The new world: CLO market navigates new risks, new regs in 2017

Risk retention is finally here, but the rule is practically old news for the CLO market. Given that managers have had two years to prepare their compliance models, market players are focused on new set of challenges and risk factors on the horizon.

The price of leveraged loans in an ongoing impediment to the new issue market, with the potential to significantly eat into issuance totals. Meanwhile, resets and refinancings continue to thrive under the auspices of the Security and Exchange Commission’s “Crescent Letter”. Against this backdrop, credit concerns are deepening. Certain sectors, such as energy and healthcare, continue to show signs of stress, while other sectors like retail are also waver. Despite all this, a handful of managers have successfully forged ahead to issue new deals at spreads that are at cyclical tights. Market concerns aside, investor demand for CLOs appears to be insatiable.

Participants in the roundtable were:
Kevin Kendra, managing director, Fitch Ratings
Tom Majewski, managing partner, Eagle Point Credit
Francis Mitchell, Webster Bank
Tom Shandell, CEO, Marble Point Credit

Outside of technical factors, the CLO space, like the rest of the world, is coming to terms with a new government in Washington, DC. How the new administration’s policies will effect US credit is a topic of great interest, particularly in healthcare where the repeal of the Affordable Care Act is likely to have far reaching implications. Tough talk from President Donald Trump on drug pricing is also raising eyebrows in the debt markets, and after a flurry of headlines around Valenty Pharmaceuticals — the largest single company exposure in the CLO universe — loan managers will need to keep a close eye on the sector.

Navigating the market in this new era will certainly pose its challenges. GlobalCapital gathered a panel of experts from across the market, including issuers, arrangers, investors, legal experts and rating agency analysts, to discuss what CLO players can expect in a time of immense change.

Sean Solis, partner, Dechert
Jim Stehli, managing director, Mizuho
John Timperio, partner, Dechert
Medita Vucic, director, BNY Mellon
Sam Kerr, senior reporter, GlobalCapital

GlobalCapital: The obvious starting point is risk retention. Now that it is finally with us, how is the market reacting to the rule?

John Timperio, Dechert: US CLO managers have had two years to think about their compliance strategies and take steps to implement them. We would say approximately half to two-thirds have a strategy in place that could be long term, medium term or short-term strategy. What’s been interesting in the capital formation front is that I think a number of folks who have been looking at shorter term strategies have been a bit emboldened by the success of capital raises generally and are looking to engage in longer term more strategic thinking on risk retention. But I think managers in the CLO market have been out front on the risk retention capital formation but that is kind of half of the discussion. The other piece that is happening in real time is determining the disclosure and the necessary changes to issue risk retention compliance CLOs, and that process continues at the moment.

Sean Solis, Dechert: I think the other question is consolidation. I think one of the things we have seen is the number of folks who have not traditionally been in the CLO market
using risk retention as an opportunity to get into the market. They have capital and they feel like there are folks who won’t be able to stay in the market who will need to sell their platform, as we saw with the ACAS situation, which wasn’t necessarily driven by risk retention but was a natural evolution of what’s going on in the market. But we’ve seen a number of new players, which is a very sanguine sign for the market overall. People are really committed to the space because they have the capital to do it. Will there be consolidation? I don’t know, but I do think there are going to be a lot of new managers who we traditionally haven’t seen in the market now because risk retention has presented an opportunity they want to explore.

John Timperio
Dechert

Timperio, Dechert: Sean raises a good point. I think one person’s dislocation is another person’s opportunity. Certainly, at Dechert we’re working with a number of shops that are looking to set up CLO platforms and issue first-time CLOs. We’re also working with folks who have been out of the market for a number of years who are looking to come back in, so it will be interesting to see the shape of the market going forward.

