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Professional Perspective

Trends in CLO Collateral and Performance

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Part I of this three-part series provided a primer on the structure and features of collateralized loan obligations. Part II below analyzes the rapid expansion of the collateralized loan obligation market following the 2008 financial crisis and leading up to the current, pandemic-induced downturn and introduces some of the potential legal consequences of this activity. Part III of the series then addresses specific disputes that may arise between CLO market participants.

CLO Trends Pre-2020

CLOs have been available as an investment instrument since the 1990s. However, prior to the 2008 financial crisis, they constituted a relatively small portion of the U.S. structured finance market, which had been dominated by the more well-known residential mortgage backed securities (RMBS) and other asset backed securities (ABS) such as collateralized debt obligations (CDOs).

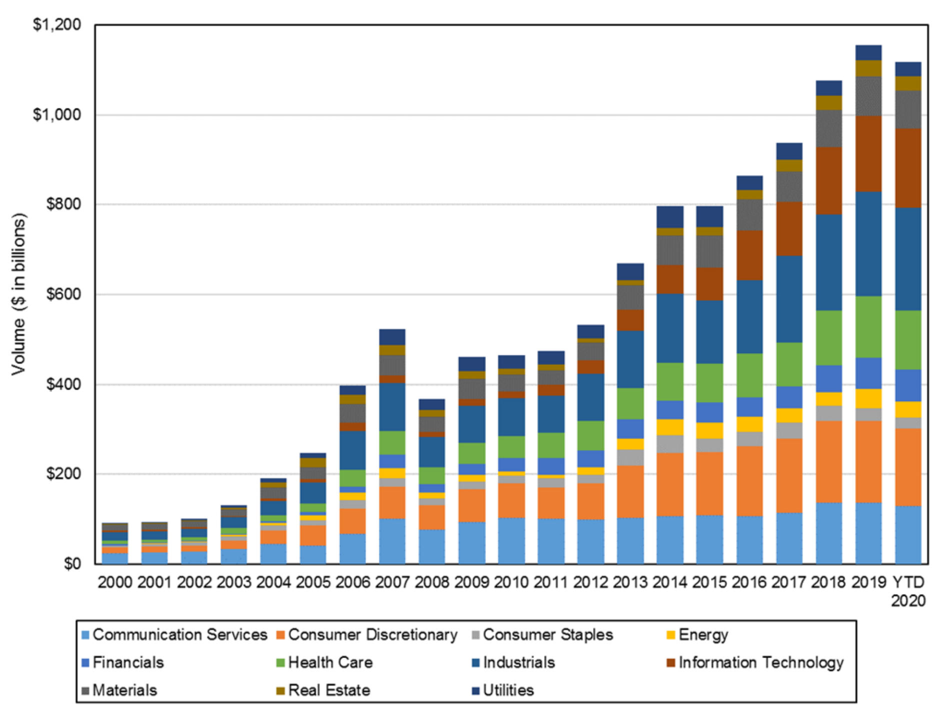
Compared to those products, however, CLOs performed relatively well during the financial crisis, at least partially because CLO collateral was diversified across multiple industries rather than centralized in the residential mortgage loan market that was the epicenter of the last financial crisis.

Post-Crisis CLO Volume Increase

CLOs became an increasingly significant part of the U.S. financial sector following the 2008 financial crisis. In the historically low interest rate environment that prevailed in the decade following the crisis, both the CLO market, and the underlying leveraged loan market on which it relies, nearly doubled in size.

Between 2008 and 2019, the leveraged loan market—more than half of which is packaged into CLOs—increased from roughly $600 billion to $1.2 trillion, as shown below by industry sector. Most sectors reached peak volumes in either 2017 or 2018. In 2017, the consumer discretionary sector—which has been the largest sector since 2015 and includes non-essential consumer goods and services such as high-end apparel, leisure travel, hotels, and entertainment—issued over $300 billion in leveraged loans. Similarly, the two next largest sectors—financial and technology—each issued over $200 billion in 2017.

