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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Collateralized Loan Obligations: Subprime Déjà Vu?

By **George Oldfield and John Anthony**
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George Oldfield


John Anthony

With a record volume of low credit quality loans being securitized in funds that issue collateralized loan obligations, or CLOs, alarm bells are ringing for some market observers, and some investors, who cite parallels to the subprime mortgage market in the 2004-2008 era.[1] Given the amounts of B, B- and CCC credit rated loans backing large, AAA rated tranches in newly structured CLO issuing entities, it is important to review carefully each step in the securitization process. If the subprime mortgage parallels prove to be prescient, a credit crunch will lead to extensive litigation brought by unhappy investors and regulators. In particular, due diligence and disclosures on loans, underwriting practices, portfolio management operations, loan servicing, representations and warranties in offerings documents and fiduciaries' actions are all likely avenues for plaintiffs to explore in seeking redress if CLO investments go south.

Institutional fixed income investors with large legacy fixed payment liabilities, like insurance companies and pension funds, have suffered for years through the Federal Reserve System's policy of monetary easing. The hunt for better yields has led many of these investors to buy into CLO funds. CLO funds invest in "leveraged loans," which are below investment grade, syndicated loans made by banks to highly levered corporations. Leveraged loans usually pay a fixed risk-based spread over LIBOR and as such offer both a yield premium and a partial hedge against increases in inflation. The default rate on leveraged loans has historically been relatively low. Thus a CLO's leveraged loan portfolio initially appears to offer tranche investors reasonable returns for assuming the credit risk conveyed by the loans but diversified in the multi-credit holdings of the CLO fund.

Because the loans used as collateral usually are low rated, and because the Dodd-Frank risk retention or "skin-in-the-game" rule no longer applies to open-market CLO funds, the way these entities are structured and financed bears close scrutiny.[2] By requiring managers to hold 5 percent of a CLO's investments, the skin-in-the-game rule was supposed to give CLO managers the incentive to structure transactions with careful attention to the credit quality of the underlying corporate loans used to back the CLO deals brought to market. Supposedly, if the CLO manager is also an investor, then the risk retention rule would force the manager to use care in setting up the transaction. While inventive CLO managers previously managed to minimize their deal exposures, the elimination of the skin-in-the-game requirement in February 2018 has brought new CLO sponsors into the market with zero risk retention deals. Now 2018 CLO issuance is on track to exceed the record level of issuance in 2017.[3]

More significantly, strong investor demand has allowed CLO managers to loosen controls over investment quality, such as to allow increases in permitted exposures to riskier loans.[4] Further, many recent CLO funds disclose that their managers can vary investment parameters without the approval of investors. Investors may be surprised to discover that the amount of exposure they have to the riskiest forms of corporate debt has increased since they made their initial investment. Losses could greatly exceed initial expectations if corporate credit conditions deteriorate.

Typical Open-Market CLO Deal Structure

Open-market CLOs are actively managed special purpose entities that issue tranches of notes with different risk profiles. In the U.S., a deal underwriter usually distributes tranches of CLO notes to qualified institutional buyers as defined under Rule 144A of the Securities Act. Repayment of the issued notes comes from interest and principal payments on the leveraged loans used as collateral by the CLO issuer. At no point does a CLO manager own or control the leveraged loans — a key reason why open-market CLOs were ultimately excluded from the risk retention rules. Subordinated management fees and incentive management fees for managing an issuer's loan portfolio are set to ensure that a CLO manager has incentives somewhat similar to equity holders.

Several different parties are involved in the formation, structuring, funding, management and distribution of CLO notes. The arranger, often a large universal bank, establishes a short-term warehouse facility to accumulate leveraged loans (frequently originated and syndicated by the arranger itself) for the manager of a proposed new CLO issuing entity.[5] The manager, which is the promoter of the CLO deal, sets up an entity, frequently a Cayman Islands domiciled corporation, to be the deal's vehicle.[6] The entity buys the warehoused loans that are accumulated for the manager's deal, as well as future loans as its portfolio is built out according to its investment guidelines.[7] The entity that buys the loans is the actual issuer of the CLO notes, which are collateralized by its purchased loan assets. The CLO tranches issued by the entity, when sold, provide the funds for the entity's purchase of the warehoused loans. The entity's manager runs the loan portfolio, for which it is paid agency fees by the entity.[8]

In doing a deal, the manager and the CLO tranches' underwriter (usually the arranger again), seek to set up a tranche structure that can be readily sold to investors. Then the underwriter buys the entity's CLO tranches as a principal and immediately sells the CLO tranches to the initial CLO tranche investors.[9] The economic purpose of this complex series of transactions is to create a structure of CLO note tranches worth more to initial investors than the costs of the loans and fees that go into the CLO notes' creation.

