Navigating in dangerous waters

Cover story

The message from CLO investors is 'come on in, the water's lovely' and, for the time being, this may hold true. But concerns about downgrades and lower-rated paper are growing. Irwin Speizer explores the threats

After another solid year, collateralised loan obligations entered 2020 facing new headwinds. Loan quality is slipping, defaults are edging up, good lending opportunities are becoming harder to find and new CLO issuance is expected to decline from the hectic pace of the last two years.

But if CLO managers and investors are worried, they are not showing it. When Lawrence Berkovich, a partner in the structured finance practice in the New York office of international law firm Allen & Overy, attended a CLO conference in California in December, he expected to hear some worries about the upcoming year. He encountered the opposite.

"It was hard to schedule meetings because managers were too busy talking to investors," Berkovich says. "Right now, people are positive and it is business as usual. But they are keeping in the back of their minds that the cycle will eventually end."

Standards slipping

Although managers and investors appear to be confident that CLOs will do just fine in 2020, others are raising concerns. In December, the Financial Stability Board, the international organisation that monitors and makes recommendations about global financial markets and regulations, published a report pointing to vulnerabilities in leveraged loans and the CLOs that securitise them.

The FSB concluded that loosening loan standards are making more leveraged loans and CLOs vulnerable to major economic shocks. It warned that defaults could spike and that if problems in leveraged loans and CLOs become too serious, they could infect the rest of the financial markets, particularly as the size of the CLO market continues to grow and banks remain heavily invested in it. Assessing the risk is difficult, the FSB said, owing to the complexity of the relationships involved, which include corporate borrowers, private equity firms, leveraged loan issuers, CLOs and banks.

CLOs hit a high of $400 billion in global outstanding issues in 2008, then retreated during the recession. CLO issuance started a rebound in 2012 that has only now begun to level off; the outstanding global total is now around $900 billion and closing in on $1 trillion, according to various estimates. CLOs remain concentrated in the US, which accounts for more than 70 percent of the business. New CLO issuance hit a one-year record in the US of $127.7 billion in 2018. Issuance began tapering off in 2019 but a strong rally in the fourth quarter

should put the final total for the year close to the 2018 level. For 2020, banks are forecasting a broader retreat, with estimates of new issuance ranging from $60 billion to $100 billion.

The FSB warning about rising risks in CLOs reminds some observers of the problems with collateralised debt obligations that triggered the financial crisis. However, not even the FSB suggests there are problems of that magnitude. The subprime mortgages that infected and toppled mortgage-backed securities in the last recession are not much like the leveraged business loans inside CLOs. Each of those CDOs could hold thousands of residential mortgages, and large numbers of home loans were issued with little real oversight during the real estate boom that preceded the crisis. Each CLO holds about 100 to 250 loans.

When CDOs imploded in the real estate collapse, banks teetered towards failure. One reason for this was the mortgage-backed securities market, at $9 trillion, was one of the largest pools of assets in the world and a favoured investment of major banks. CLOs are also widely held by big banks, but the CDO market at the time of the last crisis was 10 times the current size of the CLO market. Leveraged business loans are a far cry from the subprime mortgages that crept into CDOs. And CLOs proved to be resilient in the recession, thanks in part to the size and strength of AAA tranches, which avoided default.

Renaud Champion, head of credit strategies at Paris-based fund manager La Française Global Investment Solutions, says the recent increase in leveraged loan risk, though noticeable, is far from problematic. Leveraged loans remain less risky than high-yield bonds and stay in more stable hands, he says, yet critics focus on leveraged loans and CLOs.

"There has been so much negative press about CLOs over the past 12 months," Champion says. "So many people try to draw parallels with the subprime mess. I struggle to see anything similar to that."

When analysing the CLO market, most of the focus is on one particular segment: broadly syndicated leveraged loans in the US. These large loans, often of $250 million or more made to large corporations, comprise the bulk of loans found in CLOs. Mid-market CLOs are a much smaller and slightly different sector. After broadly syndicated loans are securitised into CLOs, the AAA-rated tranches have usually been gobbled up by large international banks and insurance companies. Lower-rated tranches end up with other buyers.