Figure 1: Outstanding Leveraged Loans by Sector 2015–YTD 2020 (S&P LCD data)

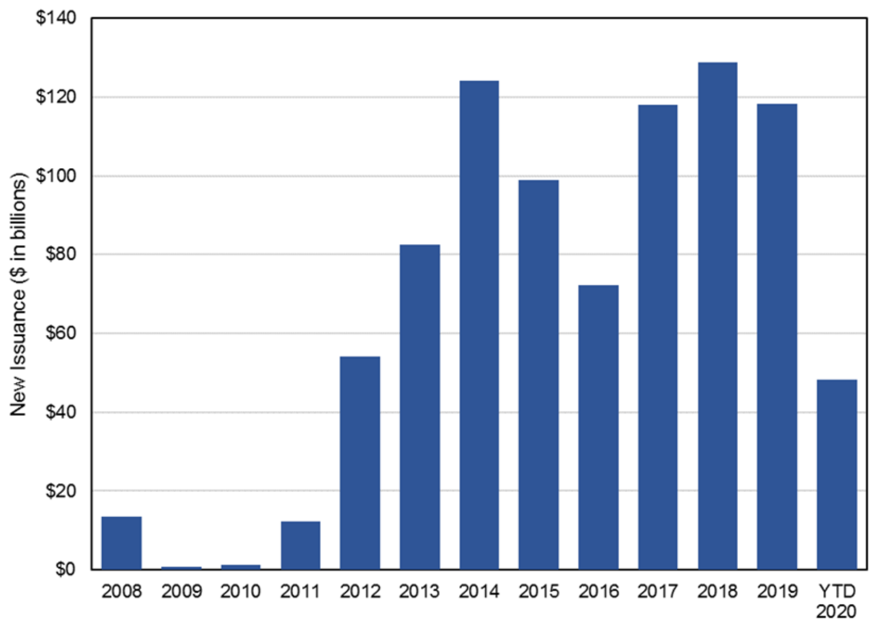


During that same period, the CLO market grew from $308 billion to $617 billion, ultimately comprising 38% of the U.S. ABS market, according to the Securities Industry and Financial Markets Association. In 2018 alone, based on data from Standard & Poor's, CLO issuances in the U.S. topped $125 billion—a record for that market, as shown below.

The fluctuations in CLO issuances are highly correlated with supply and demand in the underlying leveraged loan market from merger and acquisition activities, and with private equity firms entering the CLO market as both portfolio managers and borrowers. The share of M&A-purposed loans in the leveraged loan market reached 63% in 2008, before dropping to 13% in 2009. Since then, its share recovered, reaching 39% in 2019.

The CLO market cooled slightly in 2019 when interest rates began to increase. This was driven largely by a drop in restructuring of seasoned deals, while new issuances, including those backed by commercial real estate loans, continued apace.

Figure 2: CLO Issuances Volume 2008–YTD 2020 (S&P LCD data)

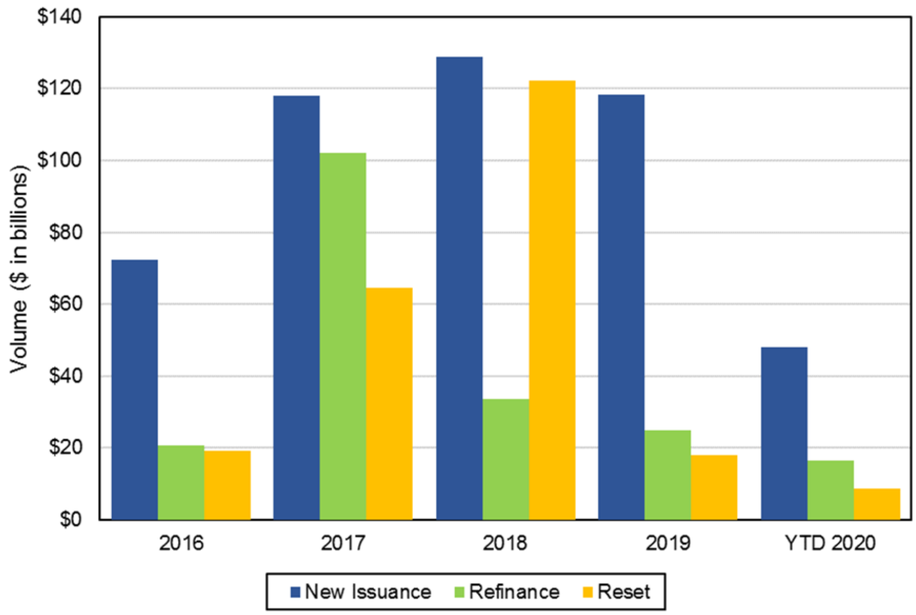


Refinance and Reset Activity

In 2017 and 2018 there were notable increases in CLO refinance (refi) and reset transactions, as credit spreads tightened based on interest rate and macroeconomic conditions. As discussed in Part I of this series, each of these transactions allows the equity holder to capture a larger interest rate spread to increase the expected return on investment. Additionally, resets provide the option to adjust the maturity date and extend the life of the CLO.

