Lee Shaiman

Executive director

Loan Syndications & Trading Association

Credit risk is rising, but any failures among CLOs will not impact the financial system as a whole

> Superficial analysis in the press fails to account for critical differences between CLOs and CDOs

In the January edition of *Creditflux*, Tom Majewski offered a timely counter to the large number of recent articles in the financial press that have criticised leveraged lending and CLOs [page 37, "We are yet to find a mass-media article that devotes attention to the potential merits of CLOs"]. I agree with Majewski that these pieces are heavy on the rhetoric and speculation and light on the facts, and while his piece did a good job of laying out the basic issues, I think it is worth examining and rebutting at least one of the negative arguments in greater detail.

As Majewski implied, the most common mistake these articles make is when they point to the similar structure, size and credit ratings of CLOs and CDOs, and conclude that, because they are similar in these respects, then they must be similarly risky. But this is a superficial analysis that fails to account for the many critical differences between the two types of structured vehicle — differences that ultimately tip the scales when determining how similar CLOs and CDOs are in reality.

Active management makes a difference

One important difference is that CLOs are actively managed, whereas the pools of mortgages underlying the CDOs that led to the crisis were fixed at the beginning of the vehicles' lives. So when a loan owned by a CLO begins to appear riskier than it originally seemed and no longer meets the credit criteria of the CLO, the manager can sell the loan and replace it with a more appropriate one.

This is in contrast to the situation in which CDO investors found themselves in 2008: once it became evident that cash flows supporting even triple A-rated tranches were at risk, no recourse could be taken to adjust the portfolios.

Another important difference relates to the total amount of leverage in the system. One reason a downturn in CDOs led to a broader crisis was that investors were allowed to write credit default swaps against them and notional values far exceeded the value of the underlying assets. When the CDO market collapsed and CDS came due all at once, the insurance companies that underwrote them had insufficient capital to make good on their obligations, leaving CDO investors holding the bag.

This sort of imbalance does not exist in the CLO market today and, in fact, the imbalance is reversed: now the value of loans far exceeds that of their corresponding CDS. The ability of insurers to make good on swap payments in today's market should ease any pressures in the system in the unlikely event of a mass default of leveraged loans.

Banks are taking a different approach

The final difference worth mentioning has to do with who is most prone to a downturn. In 2008, it was the banks that were heavily exposed to a downturn in the CDO market. They had invested heavily in CDO notes, which failed to pay off once the market turned, and, as we have seen, the CDS they purchased to cover their risk did not pay out. This led to a general tightening of credit and put a great strain on the financial system as a whole.

The situation is much different in the CLO market today. Banks limit their purchases to triple A-rated notes only. Since these tranches have never suffered a loss and are unlikely to do so during the next default cycle, banks are unlikely to be materially impacted, and the financial system should continue to function effectively.

None of this is to say that the trends critics point to do not indicate higher-than-usual levels of credit risk. They do, and we have not hesitated to acknowledge that. But to suggest that they therefore indicate systemic risk is a non sequitur and does not hold up under close scrutiny.

The similarities between CLOs and CDOs are merely superficial, and their differences are far more important when analysing the risks CLOs present to the broader economy.