Tom Majewski, Eagle Point Credit: Consolidation is the wrong word. Maybe some changing of hands is probably a better way to think of it. If you look at some of the substantive M&A that has occurred — CIFIC, ACAS, Credit Value Partners, Octagon, Hildene, Feingold, Sound Harbour and West Gate — with the exception of one or two, those are just platforms changing hands. The two that involved teams departing in one case had nothing to do with risk retention, and in one case, all but one of their CLOs were already risk-retention compliant. There haven’t been many instances of big collateral managers acquiring small managers. So I think the concept of consolidation is probably not the way to think of it. Those that are too small to survive, probably don’t have much to sell and there might not be anything to buy. So I would say most of the changes that are going to happen in the market have already occurred, 106 firms issued in 2014 and only 82 issued last year, but that’s down only five year over year from 2015. Notably, I think people would be surprised to learn that there were 15 new entrants last year that didn’t issue CLOs in the prior year.

The landscape is changing and while banks are predicting 30, 40, or 50 issuers this year, in our opinion that’s far too low. Looking forward there is also a handful of firms that have announced intentions to get into the issuance business which haven’t previously. Large firms like Guardian Life and Teachers who have very deep pockets have been able to enter the market. In terms of the retention funds, it has been interesting to see what actually happened. I think a lot of the most sophisticated LPs have appreciated the agency risk that has been embedded in those vehicles and we are aware of a number of opportunities to buy minority equity at prices lower than the risk retention price for majority equity. Horizontal retention vehicles are set to promulgate someone issuing CLOs, not necessarily maximizing long-term equity returns. So a number of investors we have seen shy away from retention strategies and I would wager more CLO equity capital has been raised away from retention, excluding two vehicles, than has been raised for retention last year.

Overall the best thing we see is that equity is generally in stickier hands via long-term permanent capital vehicles or risk retention vehicles. Whatever form in the capital comes in, it is less and less in the hot money hands which we were seeing active in the market in 2014.

Kevin Kendra, Fitch Ratings: We see the same trends that everyone else is talking about as far as the shifts in who’s actually going to manage these CLOs, that’s the manager consolidation question. It’s uncertain in my view as to whether we will get 82 issuers this year. However, long term when you think about 2018 after some of these other platforms get themselves in place and up and running the number of issuers should stabilize. There are still some questions around risk retention and how the regulators respond to certain structures etc. I think we will be back to a more natural state, around 80 issuers.

As far as the other aspects of risk retention, we are often asked the question, ‘what’s a rating agency going to do if a structure is deemed not to be compliant with risk retention’. It’s important to remember that we provide ratings on the notes of the CLO. The question really is what is going to be the long-term impact on a manager and any potential impact on that structure and on the entity itself. When we assign our initial ratings we are looking at what is the worst case or stress case portfolio that we’re trying to assess. We don’t think there is a direct fundamental credit impact on the notes if a structure is deemed non-compliant, however there could be an indirect impact on what is going on at the manager shop, what is going on with their ability to retain talent and whether they can transfer a risk retention vehicle if there is a problem with a manager down the road. So those are questions that we would ask, and it will be on a case-by-case scenario.

The trickier thing about risk retention we get asked a lot is not necessarily what the impact on the CLO, it’s around the financing a vertical strip. To some extent, the fundamental concept of risk retention and the fundamental concept of structured finance are diametrically opposed. In structured finance, the concept is that we want to separate the performance of the assets from the originator, but risk retention says ‘no you have to hold that risk’. So there are two diametrically opposed concepts. I think if you look at the financing of one CLO, it’s pretty easy to say this can probably fit in the structured finance box, but when you start looking at risk retention of multiple CLOs in one structure, it starts looking more like a specialty finance institution. So it is asking us to look at a box which we haven’t looked at before and it will probably take a little more time working with our financial institutions folks to develop the right framework. We have had some initial conversations. It’s just going to be slightly more complex depending on how the structure is being put in place.
Majewski, Eagle Point: As we looked at a number of the transactions we’ve been involved in, a few have been repeats with the same collateral manager and the same vertical retention financier. Probably the two trends we’ve seen is that for the first time through, the financing is like negotiating a separate deal simultaneously. It was cumbersome. On the second or third deal, people just changed the dates and spreads and the process went much more easily. For investors, buying the retention financing notes is actually a very attractive piece of paper. For many insurance companies, they get a premium return and a very good rating for senior CLO paper which they would otherwise buy. There is the added risk of complexity because there’s something in between the investor and the security that they would be buying, but the uptick in return seems to far outweigh the complexity and has sophisticated investors interested.

