

# The Fed's Volcker Postponement

## Alert: Getting Banks Back into Triple-As

- The Volcker Rule announced in December pulled many banks away from the US CLO market. US Banks grappled with the fear that they would be forced sellers of non-compliant deals (that is, CLOs containing any asset class other than loans, and thus the majority of the universe). Though the rule was meant to prevent bank ownership in hedge and PE funds, even CLO triple-A holdings were affected (see [Volcker Clouds, Opal Highpoints, and Impact of Consolidation](#)). Even non-US banks would be affected by the scenario of systematic selling. Figure 1 shows how banks' share of CLO purchases fell this year, giving funds an opportunity to buy into wider spreads. Yesterday's statement has 'kicked the can down the road' but can aid in the return of bank buyers, even if the problem of forced sales is unsolved.
- The US CLO market had hopes of older deals being grandfathered as with CDOs of Bank TruPs. There were several hearings and an amendment proposed by Barr in February ([More, not Clearer, on Volcker](#)). What last night's statement has done is give banks time till July 2017 to get their house in order (previously the extension had been till July 2015). This means that US banks have to convert their CLOs into compliant structures, or be unable to hold such positions, beyond that date.
- We reckon that the size of the problem is about \$30bn. Based on typical amortization rates, we forecast the notional of all deals by mid-2017 at about \$135bn (Figure 2), of which \$114bn are CLO 2.0s. The actual number will be less because many CLOs will be refinanced before that time. This will be due to high costs - say, triple-A coupons exceeding 150bps (Figure 3) or deleveraging. Moreover, the number of non-compliant deals by then will only be \$76bn as over 50% of CLO 2.0s do not contain any bonds (Figure 4). About \$40bn of tranches will be triple-As and double-As (and thus bank-friendly). Finally, though forced selling is painful for all, US banks will likely be only 60-70% of the triple-A holders.
- What should banks do? They can hope for another extension as 2017 approaches, but that may not be the best option. They should try to transform deals into compliant structures (such as the recent Avalon IV deal). Such restructurings will be simpler for large triple-A buyers with bargaining abilities, or for managers who hold all the equity or those who strategically do not invest in bonds. Giving up manager-removal rights may also help. In other cases, equity holders may want a sweetener to give up their option to hold bonds. Triple-A holders should consider such options. The good news is that there is a market for shorter-dated triple-As so that sellers in CLOs close to the end of their reinvestment periods should find market support. It is better, however, to prepare for an eventuality, and not face a negative surprise.

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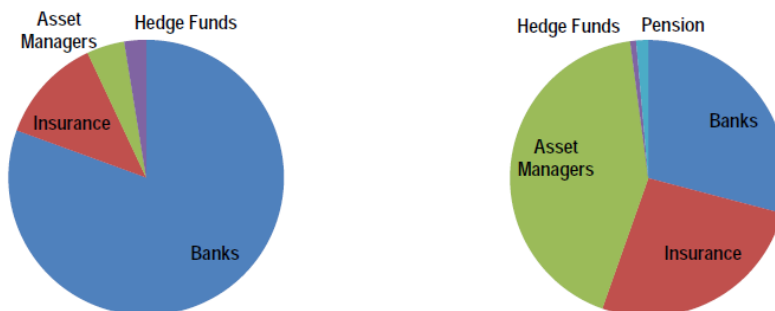
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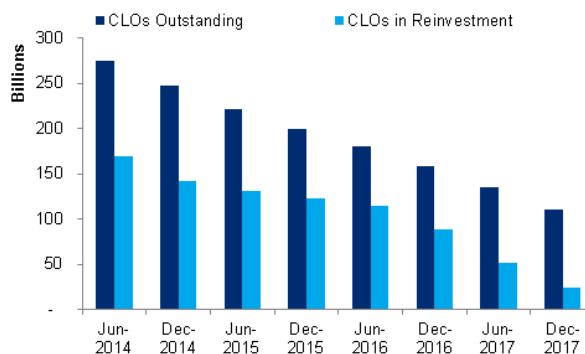
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Figure 1. Change in triple-A buyer base between 2011-2012 (left) and 2014 (right)



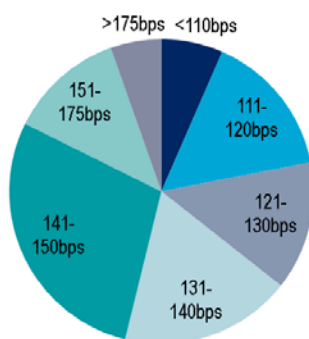
Source: Citi Research

Figure 2. CLOs within reinvestment, and expected outstanding profile



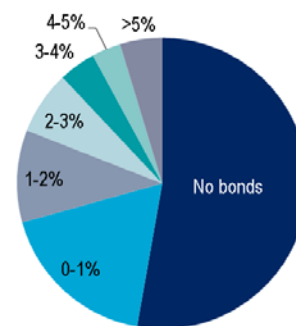
Source: Citi Research

Figure 3. Distribution of 2.0 AAA Coupons



Source: Citi Research

Figure 4. Percentage of CLO 2.0 Collateral in Bonds



Source: Citi Research

## Appendix A-1

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