Share of outstanding US leveraged loans rated CCC+ or lower (%)

As of 30 Sep 2019

Source: S&P/LSTA Leveraged Loan Index; LCD, an offering of S&P Global Market Intelligence

Early warning

An early warning sign of trouble for CLOs came in 2019, when Japanese banks retreated from the market after the country's regulators raised concerns. Yield-starved Japanese banks had fled to CLOs in such droves that they bought up an estimated 15 percent of outstanding issues. In October, the Bank of Japan said that even top-rated tranches of CLOs could fall "substantially" in value during a significant market downturn. It instituted new risk retention rules for CLO investment, similar to those in Europe, which require CLO managers to maintain a stake in the issues (the US dropped risk retention rules in 2018). Yet, although Japanese regulators worried about the value of CLOs being affected by market disruptions, they acknowledged that the risk of a significant rise in defaults in AAA tranches was small.

Norinchukin Bank, the biggest buyer of CLOs among Japanese banks, responded to the warnings by scaling back significantly from its CLO buying spree. Worries that the retreat by Norinchukin and other Japanese banks might disrupt CLO markets proved unfounded when other buyers, such as insurance companies, stepped in to buy AAA tranches. In the end, the Japanese experience highlighted the broad appeal of CLOs to investors.

"When the Japanese pulled out of the market last year, you would have expected spreads to widen," says Don Young, partner and co-founder of CBAM Partners, a credit investment manager that issues CLOs. "Instead, they tightened. There were large North American buyers who stepped in and bought AAA tranches that would have gone to Japan."

And the Japanese did not stay away for long. The mild warning from the Bank of Japan was not viewed as a roadblock to new CLO investment. In November, Shizuoka Bank announced it would step up its investment in CLOs, joining others that were buying again.

"One of the big themes of 2019 was that Japanese regulators gave a thorough look

at CLOs and gave them a general seal of approval, so many Japanese banks are back to buying at the AAA level," says Thomas Majewski, founder of Eagle Point Credit Management, an investor in CLOs.

Nevertheless, the brief skittishness of Japanese banks – the second-largest holders of CLOs behind US banks – was unsettling. Banks play a fundamental role in both CLOs and leveraged loans. Banks are the largest holders of leveraged loans, followed by CLOs themselves; and within CLOs, banks are the largest investors.

One recurring topic of debate in the CLO space is the question of covenant-lite loans. These loans, which lack covenants, had been rare prior to the recession, but have since overtaken the market. Covenants that once held borrowers to financial targets are gone and, with them, the ability of lenders to intervene and declare defaults if those targets are not met. Removal of covenants allows a company to continue operating rather than being forced into default. The FSB says covenant-lite loans can delay defaults for struggling companies, increase the size of defaults and lower recovery rates for lenders. They can also increase default rates by allowing weaker companies to obtain loans.

But is covenant-lite necessarily a bad thing? Some CLO investors – notably equity investors, which are subordinate to debt investors in a default recovery – see positives. With covenants, a company that makes money but misses targets could still be forced into a 'technical' default. Strong companies do not need covenants, and

The challenges of risk retention

Diverging paths in the US and Europe have made things trickier for managers

For CLO investors, a key concern is keeping managers aligned with their interests. One way to do that is to make managers retain an interest in the CLOs they manage. This is accomplished through a structure called risk retention, in which the manager must maintain ownership of a percentage of the CLO.

The US and Europe were united in requiring risk retention until 2018. As the result of a court case, the US dropped its retention requirement. In Europe, risk retention is still in force and managers must retain 5 percent ownership in their CLOs. Japan, after reviewing CLO exposure by its banks in 2019, established new risk retention requirements.

The divergence between the US and Europe, and now Japan, has created some headaches for US managers, some of which have been looking to expand into Europe. When the US required risk retention, it was simpler for a US manager that already had a risk retention solution to transfer that model to Europe. Now managers that dropped their risk-retention provisions and are looking to move into Europe may need to start anew. However, firms that had established separate funds in which they retained the requisite stakes have been able to transfer such vehicles to Europe.