Jim Stehli, Mizuho: We’ve also seen a lot of longer-term dedicated CLO equity money coming into the market that wasn’t there before. I’ve been surprised by the amount of money that has been put aside already for new players, where an insurance company has hired a CLO PM to build out their credit business and has $200 million earmarked for equity and risk retention compliance.

Certainly this year, there’s a pretty high floor as far as the demand side of the equation. Obviously loans may or may not cooperate but I think that’s an interesting point to look at. The real question then becomes whether or not we have some reform this year and what happens to all that money?

Medita Vucic, BNY Mellon: I would say that we have seen consolidation from the trustee perspective and I think Tom made an excellent point there. I also see new entrants coming into the market and where we see an opportunity for us is new managers emerging needing to create operational efficiencies. I would say that depending on whether you choose a [capitalised manager vehicle], [manager owned affiliate] or [capitalised manager owned affiliate], there are different reporting needs for collateral managers, lenders and investors. A collateral manager can gain efficiency by selecting one service provider for its risk retention solution, which can include fund administration, accounting, trustee and collateral administration services. We are seeing a trend where investors can be influencing whether a collateral manager utilizes one or many service providers for risk retention.

Tom Shandell, Marble Point: I come from the viewpoint that you have a pool of capital that is investing in bank loans, so there are cash flows coming from assets. How does that get divvied up to various constituents? Risk retention then adds a different element to that. As Tom alluded to, there are investors who want exposure to the ultimate asset class and they want it in different ways. I think it presents an opportunity for investors to make a superior return because of all these structures that have to be adhered to that are siphoning off some of the cash flow. So from a manager’s standpoint, I guess the objective is to satisfy all the constituents and still have a result in which it is an attractive return for the manager, and not give up, because basically risk retention in my mind means giving up some economics to satisfy the structure. I think if you employ some creativity you can satisfy all the constituents and still walk away with a good result. From a manager’s standpoint it is about investing in good assets and having the cash flows from those assets be sufficient to be able to satisfy all the constituents, which now has become more complex in order to satisfy risk retention. So it’s a puzzle, but with uncertainty comes opportunity.

GlobalCapital: How can CLO managers differentiate themselves in 2017?

Majewski, Eagle Point: It’s all about performance. The price of entry into, or remaining in, the CLO market has gone up. That already has been established and it is really about who can outperform.

Vucic, BNY: I would say standardization can be a differentiator, however, investors will look at performance. The help measure performance, data and the availability of data is important.

Stehli, Mizuho: Performance here is measured in different ways by different people. There is a lot of transparency today, right down to the market value OCs and the weighted average price of portfolios, etc. CLO researchers have now gone out and done what they should be doing, which is to provide different measurement tools to analyze how a manager is performing, such as WARF, WAP and MVOC, as well as cash flow on equity and how stable it is.

In Japan for example, triple-A investors can come in and say ‘give me 2750 WARF and a lower average spread’. They are slow and stable and are not necessarily looking for a huge cash-flowing CLO manager. What I find very interesting is, if you look at some of the credit managers in this space, some of them have achieved a kind of magical position of being in the top five or six of the triple-As and the top five and six in equity, whereas others may have great credit performance but they can’t seem to latch on at the triple-A level with a strong following. That’s an interesting dynamic because they bring more of a credit focus to what they’re doing with the portfolio.

Certainly performance—that’s the short answer—and then the longer answer is what’s important as it relates to the type of investor and where they are in the capital stack. That’s always going to be an interesting conversation, and certainly the information now is more available to investors than it was five or ten years ago.

GlobalCapital: Francis, how are you as an investor thinking about all of this?