The combined volume from refis and resets was over $160 billion in 2017 and over $150 billion in 2018, surpassing new issuance volume each year. Moving into 2019, this activity began to slow down—with a combined drop in volume of about $40 billion—as the Federal Reserve signaled a pause in interest rate increases.

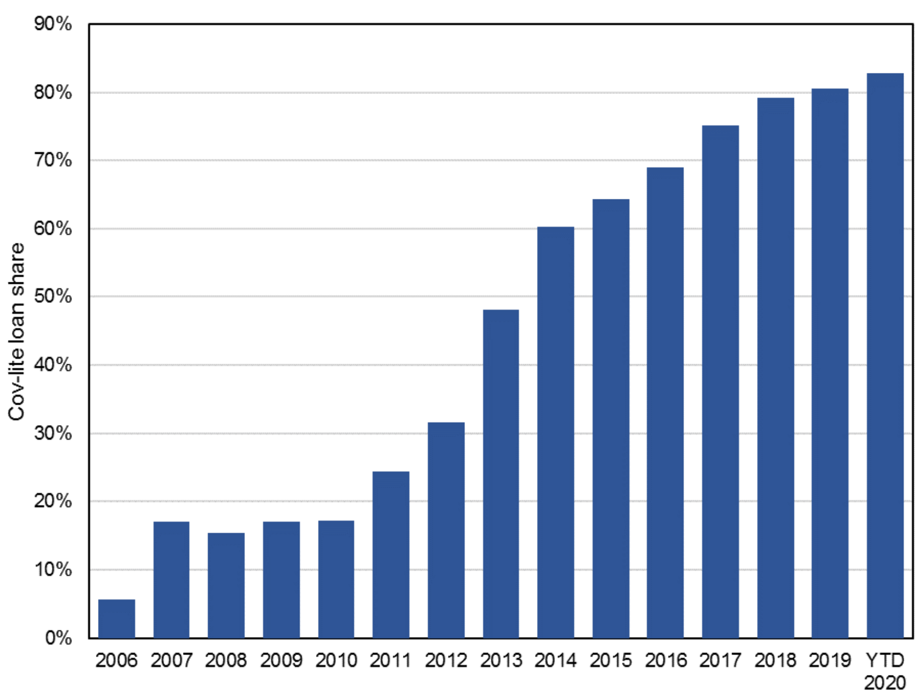
Figure 3: New CLO Issuance vs. Refinance vs. Reset (S&P LCD data)



As discussed in Part I, the significant demand for CLOs over the last decade has in part been driven by the higher returns offered by CLOs compared to other fixed incomes products along with a perception that CLOs are relatively safe based on historical performance. However, recent vintages of CLOs are not necessarily of the same quality as those that survived the last financial crisis. For example, there has been a rise in so-called covenant-lite or cov-lite loans. As discussed in Part I, these loans do not contain periodic financial maintenance tests that must be met by the borrower, and thus provide relatively fewer credit and legal protections to investors.