"Today, the biggest hurdle for US managers looking at Europe is risk retention," says Cameron Saylor, a structured credit partner in London at international law firm Paul Hastings. "Managers that have raised dedicated risk retention money may find it easier to get deals priced."

Most of the largest CLO managers already have retention funds, Saylor says, so it is newer and smaller US managers that are facing the biggest challenges in Europe.

Leveraged loans, high-yield bonds and growth in CLOs

Institutional leveraged loans and high-yield bonds outstanding in US and EU

US high-yield bonds (lhs)
US leveraged loans (lhs)
EU high-yield bonds (rhs)
EU leveraged loans (rhs)

Global primary market issuances, revolvers vs institutional loans (%)

Revolvers and term loan 'A's
Institution loans, typically bought by range of non-banks and some banks

US and EU CLOs outstanding ($bn)

European CLOs
US CLOs

Source: Financial Stability Board (based on data from the US Federal Reserve, Bloomberg Finance; S&P Global Market Intelligence, Bank of England calculations, and European Central Bank calculations using AFME and SIFMA data)

lenders recognise that. "If you look at all the companies that have had covenants, they generally are the worst borrowers," says CBAM's Young. "If you had a covenant, it is because no one wanted to lend to you. I would rather have a good company with no covenants than a bad one with covenants."

There are examples to support that argument. Majewski points to Weight Watchers as one. The company faced challenges a few years ago and earnings plunged. If its billion-dollar loan had contained covenants, it probably would have breached them and fallen into default. Instead, it continued to operate and make debt payments until it signed a deal to sell part of the business to Oprah Winfrey. Profits jumped and the company was back on track.

Young adds that covenants constrain a CLO manager's ability to make changes in an existing CLO. When loans go bad, managers will sometimes try to sell those loans out of a CLO; but if the loan has covenants, buyers become scarce. "You might get some benefit from covenants, but you can't sell the loans," Young says. "You have a covenant but no liquidity. I would rather be able to sell out of a loan."

The FSB takes a more positive view of covenants. It says that removing them may have made it too easy for companies to obtain loans and led to higher corporate debt levels.

Yet covenants have been out of favour for so long in the US that it would be difficult to revive them there. "I don't think covenants will ever come back," says an anonymous market source. "It has been a permanent shift."

However, it is not just covenant-lite loans that worry the FSB. There has been a gradual loosening of loan quality as borrowers have been able to demand more favourable terms and conditions as a result of a shift in supply and demand. "There has been a tightening of supply in the past year," says Patricia Lynch, a partner in the finance practice at law firm Ropes & Gray. "Fewer new loans are making it to market. That has put borrowers in a strong position and gives them a certain amount of negotiating leverage. The test is going to be if that triggers more defaults."

Defaults on the up

Companies with greater debt and leverage tend to be more vulnerable to stress and downgrades during economic downturns, the FSB says, and CLOs could wind up battling higher default rates in a recession as a result of covenant-lite lending and weaker loan conditions. However, the FSB goes on to say that changes in CLO structures since the financial crisis have provided a better cushion against risk.

Rating agencies are projecting increases

Holders of leveraged loans and CLOs, as of December 2018 ($bn)

Banks: US, EA, UK, Japan[1]
CLO
Investment funds[2]
Insurance corporations[3]
Pension funds: US[4]
Other financial organisations: US[4]
Other non-financial organisations: US[4]
Unknown[5]

Holders of leveraged loans

$1,368bn | $743bn | $329bn | $56bn | $683bn

Holders of CLOs

$207bn | $129bn | $135bn | $57bn | $55bn | $55bn | $106bn

1 based on supervisory data from the US, EA, UK and Japan as of end 2018; leveraged loan exposure shown includes undrawn facilities, while pipeline exposure and CLO warehouse facilities are excluded
2 based on analysis of supervisory and commercial data by European Securities and Markets Authority staff and review of data from Moody's, Morningstar and Datascope by US Securities and Exchange Commission staff
3 based on data from European Insurance and Occupational Pensions Authority and National Association Of Insurance Commissioners
4 CLO holdings of US pension funds, US other financial organisations and US other non-financial organisations are estimated, based on Treasury International Capital data shares as at 2017
5 estimate based on $3,179 billion estimate of leveraged loans and $743 billion in CLOs as at December 2018, assuming CLOs are entirely invested in leveraged loans – thus the estimate of unknown leveraged loans could be larger, if CLOs are actually holding other asset types; numbers rounded