Francis Mitchell, Webster Bank: I would probably look
at risk retention and how that makes it more difficult with some of the consolidation going on and some of the "changing of hands" that was mentioned in the prior conversation. This becomes difficult because you try to vet one manager and then somebody else takes control of the investment management. You don’t know if they will retain the same type of management philosophy and then at the same time in the market, you currently aren’t seeing spread differentiation between tier one, two and three managers at the top of the stack. Now I’ll have to deal with potential losses during a pullback for owning a tier 2 or 3 manager with none of the upside of owning one, i.e. wider spreads.

So at some point you have a transaction where a manager can’t comply with risk retention going to some newer firm who has not previously been in the CLO space but has a lot of AUM, and the ability to comply with risk retention. All of this is a little bit out of your hands, and it could be good or it could be bad, depending on who your platform was originally with, and who takes over, a roll of the dice I guess.

So there is a lot of money to put to work but not a lot of M&A activity. If we look at the equities, the equity market is valuing companies very highly and private equity does have a lot of money to put to work but they want to be careful. They remember what happened the last time they were stretching to put money to work, the financial crisis came around. But also, you have the federal guidelines that limit the amount of leverage you can put on an LBO. In 2006, 2007, the way that private equity looked at it meant they could pay a higher multiple for a business but were able to borrow more, making equity work. That’s no longer possible, so there’s a mismatch between what sellers want to get for their companies and what buyers are willing to pay. Bankers are still out there pitching their clients, and even though they are not making money on these repricings, they’re still doing it to keep their clients happy and we’ve just seen the spread come out of the market.

I think that is going to present a lot of problems for CLOs. The weighted average spread tests are getting tighter and tighter. Maybe that is going to cause something to change because maybe people won’t just accept what’s happen-
pening in the marketplace. Every once in a while, our market is such that the reprices come and as a manager, you don’t like it but you can’t afford to lose a good piece of paper, even if you’re earning less spread. At some point something happens where the community as a whole says, ‘no, we’re not going to let that happen anymore’. So maybe tightening weighted average spread tests will cause the market to say ‘stop’. But it certainly hasn’t happened in January and I don’t see anything happening soon to change it, but I am hoping for it. The other thing that typically happens to change the market is something external, and I can’t tell you what it is but it always happens, and in the past it has been a sovereign debt crisis, something geopolitical. China’s softening economic situation was the catalyst in the recent past. Something will happen, I can’t say what it is but I hope it happens soon.

**Solis, Dechert:** It’s interesting what Tom says about loans because it goes down to performance as well. What is the key in dealing with low loan supply? It really comes down to your allocations. What are your relationships with these banks as this universe of loans shrinks? There may be a few names you want, so how do managers get their allocations and what is their relationships with the banks who are the biggest players? In this world of limited supply it becomes a key differentiator if you have access to that.

**Kendra, Fitch:** You also hear other managers have different strategies and take advantage of the high loan prices and to take money off the table and wait for that external event. It is an interesting differentiating factor to see how managers are going to react, but that is something to watch and monitor.

**Timperio, Dechert:** Has the change in the administration impacted your view or views on where we are in the credit cycle? Has this made you more bullish, less bullish, or is it too early to tell at this point?

**Shandell, Marble Point:** It’s probably too early to tell at this point. It’s well publicized that our president likes to say things, but when we saw the Senate hearings with his cabinet choices it was a lot less extreme. So I think it’s too early to tell what will actually happen. I think some things are pretty clear. I think the government will spend more money for projects so fiscal spending on the margin will help the economy. Other parts of his plan, I don’t know how to read just yet. It gives you some good support for a decent economy. People have operated under that scenario anyway, that the US economy is growing at an okay clip and whether it grows at a faster clip, we will have to see. Perhaps some of his talk on being tough on trade might backfire and that might have an offsetting effect. I think it’s too early to tell but I think most of what we see is benign in terms of default experience.

**Vucic, BNY Mellon:** The possibility for regulation being rolled back and the credit cycle impact in healthcare are wildcards. So do CLO managers diversify their credits and look at the assets they are buying as a result of these wildcards?