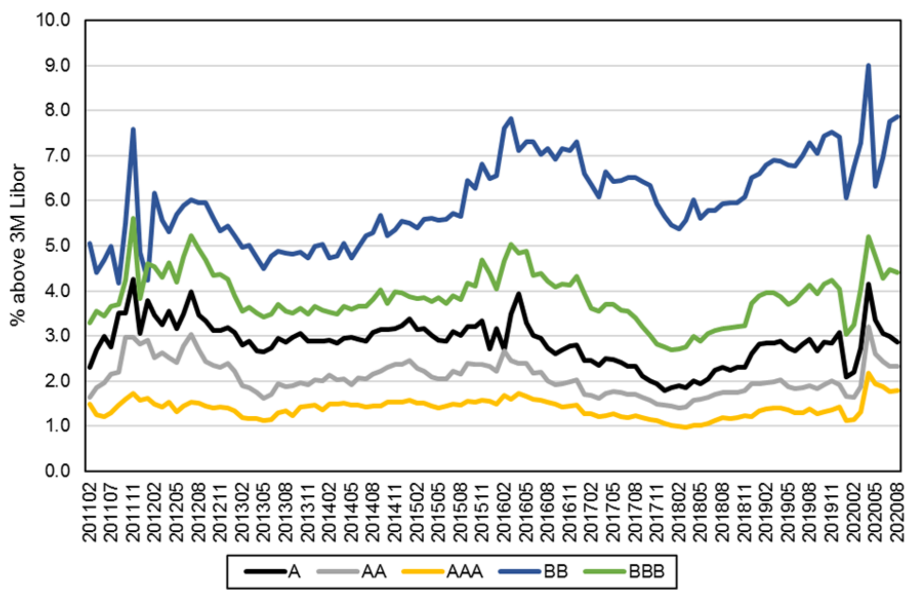
Covenant-lite loans' share in the outstanding leveraged loan market was over 80% at the end of 2019, compared to less than 10% in 2006, as shown below. Similarly, as the leveraged loan market grew, the underlying credit quality of corporate debt and the average credit ratings of subordinated CLO tranches began to fall, suggesting an increased appetite for risk.

Figure 4: Share of Covenant-Lite Loans in Outstanding Leveraged Loans (S&P LCD data)



The volume of CLO issuances is inversely related to the spreads on non-equity CLO tranches. This is because higher spreads on non-equity tranches will tend to reduce the returns that are available to equity holders. For instance, the decline in CLO issuance volume in 2015 and 2016, as shown in Figure 2, largely coincides with the widening of yield spreads between non-equity CLO tranches and the three-month London Inter-bank Offered Rate (LIBOR) in 2015 and 2016, as shown in Figure 5.

Figure 5: Non-Equity CLO Tranches Yield Minus 3-Month LIBOR (S&P LCD data)



Warnings of Increased Risk

By 2019, the rapid growth of the CLO market and the accompanying expansion of risk began to attract the attention of regulators.

In its May 2019 Financial Stability Report, the Federal Reserve pointed to the expansion in the leveraged loan market and observed that "risks associated with leveraged loans have … intensified, as a greater proportion are to borrowers with lower credit ratings and already high levels of debt. In addition, loan agreements contain fewer financial maintenance covenants, which effectively reduce the incentive to monitor obligors and the ability to influence their behavior."

The Federal Reserve ultimately concluded that the "historically high level of business debt and the recent concentration of debt growth among the riskiest firms could pose a risk to those firms and, potentially, their creditors." Similarly, in January 2019, Mark Carney, the governor of the Bank of England, drew an express parallel to the residential mortgage-backed securities (RMBS) boom and subsequent financial crisis when appearing before the House of Commons. Specifically, he warned with respect to cov-lite loans that "the subprime analogy isn't perfect, but it's on the road to 'no doc' underwriting" of more than a decade ago.

Moreover, in December 2019, the Financial Stability Board issued a report detailing the risks associated with leveraged loans and CLOs. The report concluded that "vulnerabilities in the leveraged loan and CLO markets have grown since the financial crisis."

In terms of risk exposure, approximately 80% of the outstanding U.S. CLO volume is held by U.S. investors according to research by the Federal Reserve, as discussed in Part I. Insurance companies comprised almost 33% of domestic CLO holdings, and depository institutions and other financial organizations hold around 28%. Mutual funds, in particular, hold a large portion of the investments in the relatively riskier equity tranches (Part I, Figure 7.) In the first quarter of 2020, U.S. banks held almost $99 billion in CLO securities, which represented an increase of $8.7 billion from a year before.

Despite these warnings, in the first two months of 2020 there were $14 billion in new CLO issuances.

Recent Market Turbulence

Things changed in March 2020. As the world scrambled to try to slow the spread of the coronavirus pandemic, the leveraged loan and CLO markets pulled back along with the rest of the economy. The economic effects of the global shutdown were immediate and severe. The U.S. economy officially entered into a recession in February 2020. Unemployment in the U.S. skyrocketed to 14.7% by April 2020—the highest rate and largest month-over-month increase ever recorded by the Bureau of Labor Statistics—and remained at 8.4% as of August 2020.