Source: Financial Stability Board

in default rates in 2020. Fitch Ratings has said the institutional leveraged loan default rate at the end of 2019 was 1.8 percent, which is about the same level it had been at the end of the previous year. However, the agency has also forecast that the rate will rise to 3 percent by the end of 2020. Although that would represent a significant year-on-year increase, the rate would still be well within a manageable range and way below the levels seen in the last recession, when defaults were in the double digits. Moody's forecast for 2020 sees no more than a limited rise in default rates.

Of course, the performance of companies and their ability to repay loans will depend on the health of the overall economy. So far, the economic expansion has managed to shake off a series of financial and geopolitical challenges to remain one of the longest on record. A strong economy goes hand in hand with a positive credit cycle. Should the economy slow dramatically, the credit cycle will no doubt follow and begin showing higher rates of default.

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>
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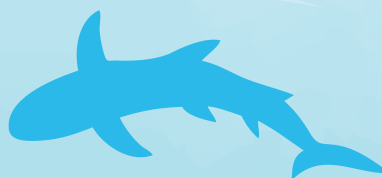
But even if the economy continues to perform reasonably well, CLOs could face challenges from loan downgrades by rating agencies. CLOs are built to manage risk by spreading exposure across business sectors and loan quality. At the bottom of the stack are loans rated CCC, which typically make up no more than 7.5 percent of a CLO. These loans may be in default or headed there.

A worry for CLO managers is that too many loans might be downgraded to CCC, which would upset the balance of risk. Rating agencies are keeping a close eye on company performance, particularly at this late stage in the credit cycle. CLO managers, in turn, are keeping a close eye on rating changes. Jeremy Ghose, head of fund manager Investcorp Credit Management,

expects more downgrades to B3/B- in 2020. Others are wary of downgrades to CCC status that might be enough to force corrective action by CLO managers.

CLOs depend on overcollateralisation to help manage risk. They must pass an overcollateralisation test and face consequences if they breach the stated level of overcollateralisation. A key part of that equation is the amount of CCC-rated assets in the CLO. A breach of the collateralisation level can often be quickly remedied by a manager. But a serious breach can be deadly.

"One of the key issues is the over-collateralisation test," says David Heilbrunn, senior managing director at Churchill Asset Management, a mid-market lender and CLO issuer. "Breaching the OCT ratio results in the amortisation of a transaction's



Here come the hybrids

But with no sign of a recession just yet, are they here too soon?

You know it's late in the economic cycle when hybrid securities arrive on the scene. There are now two in the loan securitisation sector: enhanced CLOs and hybrid CDOs. Both are touted for their ability to thrive during economic downturns.

The new CDOs, which focus on lower-rated corporate bonds and leveraged loans, anticipate having enough cash on hand to be able to buy riskier debt at greatly reduced cost during an economic slowdown, and to be able to generate a healthy return from it.

CDOs have been out of favour since the last recession, when they became the central catalyst in the market meltdown through the collapse of mortgage-backed securities. The new hybrid CDOs are venturing into CLO territory by bundling risky leveraged loans and high-yield bonds. A number of managers, including Fortress Investment Group and Blackstone, have begun offering these hybrid CDOs.

With the help of these new hybrids, CDOs began growing again in 2018 for the first time since the crisis. New issuance, which had fallen every year since 2008, notched a gain in 2018 that is expected to continue.

In the CLO space, there are now about a half dozen "enhanced" CLOs that specialise in the riskiest loans: those rated CCC.

Created to take up the slack in conventional CLOs, these vehicles are designed to hold dramatically more of the lowest-rated loans. Traditional CLOs typically limit exposure to CCC loans at 7.5 percent, but many keep the ratio much lower, often at about half the limit. Enhanced CLOs can have up to 50 percent of C-rated loans. *The Wall Street Journal* has counted five of these enhanced CLOs coming to market.