**Shandell, Marble Point:** I think it’s always something to think about and watch. Let’s take healthcare. Healthcare in general is a very large part of our economy. Who would be hurt by repeal and replace of the Affordable Care Act? Well, hospitals and hospital-oriented issuers. But the interesting thing is that for some time now hospitals haven’t been good credit anyway, so it’s something we’ve been avoiding in any event.

Another problem industry is retail, most of which is challenged. But there are some good retail companies in our space. There are companies that focus on pets. People will spend on pets what they won’t spend on themselves. But mall-based retail is challenged, and we as an industry tend not to not get great names anyway. So as a manager you’re always focusing on things like that. Focus on regulation by a team of analysts, whether it’s healthcare, whether it’s media, whatever the regulated industry, is a differentiator of managers. When you have somebody in healthcare who is really plugged into what is going on in Washington, that’s a big benefit.

**Kendra, Fitch:** I would say that when we start talking about the underlying credits which we are monitoring in 280 plus CLOs, we’re looking at idiosyncratic versus systemic risk or macro risk. A lot of what we are seeing is idiosyncratic. You think about what the impact will be of the new administration on systemic risk. We think about healthcare in terms of regulation, and I agree with what you’re saying, Tom, it’s not necessarily going to be impacting an entire sector.

Those are risks which we think about, but the CLO structure itself is fundamentally set up to protect against sector concentrations and focuses on that big exposure to systemic risk. It might impact different parts of the capital structure differently and you wouldn’t want to have concentrations in an underperforming sector, but the senior debt is fairly well protected because of the CLO structure.

**Mitchell, Webster Bank:** I am more focused on where spreads are, so when you think about an investment bank portfolio we play second fiddle to what the rest of the bank’s goals are. So for us I’m looking at a lot of these refinancing deals, with double-As in the 160bp, 165bp area and as a bank you have FDIC insurance costs. That will come out of your spread, so all of a sudden they don’t look as attractive as they did in December at 180bp, 185bp. I think for us we start to look at other potential fixed investments because, at least for our bank, we have had a lot of growth organically in floating rate assets. I think there are other assets, student loan ABS for example, where it may be more difficult for smaller banks to get involved because, as I mentioned, you need that specialized product model and expertise, but that is what happened in CLOs. If you look at regional banks and the smaller banks I don’t think in 2012 they had that modeling ability and product...
knowledge. So I think there could be a little bit of pullback at these levels for the AA tranches and I just don’t know whether these type of levels will be sustainable.

Stehli, Mizuho: The offset to higher prices in the loan market is what’s happening in the CLO market. It’s had a dozen refis already year to date and we’ve had one new issue, so when you look at those refis, we’re taking 20 to 30 basis points off the table in the cost of funds. That’s a tremendous offset to the benefit of the deal notes and the equity. These are typically either late 2013, but more often 2014 deals, and that’s very helpful when you get back into where we are on a weighted average spread basis. So as long as we’re at this part of the cycle where the prices are high, we’re going to continue to see a huge refi wave, and that’s going to benefit CLO investors.

The other thing I’ll mention is the number of investors that we see willing to own callable bonds over par has gone up a lot. There is a comfort level on how CLO structures work and the transparency that goes with that allows a lot of new investors to be more proactive in the space. The number of participants we see in the refis themselves has also gone up significantly from just a year ago. The last refi wave we had was largely driven by a few well-known big players. Those big players are still there but there are many more participants that have come into this market on the refi side, which drives the spread down.

Majewski, Eagle Point: It really is testing the maturity of the market. Kevin and I were commenting earlier on the concept that a shorter bond should have a lower spread than a longer bond with similar risks is a time adjusted measure in the fixed income market. For the CLO market, that’s a relatively new concept. Some of the investors we are seeing buying the refinanced CLOs want a shorter bond, and in many cases those buyers are mutual funds benchmarked to the Barclays Agg which going off index a little bit to buy a small floating rate component. These funds are large, with many at ten billion, one hundred billion, or more. While a $100 million order has a big impact on a CLO syndicate, it’s a drop in the bucket for many of these larger funds.

