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Trends and Risks in Global Securitisation during the Covid19 Years

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Post-2008 decline in securitisation

- Many of the causes of the GFC were attributed to abuses of structured finance and innovations in securitisation (Turner Review in UK; FCIC in US)
- Post-crisis bias combined with a number of regulatory corrections meant that securitisation market was almost moribund between 2009 and 2014
  - New risk-weighing under Basel III
  - Risk retention rules
  - Liquidity regulation
- In the US large percentage of securitisation market post-crisis relied on government-backed issues

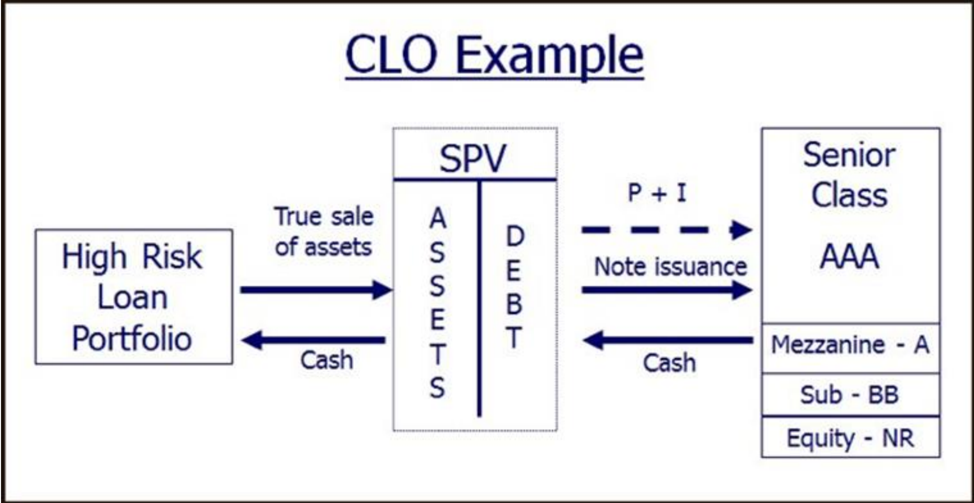
…And resurgence

- Climate started to shift in 2014 with the initiative backed by the Bank of England and the ECB to restart securitisation in Europe
- The above became a central pillar of what eventually became the EU Capital Markets Union, and the STS Regulation as part of it
- STS (in place since 2019) aims to create a more transparent market where investor can more easily access underlying information concerning securitised assets – Simple, Transparent, Standardised Securitisation
    - Aim to recreate 1990s' securitisation (S. Schwarcz)
- Securitisations receiving STS label are subject to a better prudential treatment
- Above policy mirrors global one under the Basel securitisation framework, and particularly the STC (Simple, Transparent, Comparable)

Post-crisis evolutionary trends

- Post-crisis years presented an economic environment dominated by low interest rates, a dysfunctional credit system, and at the same time, appetite for high yields
- Leveraged loans started being originated by both banks and non-bank financial institutions - Emergence of new asset class
- New market participants became the fulcrum of the structured credit market: from investment banks to private equity firms
- Leveraged loans became the main asset for a new breed of collateralised loan obligations (CLO)
- Despite resembling the traditional securitisation structure, CLOs adopted some rather peculiar transactional dynamics

The mechanics of CLOs



Key features of CLOs

- Homogeneous asset class being repackaged, and low levels of default correlations, compared to pre-crisis CDOs
- Central role of private equity firms acting as both sponsors and managers in the transaction
  - Instrumental in the process of loan syndication – no single originator
  - They often own leveraged firms that access loans
  - They engineer LBOs that stand behind leveraged loans
- True sale between asset pool and SPV, with the latter issuing tranched bonds to capital markets investors
- Indirect exposure of individual banks to CLO market

Problematic transactional features

- Underlying asset portfolio is characterised by high-risk loans: “cov-lite” loans (financial incurrence covenants instead of maintenance covenant)
- Reliability of the rating process: claim of over-collateralisation of junior tranches but in the context of dynamic transactions ratings are based on hypothetical portfolios and modelled stressed scenarios
  - Question of default correlations during the pandemic!
- Risk retention requirements: hindering viability of CLOs, exception since 2008 (LSTA v SEC), so requirement not upon CLO managers
- Employment of total return swaps by investors to hedge exposure to very risky bonds (TRSs fell within the cracks of post-2008 regulation)

Regulatory questions

- Question: would a collapse in the CLO market have spill-over effects on the financial system and the wider economy?
- A) different types of exposures that large banks have to the CLO market, and different level of interconnectedness with relevant market participants (FSB mapping)
- B) banks are better capitalised than in pre-crisis years, but their stability is largely assumed by backward-looking models, whereas shocks in the CLO market may entail scenarios not within models
- C) mechanisms of interconnectedness (TRS) create homogeneity in market participants’ balance sheets and fragility due to layers of leverage
- D) stability of CLO market portrayed during the pandemic may be the result of optimistic estimates and flawed credit ratings

Concluding remarks

- Effects of CLOs on the financial system as a whole may be as poorly understood now as CDOs were before 2008
- Reiterated and increased reliance on private debt creation has increased the level of leverage at the global level
- Basel III has played positive role in strengthening the stability of large banks, but it may be poorly equipped to deal with this new wave of financial innovation due to the peculiar transactional structure of CLO, and the involvement of non-bank entities

Thank you for listening

Further reading:

- V. Bavoso (2021) “Basel III and the Regulation of Market-Based Finance: The Tentative Reform”, *NYU Journal of Law and Business*, (forthcoming)
- V. Bavoso (2020) “Hail the New Private Debt Machine: Private Equity, Leveraged Loans and Collateralised Loan Obligations”, Vol.14 Issue 3 (141-150), *Law and Financial Markets Review*

- Q&A
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