Point-by-point rebuttal to Das's March 2 op-ed in Bloomberg Opinion

For Das's full op-ed, click here. What's below are Das's errors and our corresponding responses.

1. "Both Bank of England Governor Mark Carney and former Fed Chair Janet Yellen have warned about potential risks; regulators in Japan, where banks have been big CLO buyers, are particularly concerned."
    a. *Dr. Yellen stated at a CUNY conference that, "high levels of corporate leverage could prolong the downturn." But she did not expand that concern to investors in loans, adding "But there's much less leverage in the financial sector now as far as I can see relative to before the crisis. I think most of these risky loans are owned by investors that are not leveraged. So they may suffer some losses, but they are unlikely to turn around and start selling other assets that can lead to a firesale contagion."*
    b. *Japanese regulators have recently proposed new capital standards in all types of securitizations. It is not true that the JFSA is particularly focused on CLOs and the JFSA has not expressed such a concern.*
2. CLOs "repackage corporate loans, primarily leveraged loans, as well as consumer credit such as automobile loans."
    a. *Open Market CLOs are restricted to holding corporate credit loans, not consumer credit such as automobile loans.*
3. "Until recently, they [investors] could also rely on the fact that the banks structuring these packages had to retain a minimum amount of the riskiest securities to ensure that they had skin in the game."
    a. *Banks were never required to retain open market CLO notes; CLO managers – which are akin to mutual fund managers – were for a short time required to retain risk. However, last February, the US Court of Appeals for the DC Circuit struck down this rule, noting that, as a policy matter, CLO managers already have "skin in the game" through their fee structure.*
4. "Several aspects of this risk aren't well-understood. The credit quality of the leveraged loans which underlie the bulk of CLOs is poor, typically not investment-grade.
    a. *The companies and the risks are well understood. Instead of opaque sub-prime mortgages, leveraged loans are made to well-known companies such as Hilton Hotels, American Airlines, Delta Airlines, Pep Boys, The Weather Channel, Burger King, Dell Computer, Dole Foods and more. These loans are individually rated, they trade in the secondary market and the companies provide audited financials. Performance studies of leveraged loans and corporate credit go back for decades.*
5. "The loans increasingly have minimal investor protection, with over 70 percent lacking any covenants that would allow monitoring of financial condition and early intervention to manage problem borrowers."
    a. *It's true that 70% of new institutional term loans are "covenant-lite", meaning they do not have maintenance financial covenants. However, nearly all "covenant lite" institutional loans are pari passu with revolving loans that do have maintenance covenants. Second, institutional loans still have a large suite of protections including incurrence covenants, which limit actions that borrowers can take. Third, first lien institutional loans are senior and generally secured by nearly all of the collateral of the company.*
    b. *Recently, the rating agencies have stipulated that loan "recovery given default" may be somewhat lower than the average 80 cents on the dollar seen historically. However, CLOs are built to withstand much higher default rates and lower recovery rates than the downside scenarios rating agencies are forecasting.*

6. "Investors assume that the portfolios are safer because they're diversified. Yet, relative to mortgages, corporate-loan portfolios typically are made up of fewer and larger loans, which increases concentration risk."
    a. *Single obligors can represent only 0.5% to 2.0% of the total loans underlying a CLO. In addition, CLOs must meet strict diversification requirements, with most single industries limited to 10% of the total portfolio. Because of the industry diversification, correlation within a CLO portfolio is much lower than within mortgages or autos.*
7. "Even buyers of high-quality tranches, who may be insulated from actual losses, face the possibility of mark-to-market writedowns, where the current value of securities declines."
    a. *Mark-to-market declines are not realized losses. In the 25 years that CLOs have existed, there has never been a default on an AAA or AA rated CLO tranche. Moreover, of the 10,000 CLO tranches that Standard & Poor's rated between 1994 and 2008, just 38 defaulted. That is a 0.38% cumulative 25-year default rate, an extraordinarily low rate.*
8. "Relatively minor losses could impact such investors by reducing the protection for higher tranches and triggering rating downgrades."
    a. *CLOs are designed around the probability that there will be credit losses suffered by its loan investments, and are built to withstand loan defaults and downgrades. CLOs also have credit quality tests to assure that the overall credit quality of the portfolio is maintained.*
9. "Losses may create difficulties in rolling over funding, leading to a liquidity squeeze…that would accelerate declines in prices. As we saw last December, problems with CLOs may result in a contraction of credit."
    a. *CLOs played no role in the decline of loan prices last December. Like nearly every market, the loan market saw a significant withdrawal of mutual fund money, which translated into a temporary decline of asset valuations. While there was more than $15 billion of loan mutual fund outflows in December, there was nearly $6 billion of CLO formation in that month, according to S&P/LCD.*
10. "In the case of a downturn…banks will be stuck with unsold inventories of underwritten loans."
    a. *In testimony before House Financial Services Committee, Federal Reserve Chairman Jerome Powell stated, "Our supervision of banks indicates that banks do not have excessively high exposures to these highly levered, non-financial corporations and also don't have excessively large pipelines of commitments that they've made, which are two things they did have before the financial crisis but don't have now."*
    b. *The Federal Reserve, OCC and FDIC observed better pipeline management in their January 2019 Shared National Credit Review, noting "Agent banks are better equipped to assess borrower repayment capacity and enterprise valuations, and have developed other risk management processes that better align with safety and soundness principles."*
    c. *Subsequent to the Financial Crisis, banks have been very disciplined in their underwriting and pipeline management. According to Loan Pricing Corporation Data, banks' unsold leveraged loan pipelines topped-out at $250 billion in 2007. In 2018, the monthly rolling average was $49 billion.*
11. "Fears about the financial position of banks and investors will create contagion as depositors refuse to fund banks and investors demand their money back."
    a. *In testimony, Federal Reserve Chairman Jerome Powell explained, "if there were unexpectedly high credit losses among non-financial corporates, then, yes, the banks should have plenty of capital and liquidity to absorb those losses… It would not be the kind of thing we saw in 2008."*