In terms of the arbitrage, no one has ever issued a CLO where they say “the arbitrage feels great!” Either loans are too rich or CLO debt is too expensive. There has never been a deal where we have had a great arbl. While a lot of people just add up the DMs on the right side of the balance sheet and compare that to the yield on loans, there is a lot of detail behind the scenes. The bad news is that triple-As now have 35 points of subordination, up from 18 points ten years ago. That is trending the wrong way and I believe it will come down over time. At the same time we are seeing five year reinvestment deals become more standard than not and we are seeing junior debt get issued at higher and higher prices. The math that makes equity investors happy is that we would rather sell double-Bs at par at 700bp rather than at a discount at 675bp. To the extent we can get the issue price much closer to par on the debt is tremendously valuable towards delivering equity returns. So there is a lot of detail behind what the spread on loans is versus what the spread on debt is in order to make equity investors interested. When we compare today versus a year ago when we had this roundtable, the reinvestment option was heavily in the money for CLO equity investors then. You could buy loans at 90 cents on the dollar. Unfortunately loans are at 101 today but we are able to tighten on the finance side of the balance sheet through CLO refinancing and resets.

GlobalCapital: Asian investors were big players in the CLO market in 2016. But with the new administration’s potentially hostile trade policies, is there likely to be an impact on the Asian investor base?

Majewski, Eagle Point: Notwithstanding the headlines and the political rancor, there is a worldwide trend of investors seeking dollar denominated floating rate assets. Political tides will turn and trade will invariably ebb and flow. There are many pockets in developed markets where investors are trying to find a way into floating rate dollar denominated assets. Now that may take a number of forms and CLOs can be a great way for investors to get access to those assets. Some of the trends in a few countries is less about getting into dollars and more about getting money out of their own currency. So whatever may be happening here, for many, it may still be better than being elsewhere.

Stehli, Mizuho: The story around Asia is different in different places. Japan has been investing in CLOs since the beginning and they continue to be there throughout. Over the last year or two we have seen an increase in the number of investors and their ability to participate. I think in 2015 it has been estimated that about 25% of the market for triple-As was out of Japan and 2016 was certainly higher. Part of that has to do with the dislocation and some of it has to do with the steady hands that continued to participate in the first half of the year. Outside of Japan, you have very active participation from Korea and you have some new entrants from China as well. China is interesting. You see them both participating in outstanding deals or getting behind Conning which then gets behind buying Octagon. You look at some of the money that is coming in, it’s not CLO money, but Skybridge was just sold to what is basically a Chinese conglomerate. So while you talk about a new administration and what the impact will be for China, at the end of the day Chinese companies that need to be invested are buying.

Kendra, Fitch: Our GDP forecast for the United States is a positive number and it’s probably the highest of the developed markets, so you are going to see a lot of interest in wanting to have exposure to US markets. I think you will continue to see a trend where interest rate concerns are global and depending on your interest rate environment that drives interest in investing in asset classes that have
higher yield prospects. So I think from a macro perspective we see that shift and it has been going on for a long time. We do a lot of investor education so we are going to continue to educate people in those pockets on understanding the US CLO market and the US leveraged loan market. Don’t discount the domestic demand though. It definitely ebbs and flows depending on the month or what is going on inside any of those institutions, but I do think we still have strong demand domestically. Now that US deals are going to be dealing with risk retention, that could also open up the market for more European investors.

**Stehli, Mizhuo:** I was just going to throw one last thing out there in terms of FX. We are definitely seeing a stronger dollar and that is going to have an impact on the yen-dollar for example, which is not at its highest level, but still pretty high. It is close to 85-90 basis points right now for the five to seven-year part of the curve. That is a real cost implied when buying US CLOs and will put some constraint on how tight we can go on triple-A as far as Japanese CLO investors are concerned.

