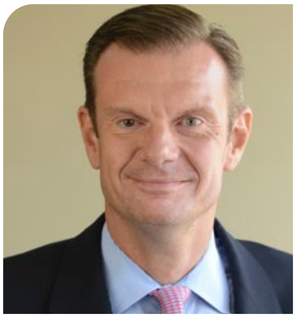

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It's great that government is trying to boost securitisations, but they're missing the mark for CLOs

> The CMBS talf proposal is simple and effective. A similar approach for CLOs would be welcomed

The efforts undertaken by the US Federal Reserve and treasury to provide liquidity and stability to the market quickly and decisively in response to the rapidly evolving coronavirus pandemic have been laudable. The financing programmes announced by officials in Washington over the past month have included a mix of measures that we remember from 2008-09, as well as new facilities intended to address the unique challenges that many businesses and consumers are facing today.

Indeed, the stated purposes of many of the government-sponsored programmes include facilitating the extension of credit to American consumers and businesses.

One of the first initiatives, which was announced in March, is the primary dealer credit facility (PDCF). It provides for an expansive set of eligible collateral that primary dealers can finance with the Federal Reserve Bank of New York. The PDCF includes provision of financing for CLO triple A paper under terms very similar to those for other asset-backed securities.

This is necessary, because the US CLO market provides long-term financing to well over 1,000 large and medium-sized US companies. These are companies you and I do business with on a regular basis — including Dell, Hilton and Asurion; they provide jobs for millions of people; and they are part of the backbone of the US economy.

Talf is less effective than PDCF for CLOs

The term asset-backed securities loan facility, or talf, is another initiative instigated to bolster lending to businesses. Regrettably, the latest terms proposed for talf related to CLO triple As contain limitations that almost certainly render it ineffective for corporate credit.

Many recognise that CLOs performed well through prior periods of market distress. According to research from S&P, CLO triple A securities have never suffered an impairment. This compares favourably to conduit CMBS, auto loans and other common forms of securitisation, many of which faced losses even at the triple A-level during the 2008-09 financial crisis. Some will be surprised to learn that, according to a research report published by Citi, 96% of cash flow CLOs issued prior to 2011 (commonly called CLO 1.0s) had a positive return even for equity investors.

Some of the attributes that made CLO 1.0s perform well were portfolio diversity, active portfolio management and an ability to reinvest principal repayments for a measured period of time.

Static pool structures are a mistake

In our view, CLOs, through their reinvestment mechanism, helped steady corporate loans by buying during the financial crisis when there were few other buyers. We believe that if pre-crisis CLOs were structured as static pools, as is contemplated under the current talf term sheet, many that ended up as successes would have instead ended up with losses for almost all investors. Put more simply, if all CLO 1.0s were static pools, its likely there would not be a CLO 2.0 market.

Rather than seeking to regulate the terms of new CLOs by encouraging static pools, limited sets of eligible collateral, etc, talf should aim to facilitate the creation of new credit for US businesses. And the easiest way to make talf effectively deliver additional credit to American businesses is to allow the purchase of existing CLO triple A securities (the current guidelines are geared towards new issue triple As).

This is the approach proposed for CMBS under talf. It is simple, clean and effective. Risk takers — those providing first loss capital for talf-financed investments — can evaluate the structure, terms and, importantly, pricing of potential investments.

Such an approach would stimulate demand for existing CLO securities, which would help tighten secondary trading levels. When these securities tighten, new issue pricing is all but certain to follow, but with the market setting the terms and conditions that are acceptable.

We believe the inclusion of secondary CLO triple A paper under talf would be the most straightforward way to achieve talf's goal of extending credit to US business. We applaud the efforts taken in Washington to stabilise the markets in these unprecedented times and are hopeful that CLOs can serve an important role in the US reopening for business.

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