The primary form of revenue for the CLO issuer is interest income on the underlying leveraged loans, although as CLOs are actively managed, the CLO issuer may earn additional income by trading loans. Loans are often repaid or refinanced well before their stated maturity and as such the proceeds need to be reinvested. The investment guidelines therefore double as reinvestment guidelines. Once fully invested, an open-market CLO entity usually owns at least 100, and perhaps as many as 225 loans. The CLO issued notes are typically longer dated, perhaps 15 years stated maturity, so the manager has a reinvestment period wherein the portfolio can potentially change at the discretion of the manager using the investment guidelines. As leveraged loans are typically medium term notes with a maturity less than 7 years, CLO's are typically redeemed at par or refinanced well before their stated maturity. Refinancing may also offer the manager an opportunity to benefit from more borrower-friendly terms and conditions.

The rating given to a CLO tranche is a function of the credit quality of the underlying leveraged loans and the payment priority of the tranche. As the underlying leveraged loans are themselves rated, rating agencies can use historic loss data on corporate defaults to assign ratings to the CLO tranches. According to Standard and Poor's, AAA ratings are based on an ability to repay during an extreme level of stress similar to that experienced in the Great Depression. As AAA funding is the cheapest funding available, arrangers seek to maximize the size of the AAA tranche to meet this stress scenario. Often the credit rating agencies allow the highest rated AAA tranche to represent a very high percentage (perhaps 60 percent) of an issuer's funding. Other tranches are structured to meet less severe stress scenarios. Higher rated tranches have priority claims over cash flows from the underlying leveraged loans. Loan payments flow through a payment waterfall to each tranche in priority order. After payment of interest and principal to note holders and payments of the entity's expenses (e.g., taxes, management fees and administrative expenses), any remaining cash flow goes to the issuing entity's equity holders. Loan diversification is important; agencies assess exposure to certain industries and individual borrowers, and the credit rating are impacted by correlation assumptions.

CLOs Getting Riskier

Recent CLO arrangements provide greater scope in transaction documents for managers to amend investment guidelines and collateral quality tests. In short, it has become easier for a CLO manager to make amendments that benefit either itself or some tranches of note holders at the expense of other tranches of note holders. For example, a manager may only require consent from certain note holders if the manager determines that there would be a material adverse effect on those notes without the amendment. Another CLO provision may include a very short objection period (one or two days) for note holders to respond to a manager's proposed amendments.[10]

Just as investors have been hunting for higher yields, it appears that some CLO managers have been reaching for higher yielding, lower quality loans. Indeed, the exposure of CLOs to CCC loans, the lowest quality rating class, are at record levels.[11] This comes as yields on B/B+ loans, historically the sweet spot for CLOs, have declined significantly.[12] The average increase in exposure to CCC loans no doubt means even greater than average holdings by a number of CLO issuers. Managers justify declines in portfolio credit quality by the need to meet minimum interest spread tests or a desire for higher returns, yet investors may not benefit ultimately from higher exposure to the riskiest forms of corporate loans. The weakening of investor protections in some newer generation CLOs will likely be exposed during less benign periods of default risk while well-structured CLO funds with strong managers are less likely to experience similar difficulties.

Another example of the increased riskiness of some CLOs is the increase in exposure to covenant-lite, or cov-lite, loans.[13] Terms for recently issued or refinanced CLOs have provided greater flexibility for CLO managers to invest in cov-lite loans.[14] Cov-lite loans lack a key element of lender covenant protection: the ability to intervene in advance of a payment default should the borrower's financial performance decline. Such protection normally occurs through maintenance financial covenants, which require a borrower to maintain certain financial ratios, such as a minimum level of interest coverage or a maximum level of debt relative to cash flows. Failure to meet these maintenance covenants in regular loans would typically cause lenders to renegotiate terms or to implement mechanisms (for example, accelerated redemption) to maximize their chances of full repayment. Cov-lite loans, however, provide none of these protections. Rather, cov-lite loans only include incurrence based financial covenants, which merely restrict the borrower's ability to undertake certain actions, such as the payment of a dividend or further debt issuance. According to Moody's, cov-lite loans are expected to achieve significantly lower recoveries following default as compared with loans with maintenance covenants.[15]

CLO Defaults

A CLO issuer faces problems when its owned loans default in substance and stop making scheduled payments to the issuer. Then payments to the issuer's CLO investors can be impaired and the CLO tranches lose value. In such a case, the loan servicer (usually the initial arranger or loan syndicator), working as an agent for the CLO issuer, is usually tasked to monitor a defaulter's actions and to negotiate an efficient workout. At the same time, the CLO issuer's fiduciary overseer (trustee or board of directors), usually tasks its portfolio manager to be involved in the work out terms and to formulate a reinvestment strategy. All these parties may be targeted by investors if a substantial number of defaults in an issuer's portfolio severely impair payments to its investors.