**Shandell, Marble Point:** We’re a spread business, but it is interesting that leveraged loans are now becoming a floating-rate asset. I would argue that since 2009 or 2010 it was a fixed-rate asset because of the floor. Now Libor is above the floor and again we’re a floating rate asset and that’s attracting demand for our asset class.

**Majewski, Eagle Point:** I’d like to bring the risk component into the discussion. While it is hard to argue that loans are cheap today by recent standards, we only have to look back to the 2000s to see that the average CLO portfolio spread was probably at 375bp. That’s where CLOs were in 2003. Just to frame this, we got down to 225bp in 2007, but while it feels rich by recent standards, on a long term basis, this is really where loans are coming out of two and a half cycles ago. So we could argue that there is more room to run which could be bad. On the flip side, technical defaults substantially are taken off the table with covenant-lite loans and we talk about some of the challenges of healthcare or technology. Invariably, I don’t walk by a J Crew store without wishing them well every time.

There will be events in those spaces, but overwhelmingly, certainly many of the healthcare companies have runway. They don’t have covenants and it’s unlikely that they are going to have a technical default in the near term. We can probably talk about individual credits, which are not so good, but nothing we are talking about here points to a significant default wave any time soon.

**Shandell, Marble Point:** The maturity wall has been pushed out. Data on that is probably stale because of all those repricings and refinancing, but it’s probably pushed out even more. That bodes well for low defaults. And as Tom said, it’s really individual credits that have issues. Credits will default for the most part because they run out of money, not because they are going to have a technical default. And because the economy has been fine, I think it is really something external that has causes problem with an individual credit. So in retail, it’s the advent of online commerce, and the movement away from mall-based retail. Or it could be lower oil and gas prices for the energy sector.

**Kevin Kendra:** I remember a time when weighted average spread in a portfolio was 375bp as it is today. But I also remember 425bp, so it does swing and I don’t necessarily know whether it is healthy to be at 225bp. But certainly there are different points of time to look at and there is a reason why it got as high as it did. I don’t think that those factors exist anymore where you have an artificial bid on the CLO liabilities side. As far as fundamental credit goes we can think about where things are at now. We ended 2016 with a 1.8% twelve month default rate. That’s still low relative to historic standards. Some companies roll off, some roll in, so it should still be around 1.8% by the end of January. Our forecast is around 2% for 2017. That’s still relatively benign. I think one of the risk factors to think about is the impact of rising interest rates on already distressed credits like energy. Rising interest rates could have an impact on the interest coverage ratio. It probably won’t have an impact in 2017 but maybe further down the cycle.

**Medita Vucic**
BNY Mellon

**Vucic, BNY Mellon:** Data and transparency of data is what we are focusing on as the demand for it in real time is here.

**Shandell, Marble Point:** I have a question along those lines. You mention daily compliance tests, in the light of spreads coming down, and needing to test against it more and more frequently. Do you envision your industry providing products for managers so that they can very quickly interact, electronically or however, to get that information?

**Vucic, BNY Mellon:** Absolutely. Think the market is going to a point where there is more daily compliance reporting. We are working on delivering the information in various formats including electronically through our online compliance reporting system, LoanArc which will provide compliance tests and loan data. We are also looking at ways that we can help managers benchmark performance of CLOs.

**GlobalCapital:** We’ve been talking a lot about new money coming into CLOs. What are the barriers to entry in this market in 2017?

**Stehli, Mizhuo:** One of the places where we saw money forced to leave the US were in repos where you had European investors that were grandfathered in triple-A. But unless the repo deals were EU compliant, they were forced to be taken out of the trade and were really not in the position to reinvest in a non-compliant deal.

**Timperio, Dechert:** I think Jim’s right. European compliance will be a barrier to some investors, if the manager
cannot achieve it or has no way, if you are a US manager, of satisfying those requirements.

Solis, Dechert: If you have more than 10% US investors, you have to be US compliant, and a lot of European managers don’t want to deal with that. So there may be an issue for US investors because European CLO managers don’t want to be compliant with US rules yet.