Real GDP fell by 31.7% in Q2 2020. The Congressional Budget Office forecasted the GDP growth rate to be negative 5.9% in 2020. Although it is too soon to know the full extent of the damage, the economic impact of the pandemic may be long-lasting.

Unsurprisingly, this sudden halt in economic activity hit companies carrying heavy debt loads particularly hard. This was especially the case in the leading leveraged loan sector, consumer discretionary, which includes the travel, hospitality, and retail industries, all of which were severely impacted by the pandemic.

Financially struggling and overly leveraged companies in these industries began to default on their loan obligations and to seek bankruptcy protection. For example, rental car giant Hertz, which was carrying $19 billion in corporate debt when the pandemic hit, filed for bankruptcy in May 2020. Retailers J.Crew and Neiman Marcus, both of which had large debt loads as a result of recent leveraged buyouts by private equity firms, also filed for bankruptcy that month. This trend has continued through the summer and fall, with retailers Brooks Brothers, Lord & Taylor, and Century 21 filing for bankruptcy in July, August, and September, respectively.

To the extent any CLOs had a high concentration of bonds tied to these industries, the recent failures could give rise to claims that they were not properly diversified when they were first structured or during the reinvestment period. As the Federal Reserve observed in its May 2020 Financial Stability Report, defaults on leveraged loans "ticked up in February and March and are likely to continue to increase … Such developments would weaken the balance sheets of lenders, including CLOs that hold leveraged loans, and amplify the economic effects" of Covid-19.

Congress and the Federal Reserve enacted several policy measures to help stabilize the economy and alleviate the pressure on those industries that were hardest hit by the pandemic. Nonetheless, these initiatives had limited direct impact on the CLO market.

Moreover, the May 2020 Financial Stability Report acknowledges that policy interventions "may help businesses withstand a period of weak earnings by issuing new debt and extending existing credit, but many of these businesses will emerge with even higher amounts of leverage, suggesting that vulnerabilities stemming from the business sector, including nonpublic companies and small businesses, are likely to remain elevated for some time."

Pandemic Impact on CLOs and Legal Consequences

The impact of this economic upheaval on the CLO market was swift. The ratings agencies began downgrading the ratings of both CLO bonds and the underlying obligors to which those securities are exposed. As of March 31, 2020, leveraged loan rating downgrades outnumbered rating upgrades by almost 45 to 1, potentially putting many CLOs in distress. Similarly, according to S&P, default rates increased to 4.08% in August 2020 from 1.29% a year before.

Furthermore, S&P forecasts the speculative grade defaults to increase to 12.5% by March 2021. Fitch Ratings forecasts $80 billion in defaults by the end of 2020 and a further $200 billion by the end of 2021. Although the pace of ratings actions has slowed in recent months, by June 2020 roughly 30% of the assets held in U.S. broadly syndicated CLOs rated by S&P had either been downgraded or placed on negative credit watch, and the ratings for roughly 40% of BBB-rated bonds were under review.

The May 2020 Financial Stability Report predicts that material downgrades to junior CLO tranches are likely to continue, noting that the risk of such downgrades could spread quickly through the market: "Downgrades of CLO tranches could result in margin calls on leveraged investors, forcing them to reduce their exposure by selling their holdings. Such sales have the potential of putting additional pressures on leveraged investors."

