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Welcome to the Summer 2019 issue of *The Journal of Structured Finance*. This issue focuses entirely on collateralized loan obligations (CLOs) and has a guest editor, Jeffrey Stern, who co-chairs the structured finance practice at Winston & Strawn, LLP. Mr. Stern is a leading expert on CLOs, and he has pulled together a great lineup of articles for this issue.

CLOs are currently quite hot. This year's issuance volume through mid-October stands at $93.6 billion, which is slightly behind last year's pace, but still brisk.

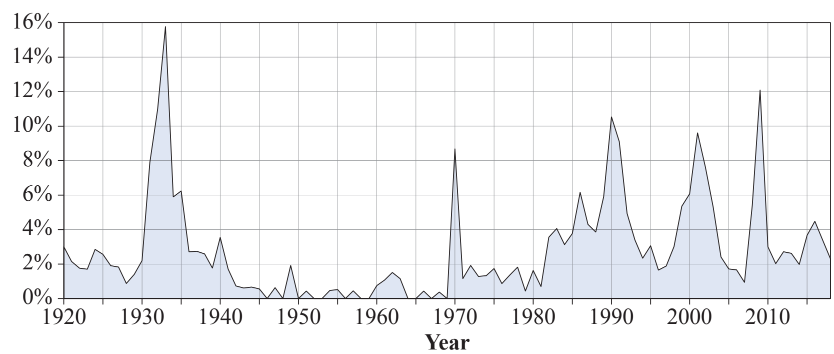
For those who are new to CLOs, here is a quick intro: A CLO is like a mutual fund that invests in loans to highly leveraged companies (i.e., companies with speculative-grade credit quality). However, unlike a mutual fund, most of the securities sold from a CLO are themselves bonds, rather than shares. In simplest terms, a CLO is an arrangement that raises money primarily by issuing its own bonds and then investing the proceeds in a portfolio of leveraged loans. Payments on the portfolio are the main source of funds for repaying the CLO's own securities.

An early ancestor of today's CLOs was collateralized bond obligations (CBOs). Junk bonds composed the portfolios of many CBOs. CBOs experienced a rough period in the early 2000s, when many junk bonds defaulted (Exhibit 1). Participants in those deals appear to have overestimated the diversification in the underlying portfolios.

Most CLOs have actively managed portfolios. A typical deal has a manager (i.e., a management company) that collects fees for managing the portfolio—again, like a mutual fund.

EXHIBIT 1

Moody's Global Issuer-Weighted Speculative-Grade Default Rate



Source: Moody's, Annual Default Study: Defaults Will Rise Modestly in 2019 Amid Higher Volatility (February 1, 2019).

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A standard feature of virtually all CLOs is "credit tranching." Credit tranching refers to creating multiple classes (or "tranches") of securities, each of which has a different seniority relative to the others. For example, a CLO might issue six classes of securities (Exhibit 2). Each class protects the ones senior to it from losses on the underlying portfolio. The sponsor of a CLO usually sets the size of the senior class so that it can attain triple-A ratings. Likewise, the sponsor generally designs the other classes so that they achieve successively lower ratings. In a way, the rating agencies are really the ones who determine the sizes of the classes for a given portfolio.

Companies sponsor CLOs for varying reasons. One reason is to extract a profit from the positive spread between the yield that the CLO earns on its portfolio of loans and the yield that it must pay on its own debt securities. In many cases, the profit goes mostly to the holder of the equity class, with some portion going to the manager as a performance-based fee. Other CLOs are created primarily to serve as funding source for a middle-market lender's loan production.

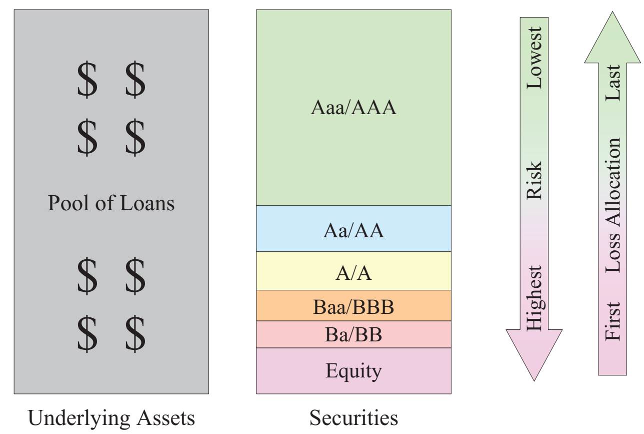
Diversification is a key idea in understanding and gauging both the risk in a CLO's portfolio and, consequently, in the securities that it issues. CLO professionals address the concept of diversification with the statistical concept of "correlation." They gauge the riskiness of a CLO's different classes by running computer simulations where they make assumptions about correlation. The rating agencies often use the same approach when they analyze and rate CLOs. For example, under its current CLO criteria (June 21, 2019), Standard & Poor's generally assumes correlation of 20% for firms in the same industry and 7.5% for firms in different industries. The rating agency uses 5% correlation for firms in different industries and different geographic regions.

The earliest phase of a CLO's life cycle consists of accumulating the initial portfolio. The revolving period comes next, during which the manager reinvests cash flow from the portfolio and otherwise actively manages the portfolio. Finally, the CLO enters its amortization phase, when collections on the portfolio must be applied toward retiring the CLO's own debt.

A CLO manager generally is required to follow certain rules in managing the CLO's loan portfolio.

EXHIBIT 2

Example of CLO Subordination Structure



Note: The relative size of the classes is not shown to scale.

The rules protect investors by somewhat limiting the manager's discretion. For example, one rule might require the manager to maintain the average yield or spread on the managed assets above a certain level. Another rule might require the manager to maintain the average maturity of the assets within a certain range.

CLOs typically include performance tests that can trigger the start of the amortization phase. For example, many deals include an "overcollateralization" test based on the ratio of the portfolio balance to the balance of the CLO's debt securities. Likewise, many CLOs include an interest coverage test, based on the ratio of interest cash flow on the portfolio to the interest that the CLO must pay on its own securities. If either ratio falls below a specified threshold, the deal would enter early amortization. The tests are designed to protect investors by triggering amortization if a deal's performance deteriorates.

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This issue includes highlights from *GlobalCapital* and a selection of industry news items from the Structured Finance Association (formerly known as the Structured Finance Industry Group), in both cases covering Q3 2019.

As always, we welcome your submissions. Please encourage those you know who have good papers or who have made good presentations on structured finance– or project finance–related subjects to submit them to us.

Submission guidelines can be found at http://jsf.pm-research.com/authors. If you have comments or suggestions, you can e-mail me directly at M.Adelson@PageantMedia.com.

Mark Adelson
Editor