Stehli, Mizuho: The flip side to that are Asian investors, coming back to your point about transparency. Wherever it comes from, whether it’s the trustee, reporting, accessibility, the manager or the marketplace, I know the analytics we have on our desk are a lot better and a lot more transparent than five or ten years ago. It’s a real-time event, so overseas investors don’t want to guess. The more they have access to information on a real-time basis, the better position they are in to make a well-informed decision about their investments.

We can look at any number of examples, such as the oil and gas industry or Valeant. Real-time moves and headlines on Valeant drove the discussion on the stock price from $250 to $15, as well as the loan price, which went into the low to mid-90s before coming back up.

We saw Asian investors with the right information in front of them reaching out to managers either directly or through us to ask questions about how they felt about Valeant. Most managers were quick to respond and gave some detailed position. It’s giving overseas investors greater ability to make decisions about a manager’s behavior. I know that this isn’t easy to analyse, it’s still interactive, but they have a lot more information at their fingertips. They ask good questions, and then hopefully make good decisions that suit them.

Majewski, Eagle Point: There is no more transparent pool vehicle than CLOs. Every month you can see every holding and every transaction. Mutual funds don’t do that and neither do hedge funds. The challenge is sometimes there is too much information, and how do you distil it.

Mitchell, Webster Bank: I would say there is a lot of work around aggregating that information and then analyzing and summarizing it, especially when you are at my level, and even more so in a timely manner. Where maybe it doesn’t add as much value because of the structure, you have 26%-27% double-A credit enhancement. You have all this information, you do get a monthly report, but then what do you do with it? You go through and look at the transactions that were made, try to understand management behavior, look if they are buying oil and gas exposure when prices are down, are they an active credit manager, or maybe they are trying to sell their oil and gas exposure into a rally. Then you speak to the manager about it, so that’s why I said it’s more of an art than a science.

Majewski, Eagle Point: We ended up spending well over $1 million a year as an advisor on system development. It’s to help our investors who all agree it isn’t very good but don’t want it to be an indigestible black box or such a mess of information.

GlobalCapital: To wrap up, what are your CLO primary issuance projections for 2017?

Vucic, BNY Mellon: Right now, I think the range is $50bn-$70bn, probably would say somewhere right in the middle.

Timperio, Dechert: I’m in the same range.

Solis, Dechert: I think $65bn-$70bn, because a lot of people were pessimistic last year about their predictions and yet it ended up being a pretty good year especially if you count resets as new deals. Although resets are going to be a lot more difficult because of risk retention.

Mitchell, Webster Bank: I’ll go on the lower end, and say $50bn. Not including refinanced deals.

Francis Mitchell
Webster Bank

Shandell, Marble Point: If you count resets, I would say $90bn.

Stehli, Mizuho: I would say go north of $60bn. I think you can go to $70bn if you count resets. Resets were $20bn last year, so you can cut that in half, as they will be harder to do this year. I think if credit remains tight, the resets could be interesting. We are looking at situations where you can take down the costs of funds and reset a deal. And there are still some outstanding questions on what’s compliant, how does that work, how do you adjust, so that number is probably smaller, but I’d say north of $60bn just on a pure new issue basis.

Kendra, Fitch: I’m going to answer the question differently. When we looked at the credit work we did last year, it was on par with what we did the year before because of the influx of resets and refinancing. When I think about what staff we need I think about the amount of anticipated credit work. I think we are going to be doing the same amount of credit work this year, though it could be in refinancing vs new issuance.

Majewski, Eagle Point: Just new deals, excluding refis and resets, we are of the view it could be $80bn-$100bn this year. Last year we were at $73bn across the market and we see a trend of new issuers. We think every issuer who issued last year can issue this year. With others entering the mix, we’re more bullish on resets as many CLOs are coming to the end of their investment period. Many collateral managers will say that they won’t put retention collateral in that but then they are threatened with the deal being called so they do a reset. Deals at the end of their reinvestment periods typically trade around clean NAV, so as an equity investor you might have other motivations. So I’m more bullish on resets.