Conclusion

To date CLO structures have performed well under stress; historical CLO defaults have been much lower than with other securitized products such as subprime residential mortgage backed securities. However, growing risk exposure facilitated by looser restrictions on managers' actions is likely to catch out some overzealous managers if harder economic times come about. The new bounds on investors' approval procedures and objection periods give greater latitude to managers to invest in the sorts of loans that can cause problems down the road. Such an environment is ripe for litigation if the riskier investment strategies implemented by some CLO managers eventually appear to be detrimental to investors.

George Oldfield is a principal and John Anthony is an associate at The Brattle Group. *The authors give special thanks to Shuyu Song and Findley Bowie for research support.*

[1] See, for example, "Three Letters Wall Street Loves and We Should Fear", Matt Phillips, New York Times, October 21, 2018, and "Systematic risk fears intensify over leveraged loan boom", Financial Times, October 30, 2018.

[2] After being announced in 2014, skin-in-the-game rules finally went into effect on December 24, 2016. In February 2018, the U.S. Court of Appeals for the District of Columbia Circuit ruled that open-market CLOs would no longer have to comply with the rules. The rules still apply to so-called "balance sheet" or "middle-market" CLOs, presumably because regulators involved believe that these structures have greater exposure to dubious underwriting, disclosure and sales methods.

[3] "CLO Machine Is Approaching Full-Tilt, and Credit Quality Suffers", Sally Bakewell, May 25, 2018.

Rodriguez Valladares, Mayra, "CLO Issuance Is Far Surpassing Other Types of Asset-Backed Securities", Forbes, November 5, 2018.

The elimination of the rules is clearly not the major driver of market growth. In 2017, prior to the elimination of the risk-retention rule, CLO issuance was up 62% from the prior year (Thomson Reuters, Leveraged Loan Monthly, June 2018, p.43).

[4] For example, some recently refinanced CLOs provide greater scope to invest in loans with less covenant protection.

[5] A universal bank provides a broad spectrum of financial services such as commercial and investment banking and other financial services such as funds management and insurance. The largest arrangers include Citi, BAML, Morgan Stanley, Goldman Sachs, Credit Suisse, J.P. Morgan and Barclays. The largest managers include GSO Capital Partners, Credit Suisse Asset Management, Carlyle Group, PGIM and Ares Management (see creditflux.com). Arrangers often state in the offering documents that the manager (not the arranger) is responsible for investment decisions surrounding the composition of loans funded using the warehouse facility.

[6] Or alternative tax-efficient jurisdictions including Ireland, the Netherlands, or Luxembourg.

[7] Investment guidelines may include, for example, a requirement to invest in a minimum percentage of secured loans, a maximum percentage of distressed loans or a maximum percentage of highly risky CCC loans.

[8] This may generate conflicts of interest with note holders, to the extent that managers have an additional incentive to generate higher equity returns by holding lower quality higher yield loans.

[9] Sometimes an additional step is taken in the process of setting up a new CLO issue in which a U.S. domiciled trust buys the Cayman Islands entity's notes and issues virtually identical notes itself. The U.S. trust is a passive pass-through entity but its own CLO notes are domestic issues that can be bought by investors that are limited to buying domestic securities.

[10] Moody's Investor Service, "Transaction documents can host hidden risks for CLO investors," 26 July 2018.

[11] For example, the exposure of 2014 vintage CLO's to CCC loans increased from 5.80 percent in the first quarter of 2018 to 6.73 percent in the second quarter of 2018. This trend is expected to continue. See "How large-scale capital raises are fueling CLO issuance", Glen Fast, Asset Securitization Report, February 8, 2018. CCC loans are two notches away from default (See Standard and Poor's website).

[12] In June 2018, the average spread on B/B+ loans was 350 basis points over LIBOR, down from over 500 basis points in early 2016 ("Leveraged Loans: LIBOR Spread for Riskiest US Borrowers Hits YTD High", LeverageLoan.com, June 11, 2018). During the recent market volatility, leveraged loan prices have declined and spreads have widened.

[13] During the global financial crisis period through to 2010, very few loans were cov-lite. Since 2011, the percentage of loans that are cov-lite has been gradually increasing, reaching a record 77 percent of all leveraged loans in May 2018. This is even higher than in 2007, when around 30 percen of leveraged loans were cov-lite. As CLOs are the dominant investor in the leveraged loan market and some refinanced CLOs have altered their investment guidelines to permit greater investment in cov-lite loans, it follows that CLO exposure to cov-lite loans must have increased. See "Cov-Lite Loan Madness Back With A Vengeance", Danielle Park, Seeking Alpha, June 15, 2017, and see "Leveraged Loans: Cov-Lite

Volume Reaches Yet Another Record High", LeverageLoan.com, June 22, 2018.

[14] "Increased cov-lite carve-outs, higher purchase limits are credit negative for US CLOs", Moody's Investor Services, March 9, 2016.

[15] "Weak structures of cov-lite loans, now the majority of US leveraged loan market, suggest lower-than-average recoveries in the next downturn", Moody's Investor Services, May 23, 2017.