a total return swap with a leverage multiple of seven to 10). But most of the time, the bank issuing a CLO (LEI0) retains the first-loss equity tranche.

During the first six years, which is called the reinvestment or lockout period, the cash flows from loan amortization and the proceeds from maturing or defaulting loans are reinvested in new loans.[2] Thereafter, the three classes of notes are progressively redeemed as cash flows materialize (Once all the cash flows are redeemed for a tranche then the tranche is retired).

Contractual terms on the asset side of a CLO (reference top part of Figure 1) might include the amount of collateral (say $1000 million), the number of loans (say 50 senior secured bank loans) and the average rating of the loans (say B1). Financial product characteristics on the asset side might also include the number of industries (say 20) with the maximum industry concentration (say 8%) and maximum single name concentration (say 4%), which helps to describe the nature of the loans. Data might also include the initial weighted average life of the loans (say six years,).

Individual tranches of a CLO (and other SPVs) would themselves not be considered legal entities.

Figure 1 below shows the customer legal entities (LE-C1 through LE-Cn) who are the borrowers of loans provided by the CLO, as well as the investor legal entities (LE-I1 through LE-Im) who fund the CLO and receive cash flows from the customers via the CLO cash flow rules. LE-0 is the sponsoring (parent) legal entity of the CLO.

[2] As the bank originating the loans typically remains responsible for servicing the loans, the investor in loan packages should be aware of the relevance of moral hazard and adverse selection for the performance of the underlying loans.

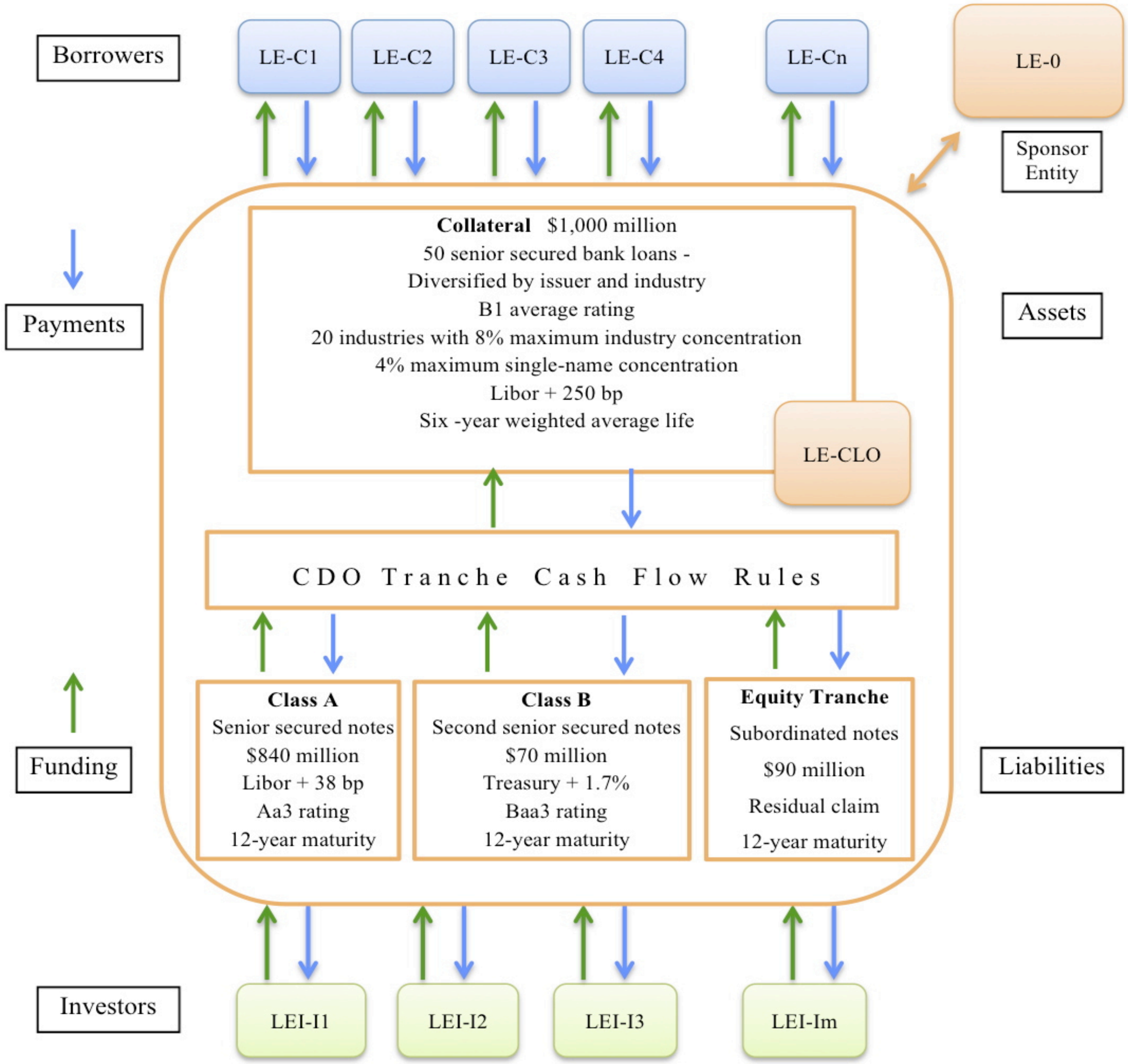

Figure 1: Use Case: Collateralized Loan Obligation (CLO) structure (LEI1)