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CLO equity delivered strong returns through the financial crisis period

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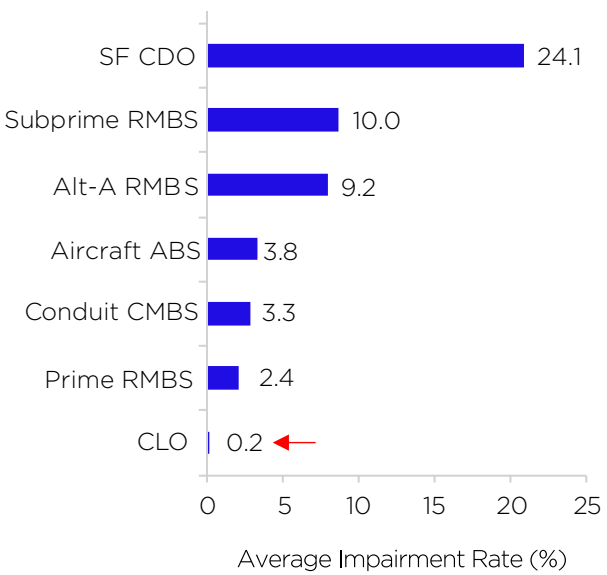
During the Global Financial Crisis (GFC) episode, default rates on the bonds issued by collateralized loan obligations, or CLOs, were far lower than those for other structured credit products such as CDOs, RMBS, CMBS, and ABS. Legacy structured finance CDOs (SF CDOs) and subprime RMBS had average annualized impairment rates of 24.1% and 10.0% respectively, vs. just 0.2% for CLO debt tranches (Exhibit 1). CLO equity tranches also performed well through the GFC. A study by researchers at the Federal Reserve Bank of Philadelphia finds that the median CLO equity tranches issued during 2005-2007 earned 13%-18% lifetime IRRs (Exhibit 2). In contrast, most of the equity and debt securities from RMBS, CMBS, and CDO transactions from the same period experienced negative returns.

EXHIBIT 1

Default rates on CLO bonds from the GFC period were far below those for other structured product sectors

Average 12-month impairment rate, 1993-2014

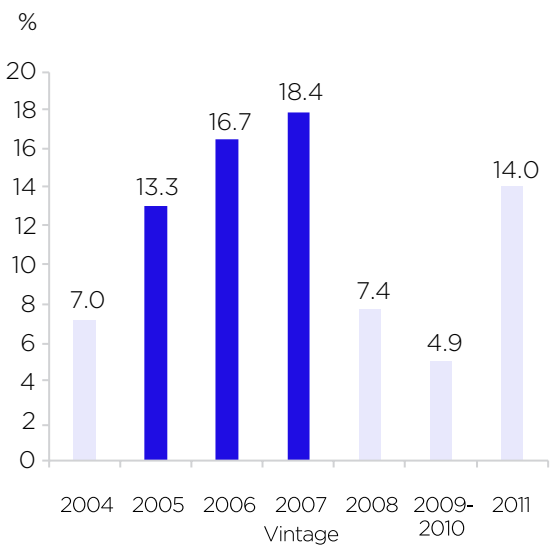


Source: Moody's, "Default and Loss Rates of Structured Finance Securities: 1993 – 2014," June 2015.

EXHIBIT 2

CLO equity tranches from 2005-2007 vintage transactions earned large positive rates of return

Median CLO equity tranche lifetime IRR by vintage



Source: Federal Reserve Bank of Philadelphia, "CLO Performance," Working Paper No. 20-48, November 2021.

How were CLOs able to avoid the distress experienced by so many seemingly similar sectors during the financial crisis? We highlight three factors that contributed to the success of CLO equity and that differentiated CLOs relative to other structured finance asset classes of this era:

Long-term funding: CLO equity tranches achieve leverage via long-term funding at fixed credit spreads. As a result, CLO managers were not forced to sell loan assets in the periods of deep market distress experienced during the GFC. By contrast, structures that relied on shorter term funding instruments (e.g., repo financing) faced margin calls and thus were forced to sell assets at distressed prices, eroding returns.

Benefits of senior-secured corporate lending: The business loans that back CLOs are senior in the issuers' capital structures and are typically secured by real estate or other corporate assets. As a result, the recovery rates on loans have historically been much higher than for high yield corporate bonds, say, which are typically junior and unsecured. The high recovery rates on defaulted CLO loan assets in turn helped to limit the losses experienced by CLO equity and debt investors during the financial crisis period.

Industry diversification: CLO collateral pools are highly diversified across industry sectors. Most prospectuses limit the fraction of total pool balance that can be allocated to any one sector or obligor. By contrast, many other structured finance products were backed by highly similar assets (such as mezzanine subprime RMBS bond tranches in the case of CDOs)[1], which all defaulted at the same time when US real estate prices declined and mortgage foreclosure rates rose.

We believe that the factors above which contributed to solid CLO equity returns during the financial crisis period continue to be broadly relevant going forward. While past performance is never a guarantee of future returns, the resilience shown by CLO equity through the historically extreme global financial crisis scenario helps contribute to confidence that the strategy can offer positive returns even if, as we expect, economic volatility remains elevated over the medium-term horizon.

1. "Collateral Damage: Sizing and Assessing the Subprime CDO Crisis", Federal Reserve Bank of Philadelphia Working Paper No. 11-30/R.

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