Continuous par build can provide a rainy-day fund for when downgrades to triple Cs pour in

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If CLO managers are preparing for mass downgrades to triple C loans, then trading gains and thick OC cushions are the best defences

Roughly 5% of US broadly syndicated loans were downgraded by Moody's during the first quarter — and an increasing amount of attention has been given to credit migration in the US loan market.

However, despite the downgrades, a report from Nomura's research team on 12 April indicates that the amounts of loans rated B3/B-, Caa1/CCC+ or lower in CLOs has not increased over the past year. These levels have remained unchanged at 8% and 4%, respectively.

This begs the question: how did this happen? Did CLO collateral managers simply sell triple Cs, crystallising losses and burning par? We believe the answer is more complex and highlights one of the most important aspects of CLOs — that most are actively managed.

Before delving into portfolio management, it is important to address the common misperception that CLOs are forced to sell triple C-rated loans. We hear time and time again from those less familiar with the CLO market that CLOs are required to sell triple Cs. While in some cases it may be in a CLO's best interests to sell such a loan, the standard market CLO documents typically do not require the sale of any triple C-rated loan.

The decision to sell these loans is not subject to a codified rule, but rather left to the prudent judgement of CLO collateral managers. While a sale is not required if the view is that a loan will continue to deteriorate, it is still likely that selling is the best course of action. In other cases, where there is greater conviction around a borrower's outlook, it may make sense to hold the position. If the market price is attractive enough, it may even make sense to cautiously add to the position.

Build in par via discretionary trading

In many cases, selling a loan that was downgraded to triple C will involve a loss compared to the original purchase price. Mindful that there will likely be a continuous trickle of downgrades to this level over time, some of the most skilled CLO collateral managers seek to actively build small amounts of par in their CLOs every month through discretionary trading. This continuous par build provides a rainy-day fund that can be used to absorb par losses from the occasional triple C sale. We believe this is a prudent approach to CLO management.

Periodically, we see an increase in the issuance of static CLOs and CLOs with reinvestment periods of a year or less. In many cases, equity investors are lured to these transactions due to their lower cost of funding compared to a typical CLO with a five-year reinvestment period.

While some static and short-dated CLOs have worked well, others have not. Many that did not perform well would have been better off had the CLO collateral manager been able to actively manage the portfolio, consistently building small amounts of par to offset losses (from triple Cs or otherwise) that will inevitably occur in a diversified credit portfolio. In the absence of significant cost savings, we believe the cost of the foregone or curtailed reinvestment option outweighs the savings on a CLO's debt costs.

Be prepared for greater downgrades

In the future, there may be periods of greater downgrades that lead to even higher triple C concentrations in CLOs. A CLO manager's preparedness for these scenarios is equally important. Once triple Cs exceed specified thresholds (typically 7.5%), the numerator of CLO overcollateralisation (OC) tests begins to be adversely impacted through haircuts on triple C loans that exceed the specified threshold. If the OC numerator drops too much, distributions to equity and junior debt tranches could be suspended until the OC test is cured.

How can a CLO be prepared? Beyond CLO collateral managers seeking to continuously build par, structuring CLOs with greater OC cushions from the outset can be very potent. Increasing the initial OC cushion typically comes at the cost of a slightly de-levered structure, but the value of the increased structural flexibility is often overlooked by market participants.

While corporate earnings have generally remained strong, we believe that thoughtful upfront structuring and active ongoing management will provide some of the best defences when credit market conditions turn.

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