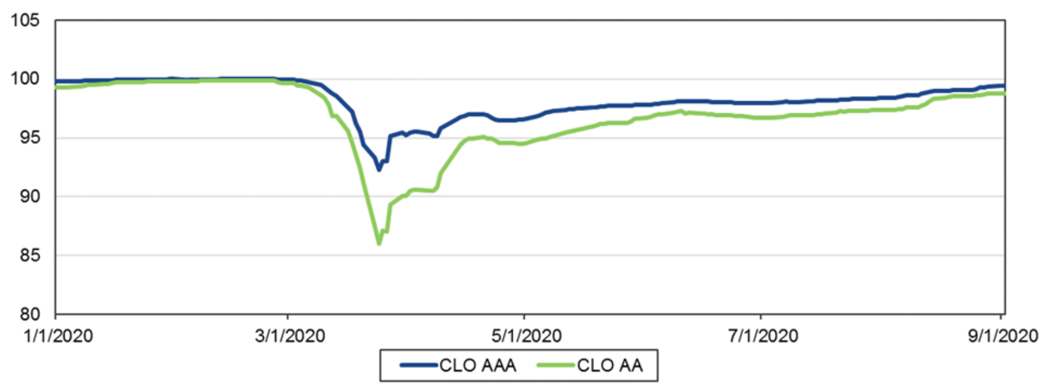
The legal agreements governing most CLOs limit the amount of low-rated assets that can be held in a CLO's portfolio. As the ratings of underlying obligors have been downgraded, some CLOs have exceeded the threshold of CCC-rated assets in their portfolios. CLOs have to mark these excess loans at their market trading price, which effectively lowers the value of the collateral. If the downgrades continue, it may be difficult to identify a sufficient supply of higher-rated debt to sustain the CLO market. Further, asset values may continue to decline as more CLO managers are forced to sell downgraded loans to maintain the required ratings mix in their portfolios.

As a result of these market changes, many CLOs have begun to fail their overcollateralization tests, in some cases even in the more senior tranches. As discussed in Part I of this series, overcollateralization coverage tests require the value of the loans a CLO holds to exceed the remaining value of the CLO notes by a particular amount, such that the underlying collateral can withstand a certain amount of loss before losses are passed to the CLO securities. In general, falling short of that requirement results in interest and principal payments being deferred or cut off to the more junior and equity tranches so that money can be diverted to pay down the senior notes.

In a less volatile market, CLO managers may be able to more readily cure overcollateralization failures through trading. But given the speed and breadth of recent downgrades, the ability of CLO managers to navigate these failures may be curtailed, and lead to disputes concerning the speed and reasonableness of a CLO manager's conduct in responding to the ongoing financial crisis. These and other potential legal disputes between CLO participants are discussed further in Part III of this series. Moreover, as discussed below, at a certain point the failure to maintain the requisite overcollateralization can result in an event of default and trigger additional rights and obligations of CLO participants.

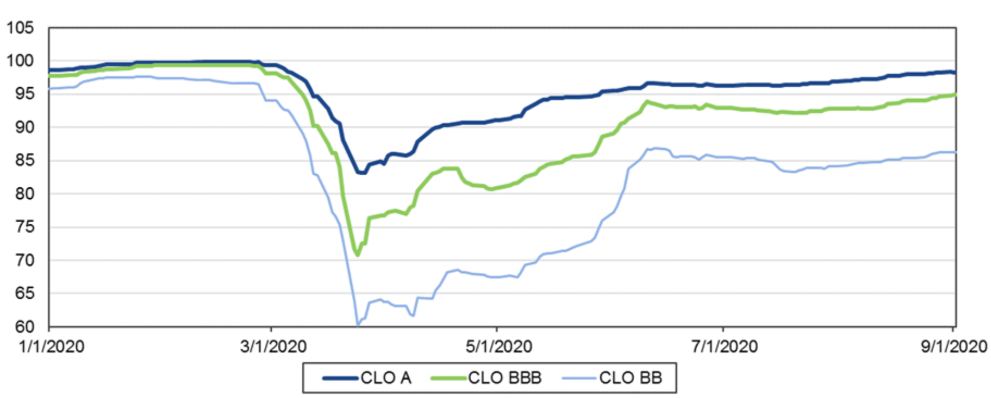
In response to this market upheaval, prices for CLO AAA- and AA-rated tranches dropped precipitously in March and April 2020, and are currently down roughly 4% year-to-date.

Figure 6: Price of Senior CLO Debt (Palmer Square CLO Indices, Bloomberg)



The prices of the mezzanine tranches—A, BB, and BBB—have been even harder-hit. The CLO BB-rated tranche price reached 60 cents at the end of March 2020, compared to 96 cents at the beginning of the year, though recovered to 85 cents by early July.

Figure 7: Price of Mezzanine CLO (Palmer Square CLO Indices, Bloomberg)



The recent market turbulence has affected the CLO market structurally as well. The average size of CLOs dropped to $388 million in the second quarter of 2020, compared to an average size of $512 million in the prior ten quarters.

