Why CLO’s Matter (Part One)

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In the classic comedic bit from the early 1960’s, Mel Brooks, as a two thousand year old man, is asked what he thought mankind’s greatest invention was. “Saran Wrap,” he answers promptly. Not the discovery of space? “That was good,” he admits.

We’re not sure what the venerable Mr. Brooks would say today if posed the same question, but we would cast our vote for the CLO.

OK, maybe collateralized loan obligations haven’t had the same historic impact as penicillin, microchips, or PEZ dispensers, but they have certainly transformed the leveraged loan landscape.

As our *Chart of the Week* shows, the shift of “risky assets” from bank balance sheets to the shadow banking universe is nothing new. While Volcker and risk retention rules are the latest headwinds to plague regulated institutions, this migration has been going on for twenty years.

Today, CLO’s, and loan, hedge and high-yield funds represent almost 88% of the market (per S&P/LCD).

What accounts for CLO’s longevity? For that matter, what is a CLO anyway?

By definition, CLO’s are securitizations backed by pools of corporate loans. Unlike auto, student loans, or mortgage-backed securities, CLO’s have experienced managers who create portfolios of senior secured assets by buying loans in the primary and secondary markets, then monitoring them closely to ensure optimal credit quality.

Once booked, these loans provide the manager with a stream of cash flow derived from the difference between the loan (asset) yield and the cost of the CLO financing (liability). That spread has fluctuated through business and technical cycles, but over time has yielded high-single digit to low-double digit equity returns, thanks to managers’ ability to leverage equity to improve returns.

One feature that makes CLO’s useful tools for managers is their flexibility in dealing with stressed credits. They can trade out of positions early, or hold on if time helps resolve an issue. Banks, who must deal with higher reserve requirements on troubled loans, may need to exit problems more quickly, which may not yield the best outcome.

Not to say CLO’s haven’t had rough patches. Some early variants were “marked-to-market,” their assets valued at market prices. The theory was that holders of the liabilities would be protected, as a borrowing base supports ABL lenders. But during the credit crisis, prices plummeted, forcing managers to either inject more equity, or sell loans at distressed prices – of course, at the exact wrong time to be selling.

Yet most pre-crisis, so-called 1.0, CLO’s, behaved as expected. Accordingly, issuance began to recover in 2010 with more creditor-friendly version 2.0 features.

Next week, we'll discuss the role that CLO's – the Saran Wrap of the loan market – will play in the further development of the demand side of leveraged loans.