STRUCTURED FINANCE ASSOCIATION

Collateralized Loan Obligations

Balancing crucial business lending with financial safety and soundness

Collateralized Loan Obligations

Serving as a very large and important finance source for U.S. businesses, CLOs make credit more available and affordable – but the market bears watching.

Background

- Collateralized Loan Obligations (CLOs) are bond investments backed by corporate business loans and purchased by institutional investors. These investment vehicles provide a significant source of financing for many diverse U.S. businesses by increasing the availability and affordability of credit for thousands of non-investment grade corporate borrowers. CLOs differ from single-name corporate loans in that they:
  - *provide diversification* across a broad pool of corporate loans for investors, thus reducing the risk to any one single loan or the decline of a particular sector,
  - *are actively managed* by an experienced corporate loan manager, and
  - *are structured*, with the lower "equity" tranches providing a higher yield but bearing greater risks as the first line of defense against losses, while senior tranches have lower yields and only take losses if subordinate bonds are wiped out.
- The tranched structure allows CLOs to better match investor preferences. Investors with lower risk appetite are more likely to purchase senior, higher rated bonds, whereas credit- and yield-seeking investors purchase lower tiered bonds. All in, this provides additional funding sources, and often at a lower cost, to the borrower – a corporation that is typically below investment grade and with limited access to traditional funding sources.
- Crucial to the CLO structure are the minimum required credit protections demanded by investors. Dynamic investor protections are embedded within the CLO structure and maintained through a myriad of tests. Investors also generally require at least one rating, and often two ratings for an investment grade bond, from a a nationally recognized rating agency.
- CLOs have a very good history of performance overall. In fact, to date, including through the 2008 financial crisis, no tranches originally rated AAA have experienced an event of default and out of 11,409 CLO tranches rated by S&P Global between 1994 and 2019, only 40 tranches, or 0.004%, have defaulted. Post-crisis, rating agencies and investors now require that CLOs feature substantially more credit enhancement to each debt ratings level compared to their pre-crisis requirements. For example, the subordination level for the AAA bonds in a post-crisis structure may be up to 40% higher than the subordination level of a pre-crisis structure.
- Uniquely, the underlying collateral in CLOs is actively and dynamically managed by their sponsors to help ensure that the bonds perform in-line with investor expectations.

What We're Watching

All of that said, CLOs – like any market instrument – bear watching by industry participants. The benefit to companies is undeniable. As programmatic buyers of corporate loans, CLOs bring greater accessibility, stability and liquidity to the corporate loan market. Given the importance of business lending and its impact on the real economy, SFA is focused on helping to identify and mitigate any possible systemic impact to the market by supporting research, surveillance, and solutions to strengthen this critical long-term financing solution. Specifically, we are focused on the following issues:

- Rising levels of corporate indebtedness, generally, and rising risk profiles of CLO portfolios, specifically: We are tracking the increase of B-rated loans in CLO portfolios, as this rating level is historically vulnerable to rating downgrades and could negatively impact a CLO's protective cushion against losses. We are also keeping an eye on the proliferation of cov-lite loans in CLO portfolios. As cov-lite loans have limited performance data, it is unclear how they will perform in an economic downturn and are therefore an area of the CLO market worth watching.
- Discontinuation of LIBOR: Since leveraged loans and CLO bonds have historically been indexed to LIBOR, a smooth transition away from this benchmark in 2021 is vital. In its published *2019 Incremental Objectives* to adopt the alternative Secured Overnight Funding Rate, the Alternative Reference Rates Committee provides a clear waterfall for selecting a replacement benchmark and spread adjustment.
- Monitor Risk Across the Market: It is important for industry participants, regulators, and policymakers to continue to monitor risk across the market. The past does not always predict the future, and the next downturn will not necessarily follow the blueprint of past recessions.
- Systemic risk: CLOs have been incorrectly compared to subprime Collateral Debt Obligations (CDOs), the structured credit product that is widely cited as having contributed to the 2007-2008 financial crisis. Although a severe economic downturn may result in meaningful CLO deterioration, we posit that there are several structural mitigants that limit the impact on the broader economy. Arguably one of the most important of which is that CLOs lack the more complex structures of past CDOs, such as synthetic exposure and re-securitization structures, that amplified correlation and credit risk. CLOs also do not mark their assets to the market, which protects CLO market valuations even as the underlying market declines.

	CDOs in 2007	CLOs in 2018
Types of Underlying Asset	▪ Non-Agency MBS, other CDOs and ABS, CDS	▪ Leveraged loans
Size of Underlying Market	▪ $2.4 trillion non-agency MBS ▪ $978 billion CDOs ▪ $851 billion ABS	▪ $1.2 trillion
Complexity		
Resecuritization (CDOs that invested in other CDOs)	▪ 14% of outstanding	▪ Minimal
Synthetic securitizataion (through CDS or other derivatives)	▪ 40-50% of issuance	▪ Minimal
Maturity transformation (i.e., long-term CDO assets funded with short-term liabilities – creating forced sellers)	▪ Common to fund via short-term as repurchase facilities ▪ SIVs funded with short-term ABS commercial paper	▪ Minimal

Source: BIS Quarterly Review, September 2019 and SFA

Conclusion

Market participants, and the government bodies that oversee and regulate them, should of course continue to remain vigilant against a wholesale degradation of the underlying loans in order to maintain credit availability to U.S. businesses in a responsible manner to promote safety and soundness, protect the financial system, and support American economic growth and job creation. Nor do we want to see a pricing bubble that would lead to excessive financial risk-taking which could challenge the overall stability of the economy. These challenges are not an indictment on the CLO market writ large, but they do bear watching as CLO funding is critical to the functioning of lower grade corporate borrowers of all sizes. AAA tranches have never experienced events of default, and credit enhancement levels are stronger today than they were prior to 2008. It is important to keep these facts in mind as the discussion evolves.

STRUCTURED FINANCE ASSOCIATION

About the Structured Finance Association

The Structured Finance Association (SFA) is the leading securitization trade association representing over 360 member companies from all sectors of the securitization market. Our core mission is to support a robust and liquid securitization market and help its members and public policymakers grow credit availability and the real economy in a responsible manner. SFA provides an inclusive forum for securitization professionals to collaborate and, as industry leaders, drive necessary changes, advocate for the securitization community, share best practices and innovative ideas, and offers professional development for industry members through conferences and other programs. For more information, visit www.structuredfinance.org.

Contacts

Michael Bright
CEO
michael.bright@structuredfinance.org

Elen Callahan
Head of Research
elen.callahan@structuredfinance.org

Ben Parish
Vice President, Government Relations
ben.parish@structuredfinance.org

Kristi Leo
President
kristi.leo@structuredfinance.org

Leslie Sack
Managing Director, Head of Government Relations
leslie.sack@structuredfinance.org