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# SFA Research Corner

**Loan Downgrades: The Canary in the CLO Coal Mine?**

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## Loan Downgrades: The Canary in the CLO Coal Mine?


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Thirty-four corporate obligors whose leveraged loans are held by U.S. Corporate Loan Obligations (CLOs) were downgraded in August, the highest monthly number of downgrades since July 2020, according to S&P's SF Credit Brief. The number represents the highest monthly number of downgrades since July 2020. S&P reports that since the beginning of the year, 120 obligors with loans in CLOs have experienced a negative ratings event. This development is significant because, in some cases, the downgrades raise the exposure to triple-C rated and non-performing loans in some CLO portfolios, indicating an increase in credit risk for the affected portfolio.

The downgrades also signal a broader weakening of credit quality across the $1.5 trillion leveraged loan market. Indeed, downgrades outnumbered upgrades for the third consecutive month, an occurrence not seen since September 2020, according to the Morningstar LSTA US Leveraged Loan Index, as reported by S&P Global (Exhibit 1). **Although downgrades in this Leveraged Loan Index remain historically low, it is also an indication of likely more credit pain to come for the leveraged loan market and for CLOs.** Nonetheless, given robust CLO bond structures and the current low level of defaults, and absent a severe and prolonged downturn, we expect CLOs, particularly highly rated, well-protected senior classes, to be in a strong position to handle some degree of credit deterioration.

Challenges facing businesses stem primarily from strong macroeconomic headwinds as cash flows are pressured by higher energy and commodity costs, high interest expenses due to rising rates, and persistent supply chain bottlenecks. **As the Fed prepares to continue its aggressive battle against inflation, bringing with it "some pain to households and business," many anticipate an even more challenging 2023.**

Rising credit risk, rising cost of funds and economic uncertainty to the downside have weighed heavily on CLO new issuance and pricing. So far in 2022, $90 billion of new CLOs have been issued, reflecting a slowdown of 20% versus this time last year (Exhibit 2). Secondary market bid-ask spreads are 55-85% wider from the beginning of the year. While still substantially below the peaks recorded at the height of the pandemic (Exhibit 3), we would expect spreads to widen from current levels to the extent that the economy enters recession in 2023.

### CLOs—A Primer

Collateralized Loan Obligations (CLOs) are structured finance securities backed by a pool of corporate leveraged loans, which are the senior-most debt obligations of non-investment grade corporate borrowers. These loans are secured by the assets of the borrowers (unlike corporate bonds), resulting in historically lower default and higher recoveries rates. Leveraged loans typically contain covenants which limit the financial operations of a borrower.

CLOs typically contain 100-150 corporate obligors across various industries. Since most CLOs are actively managed, pool composition changes during the life of the transaction in response to changes in the credit quality of the loans, the occurrence of maturing loans, and market opportunities. As prescribed in the deal documents, a manager's activity is subject to limits and tests that aim to maintain the original credit quality of the pool.

There are two generations of CLOs – those issued between the mid-1990s and 2009 (CLO 1.0) and deals issued after 2010 (CLO 2.0). Post-2010 CLOs, which have performed better than earlier CLOs, hold only leveraged loans and have more credit support than earlier CLOs.

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**Although the CLO market is showing signs of stress, with more stress expected on the horizon, CLOs have evolved to withstand high levels of stress.** A PGIM report shows that credit support levels for CLO issued after 2010 increased by an average of 38% across the all tranches. Support for triple-A tranches have increased by 65%, allowing the tranche to withstand 30% more underlying loan defaults, assuming a 50% recovery rate, according to the report.

S&P detailed the resiliency of the CLO sector in its recent CLO Spotlight report and commented on the positive impact that more enhancement has had on performance. The rating agency rated 4,322 CLO tranches between mid-1990s and 2009. Of these only 40 tranches defaulted, 15 of which were rated investment grade (AA, A and BBB). Post-2009, performance improved as structures became smarter and enhancements more robust. **Between 2010 and 2Q 2022, S&P rated 12,740 CLO tranches and only 11 tranches defaulted. Of these 11 defaulted tranches, all were rated below investment grade (BB or B rated).** Put another way, between the mid-1990s and 2Q 2022—a period that included three recessions, including the Great Financial Crisis, and an unprecedented pandemic and downturns in the energy and commodities sectors—no AAA rated CLO tranche has defaulted. And since 2010, no AA, A or BBB rated tranche has defaulted.

