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Longer reinvestment periods, the ability to buy IG tranches and improved loan settlements would improve CLOs

With yet another economic downturn in the rear-view mirror, CLO structures have again shown remarkable resilience. The asset class continues to give attractive risk-adjusted returns with medium to long-term investment horizons, while also providing strong protection for CLO creditors (debt tranches) during periods of stress.

But there is room for further improvement that could benefit all CLO investors, as outlined below.

Seven-year CLO reinvestment periods

Not since 2017 have we seen efforts to elongate CLO reinvestment periods beyond five years. Lengthening them feels overdue.

Prior to the great financial crisis, CLO reinvestment periods often ran as long as seven years. CLOs with little or no reinvestment period tended to greatly underperform during periods of stress. Active CLO collateral managers with reinvestment period runways can implement decisive swap trades or continue reinvesting principal repayments into high-quality assets at depressed prices. This aids in building back some of the market par loss. Compare this to CLOs past their reinvestment period, which can only use timing of sale to lessen risk, with no potential for upside.

When markets stabilise, CLO collateral managers which were active tend to have CLOs in significantly better credit shape than those who didn't or couldn't trade, which benefits all CLO investors.

> Purchasing IG CLO debt was a key driver of success for 1.0 CLOs

CLOs in their reinvestment period are also less likely to defer or cut payments when downgrades and defaults occur.

For CLO debt investors, longer tenors represent a possibility for higher spreads, and offer the potential for locking in longer non-call periods. For equity investors, despite the potentially higher funding cost, more tenor offers more stability for when the next storm comes.

As a market, we finally figured out how to price short tenors via refis. It's baffling that we still won't price a tenor longer than five years.

Permit the purchase of IG CLO debt

Another key driver of historic success, which has also been lost from the CLO 1.0 days, is the ability to purchase investment grade CLO debt. With the relaxation of the Volcker rule as it applies to CLOs, high yield bonds are once again a part of portfolios. However, due to rating agency limitations, purchasing CLO debt is still not permissible.

IG-rated CLO debt has historically outperformed the loans that comprise them in terms of default rates, and materially so. Frankly, more 1.0 CLO debt tranches may have faced impairment had deals not had the flexibility to buy other CLO tranches. Skilled CLO collateral managers added meaningful amounts of par by purchasing CLO tranches at highly discounted prices.

Last year we heard many CLO collateral managers excited to tell us about their ability to add double B-rated loans to CLOs at prices in the 80s, which then moved back to par as the market rebounded. That opportunity set quickly became limited. CLO debt prices lagged the loan recovery — and buying at prices which stayed depressed far longer than loans would have allowed for much more par building.

Improve loan settlements with technology

Despite the continued growth of the US broadly syndicated loan market, the settlement process remains archaic. In a world with blockchain technology and other digital, organised administrative innovations, we should not still be guessing a day before whether a loan will settle. The anxiety that persists in loan operation departments trying to match timing on intake of investor wires and outgoing settlement payments is exhausting.

Moreover, this inefficiency creates a material cash drag for investors. Instead of lining up funding with expected settlements, investors are required to pre-fund in case of a quick settle that can then drag on for days or weeks — earning little or no interest. The penalty for failing to fund a settlement when suddenly requested is the loss of promised economics through delayed compensation and, potentially, market censure.

We believe that once the near-term Libor to Sofr transition is completed, we should strive to finally solve the inefficiencies of all our collective middle-office procedures.