The borrowing cost for CLOs increased in 2020. The coupons—i.e., spread over LIBOR—on the AAA tranches increased from 100 basis points (bps) in 2019 to 196 bps in the second quarter (through June 22) of 2020. Similarly, the overall liability cost increased from 148.3 bps in the first quarter of 2018 to 244.3 bps in the second quarter of 2020.

At the same time, as the cost of debt has increased, managers have issued deals with shorter reinvestment and no-call periods which gives CLO managers the flexibility to reissue or reset the deal sooner if the market condition improves. In 2020, the average reinvestment period has decreased from 4.1 years to 2.9 years, and the average no-call period decreased from 1.7 years to 1.3 years.

Thus far in 2020, refis and resets are showing a marked slowdown due to economic stressors from the Covid-19 pandemic and signs of distress in the leveraged loan markets. These macro trends make it less likely that CLO equity holders will be able to negotiate favorable terms that will allow them to continue refis and resets at the levels seen over the last couple of years.

Events of Default

If these negative trends continue, at least some CLOs may begin to suffer losses, even in senior tranches. This may give rise to legal disputes between the many participants in the CLO market concerning, for example, whether particular contractual provisions were triggered by the failure to maintain specified structural protections and the consequences thereof. One of the most immediate legal consequences of the current conditions in the CLO market is the potential triggering of "event of default" provisions in the agreements that govern CLOs.

Generally speaking, an event of default is an event specified in a commercial agreement that triggers additional rights and obligations of the transaction participants. In the context of CLOs, the specific triggers and consequences will be dictated by the terms of a given CLO indenture (see Part I). An event of default will often occur if there is a delay or default in the payments owed to senior noteholders, or the CLO fails to maintain specified structural requirements—e.g., a given level of overcollateralization. An event of default may also be triggered by the breach of certain material misrepresentations, warranties, and covenants, even absent a performance trigger.

Part III of this series delves deeper into the potential legal disputes that can arise between CLO participants upon an event of default.

Statutes of Limitation

As the potential for legal disputes arising from the current CLO downturn increases, participants in the CLO market should also be aware of the relevant statutes of limitation that may govern any such legal claims. For example, the statutes of limitation for fraud claims are typically shorter than those for other claims and may begin to run as soon as a potential plaintiff would have had "inquiry notice" of a claim—i.e., when the plaintiff suspected or should have suspected that an injury was caused by wrongdoing.

In connection with the RMBS-related litigation arising out of the 2008 financial crisis, some courts found that civil actions and press reports related to risky mortgage lending practices from as early as January 2008—well before the worst effects of the crisis had been felt or the relevant securities had defaulted—were sufficient to put plaintiffs on inquiry notice with respect to their resulting fraud claims. See, e.g., *Stichting Pensioenfonds ABP v. Countrywide Fin. Corp.*, 802 F.Supp.2d 1125, 1140-41 (C.D. Cal. 2011).

As one court explained, the relevant trigger for the statute of limitations beginning to run was not when the full extent of the defendant's fraud had been laid bare, but rather when a "reasonable investor" exercising "reasonable diligence" should have discovered the facts necessary to state a claim—including those concerning "risks" that only later materialized.

In the CLO context, commentators and regulators have already started to raise alarms about the increased risks resulting from the rapid expansion of the leveraged loan and CLO markets. These reports, as well as the recent ratings actions with respect to CLO bonds and the underlying collateral, could give rise to the argument that the statutes of limitation on certain claims have already begun to run.

Accordingly, even if the worst fallout in the CLO market is yet to come, CLO participants should be aware of the publicly available information related to the individual bonds and collateral in which they have a stake and take steps to investigate their available legal claims at the earliest suggestion of potential wrongdoing. Likewise, defendants in a CLO action should investigate timeliness defenses that may exist in response to any claims based on facts long in the public domain.

Conclusion

As discussed above, the rapid expansion of CLO issuances and broadening of criteria for the underlying collateral over the past decade, followed by the sudden contraction and severe economic turmoil starting in the second quarter of 2020, portend several issues that could ripen into disputes between CLO counterparties.

The recent increase in defaults and downgrades could have a particularly significant impact since many CLOs have exposure to the industries and collateral hardest-hit by the pandemic. Importantly, these issues require diligence and prompt action by participants in the CLO market not only to manage the economic fallout, but also to preserve potential legal claims and defenses. The third and final part of this series delves further into the legal disputes that may arise from these recent events.