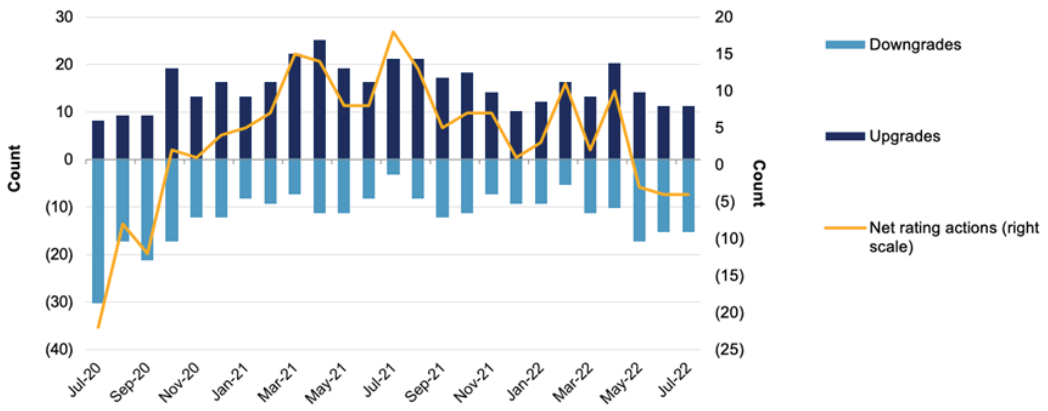
## CLOs—Waterfall, Tests and Limits

CLOs use the cash flow generated by the leveraged loans to pay the principal and interest in sequential order with triple-A investors being paid first. Losses flow through the transaction from the bottom with the equity tranche sitting in the first loss position ahead of the rated CLO notes.

CLOs benefit from coverage tests that, when breached, will redirect cash flow to pay down or better protect senior bond holders. The three types of CLO coverage tests are: Overcollateralization (O/C), Interest Coverage (IC), and Interest Diversion (IDT). Each test ratio is calculated for a specific tranche of the CLO. Normal cash flow resumes when the breach is cured.

CLOs also benefit from early warnings that indicate collateral deterioration before a cash flow is diverted. These include collateral quality tests (Weighted Average Spread, Weighted Average Life, and Minimum Weighted Average Recovery Rate) and Concentration Limits (Triple-C Rated loans, Fixed-rate, Semi-annual pay, Deferrable, and Current Pay).

***Exhibit 1. Rating Indicators Signal a Turn in Rating Momentum***
***[Leveraged Loans] Downgrades Outpace Upgrades for Third Straight Month***




*Downgrades shown as negative numbers. Data as of July 31, 2022. Sources: Leveraged Commentary and Data (LCD) from PitchBook, a Morningstar company; and S&P Global Ratings Research.* 

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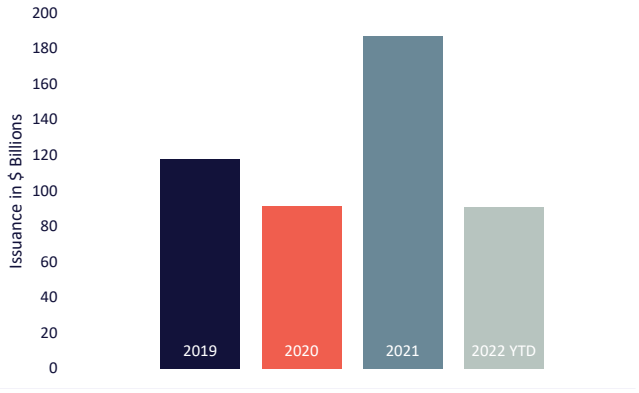
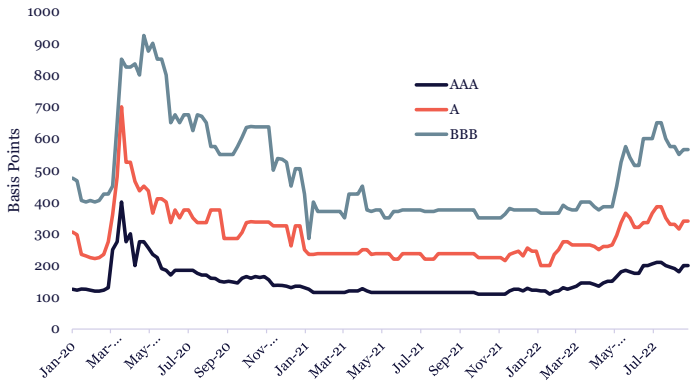
***Exhibit 2: New Issue Supply Lagging 2021 Level***




*Source: Deutsche Bank Research*

***Exhibit 3: Secondary Market Spreads Wider vs. Jan 2021***




*Source: Deutsche Bank Research*