BNY MELLON

Bloomberg Interview with Magnus Wilson-Webb, Managing Director and Strategist, BNY Mellon Corporate Trust
August 3, 2015

Interviewer: Well, there are many ways to lend a hand. One of them is through a sort of a quite complicated procedure called a collateralized loan obligation securitization structure. And we're going to talk to somebody who knows those CLOs inside out - Magnus Wilson-Webb is managing Director and Strategist at BNY-Mellon Corporate Trust Group. BNY Mellon, of course, is a custodian bank. And you oversee a lot of these CLOs. Remind us what a CLO is, because there was a point in time just a few years ago when they were a dirty word basically.

Wilson-Webb: Sure. Yeah. So CLO is a collateralized loan obligation. Basically, it's a securitization structure where the underlying assets are syndicated or leveraged loans. They differ slightly from a traditional securitization in that CLOs are actively managed, so whereas in a mortgage back security you have a pool of assets that exists for the life of the deal, in a CLO, the manager is actively trading those underlying loans for the first four or five years for the life of the deal. That's a key difference.

Interviewer: And those underlying loans, just give us an example of the formation of a very simple CLO.

Wilson-Webb: Sure. So the typical size of a CLO is maybe four or five hundred million dollars, so the manager will amass syndicated leveraged loans, maybe a pool of maybe 80, 100, 120 loans into that structure.

Interviewer: And they could be anything from healthcare company debt to-

Wilson-Webb: Yes, they're generally leveraged loans. Yeah, more sort of highly leveraged loans. It covers the full spectrum. Healthcare-

Interviewer: So consumer loans?

Wilson-Webb: No. These are all commercial loans, syndicated leverage loans into things like healthcare and autos perhaps, but no, not sort of consumer loans.

Interviewer: So then you put all that together and then you have a market suddenly in these kinds of instruments. How big was that market before the financial crisis and how much were CLOs responsible for the mess that ensued?

Wilson-Webb: Sure. I guess what's interesting about CLOs is how well they've performed over the last 20 years compared with other securitization structures. In fact, in the last 20 years, only one percent of CLO notes have ever been impaired in any way, and no AAA or AA note has ever defaulted, so it's really primarily because they are actively managed. So as the financial crisis hit, these managers were able to trade in and out of their underlying loan positions. So they all performed as intended through the crisis. Volume certainly dropped off, so they sort of got lumped in with the other securitizations with the other-

Interviewer: CDOs.

Wilson-Webb: CDOs, it's unfortunate acronyms. They sound the same but they're actually very different underlying assets. But yeah, they got tarred with the same brush.

Interviewer: I'm very curious how thorny the regulatory landscape is that you have to wade through here. We hear a lot about Dodd-Frank and the regulations still being written and reformed. How thorny a landscape is that for you?

Wilson-Webb: You're right. These are securitizations, so as such, they've been caught up in the securitization regulation. I guess the biggest issue at the moment in the CLO space is also called risk retention. So this is where the originators of a securitization structure have to maintain skin in the game. So they have to hold a five percent interest in the vehicle. And then for CLO managers, this is a challenge, because they're not the originators of the asset. They just buy assets to put into a CLO structure. They haven't had to traditionally put the capital up. Now for some managers, that's less of a problem. If they've got a well-capitalized parent, say a bank or insurance company, that five percent capital requirement is not a big issue. And in fact, they probably have been investing in their deals. But for smaller managers, it's quite a commitment. You think the average CLO as I said is four to five hundred million dollars. So, that's 20 to 25 million dollars they've got to put in each time. So the regulation that came out in October last year takes effect in December 2016, so managers kind of have two years to get this together. But it's a challenge, and what we're seeing is investors are really pushing managers now to show that they have a solution for risk attention.

Interviewer: Could you argue that it makes the CLO safer, or really does it matter because somebody ultimately has skin in the game anyway and nobody obviously wants to-

Wilson-Webb: Yes, and that's it really. The managers collect their fees based on the CLO performing as intended. And so this idea of risk attention came about obviously for more on the sort of RMBS side, where people were originating loans. They ship them off into a securitized structure and they're done. They have no further involvement and no recourse. In a CLO, it's very different. The managers are not originating loans--they're buying them, putting them into a structure, and managing them actively.

Interviewer: So now it's about a $130 billion market.

Wilson-Webb: Yeah.

Interviewer: What--is that notional value? Is that the way they describe it?

Wilson-Webb: That's about what was issued last year. The face value of CLO notes was about $130 billion.

Interviewer: And what was it at its peak?

Wilson-Webb: At its peak before the crisis it was just under 100. So actually last year was a record year. So it really tailed off considerably after the peak. It has come back very strongly. So 2014 I'd say was about 130, this year it's tracking around about 60 to 65. We're probably expecting about 100 billion again this year.

Interviewer: That's fascinating. Now, who invests in these or how takes a portion of the tranche?

Wilson-Webb: Yeah, well, that's it and the tranche is sort of the key thing. Like most securitizations they are tranche structures from the AAA all the way down to the junior note known as the equity piece. So the AAA investors have traditionally been banks, insurance companies, pension funds. And then as you move down the capital stack to the higher risk notes, higher return, you get the sort of private equity and hedge fund players coming in. Now, regulations have changed things a little bit, but those are primarily investor banks.

Interviewer: And they're all domestic companies that are involved here or could there be a CLO that--obviously with the pharmaceutical deals that have been going on, many of the pharmaceuticals are no longer domestic companies anyway. So do you find yourself--would an institution find itself investing in France or Ireland without realizing it? I mean, obviously they realize it-

Wilson-Webb: No, not generally. What you'd find is that the CLOs issued out of the US are primarily US underlying loans, but yeah, there's an active CLO market in Europe where they invest in European companies but you don't tend to get that cross-border investment in the underlying assets.

Interviewer: When you just look at the universe here, I'm curious of the number of managers. Are we seeing that number grow, reduce, what's it look like?

Wilson-Webb: Yeah, so it's been reasonably stable over the last couple of years. I think what we're expecting as a result of risk attention, is that some managers will drop out. This additional capital they have to put in, either they're not going to be able to find a way to fund themselves, or it doesn't make economic sense to do it. So I think the general feeling is we may see a reduction of maybe 20 to 30 percent in the number of managers, not necessarily in the volume. The issue is just in the number of active managers.

Interviewer: Is it only banks that have to adhere to these rules? Can other types of operations securitize a CLO and not retain the risk?

Wilson-Webb: Yeah, sure, so the CLO managers, they all have to retain the risk. So risk retention reprised to every CLO manager. Where the banks are specifically impacted I think like the Volcker Rule where the banks can no longer hold a AAA CLO note if it's not Volcker compliant. And one of the big issues for CLOs is they always used to have a small component of bonds in their underlying assets, and that meant they fell foul of Volcker. So CLOs have been busy either restructuring, amending themselves to get rid of the bonds, or this rule took effect July 21, so a couple of weeks ago. In the run up to that kicking in, we did see increased selling of AAA notes as banks were getting out of non-Volcker positions.

Interviewer: We're going to have you back I hope to tell us more about the CLO market and how it's evolving. As you say, it's at a record now, $130 billion worth of loans, but there could be implications and maybe it could shrink and maybe have implications for the broader economy depending on regulations and how that proceeds. We've been speaking with Magnus Wilson-Webb, managing director and strategist at BNY Mellon.