At times of economic stress, more loans come under pressure and rating agencies issue more downgrades. Rating downgrades for leveraged loans are already increasing: the biggest jump in downgrades during 2019 was to B-, which is the last stop before CCC. Some CLO managers have sought to head off a CCC bulge by selling off poorly performing B-rated loans.

Much of the new activity in the lower end of the leveraged loan field revolves around a recession play. Marginal loans suffer the worst declines in value at such times, and therefore offer enticing potential for profit to those with the nerve to buy them. Back in 2018 and 2019, there were widespread predictions of an imminent slowdown and possible recession. But although loan downgrades are on the rise now, predictions of a recession in 2020 are on the decline. It is unclear where that will leave the new hybrids if the good times continue to roll.

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> **DAVID HEILBRUNN**
> **Churchill Asset Management**

outstanding liabilities. If significant enough, the breach can result in the unwinding of a deal. Excess CCC exposure also puts additional pressure on the OCT, which is one of the reasons that the CCC issue is so important."

CCC-rated loans are on the rise. According to S&P Global, they now account for 7.5 percent of all outstanding leveraged loans, the highest level since July 2013. Rating agencies downgraded more loans through the 12 months to October 2019 than during the previous two years combined.

CLOs currently have about 4.1 percent in CCC-rated loans, S&P says, which is at the top end of the range since 2016. But even breaching the standard 7.5 percent CCC cap would not necessarily cause undue stress on a CLO, which has ways to cover some of the missing overcollateralisation, including the sale of some CCC loans. An analysis by Wells Fargo found that a CLO would be unlikely to get into trouble until CCCs accounted for 12 percent of its assets.

"The increase in downgrades throughout much of 2019 resulted in a flight to quality and steepening of the credit curve as many managers focused on managing the CCC buckets," says Seth Painter, managing director of structured products at Antares Capital. "Absent any material spike in defaults, most CLOs still have a fair amount of headroom before equity cashflows are at risk of diversion."

Concerns about rising CCC levels prompted some selling of B3- and CCC-rated loans at discount prices. "While the rebalancing is sensible and pragmatic, certain quality B3 names may have been caught up in the negative sentiment and have since rallied."

Still, CLO managers are particularly mindful of how rating agencies might react to any market uncertainty in 2020. In the last crisis, rating agencies were hammered for failing to detect fundamental flaws in CDOs and keeping ratings high, thus encouraging investment in instruments that were at the heart of the economic collapse.

"Ratings agencies certainly took heat in the prior crisis," Heilbrunn says. "As such, the market is concerned about the sudden and mounting downgrades. The rating agencies have their fingers on the trigger and may start to downgrade credits well before there are significant problems."

Fitch Ratings says that although it projects some downgrades for leveraged loans, it sees sufficient cushions in CLOs in the US and Europe to deal with the issue. S&P Global, though, sees reason for concern. It found that leveraged loans rated B- in broadly syndicated CLOs now account for 19 percent of assets in those CLOs, more than double the rate from 2015. Historically, B- loans have been more volatile and have a greater risk of downgrades than other loans.

In short, CLOs may be at greater risk of meaningful downgrades to CCC status in 2020, particularly if there an overall market disruption.

No tidal wave

Yet despite the many challenges, CLO managers and investors remain upbeat about 2020. The few setbacks of 2019 – including volatility in energy markets that put pressure on loans in that sector, and concerns about interest rates – have receded.

"The loan market had some big surprises last year and suffered from an increase in downgrade activity," says Scott Snell, portfolio manager at Tetragon Credit Partners. "The market feels much better today. Heading into December, there was a partial resolution of the trade war with China, the risk of recession faded away and credit fundamentals looked stronger. Given the improved outlook, investors recognised that loans were quite cheap, which encouraged cross-over buyers to move out of high yield to loans.

"Right out of the gate this year, the market feels supportive and we are seeing very good demand for CLO debt. Based on early primary activity, new-issue deals are oversubscribed and debt has tightened to levels not seen since 2018."

To those inside the CLO business, there may be some headwinds to face. But for the moment, the tailwinds appear to be prevailing. ■