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CREDIT MARKETS

Expected Surge of CLO Downgrades Slow to Arrive

Reviews so far by ratings firms suggest the market is poised to avoid the same fate as subprime mortgage-backed securities in 2008



Credit-ratings firms put collateralized loan obligations under review for possible downgrades earlier this year when the coronavirus pandemic forced many businesses to close.

PHOTO: BRIAN SNYDER/REUTERS

By [Cezary Podkul](#)

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After the coronavirus pandemic shut many businesses this spring, the three major credit-

possible downgrades. The potential wave has turned out to be more of a dribble.

Many worried the downgrades would rattle the \$700 billion market for collateralized loan obligations, or CLOs, which have drawn comparisons to the subprime mortgage-backed securities central to the financial crisis.

But with the two biggest ratings firms now about 50% done with their reviews of these securities, many are emerging with unchanged ratings or tepid downgrades of about one notch.

The results suggest that the market for collateralized loan obligations is poised to avoid the steep downgrades and forced selling that hit subprime mortgage-backed securities in 2008. Other metrics of CLOs' health have also improved, prompting more optimistic outlooks.

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“We thought things would improve, but things have improved even more than we thought,” said David Preston, a CLO analyst at Wells Fargo Securities in Charlotte, N.C. “I think it shows the resiliency of the CLO structure.”

Bankers create CLOs by buying up hundreds of risky corporate loans and slicing them up into a stack of securities with different returns. Buyers of the safest, triple-A-rated bonds assume less risk than equity holders, who take the first hit if loans go bad and a CLO loses money.

The uncertainty created by the coronavirus pandemic caused many loans owned by CLOs to suddenly become riskier, prompting Moody's Corp. and S&P Global Inc. to announce they would review hundreds of CLO bonds for possible downgrades.

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Of the nearly 1,500 bonds issued by CLOs that Moody's placed on review for downgrades, 22% have now been downgraded. Another 27% have seen their ratings confirmed, and 51% are still awaiting a final outcome of the review, according to a tally provided by the firm, which includes both U.S. and European CLO bonds.

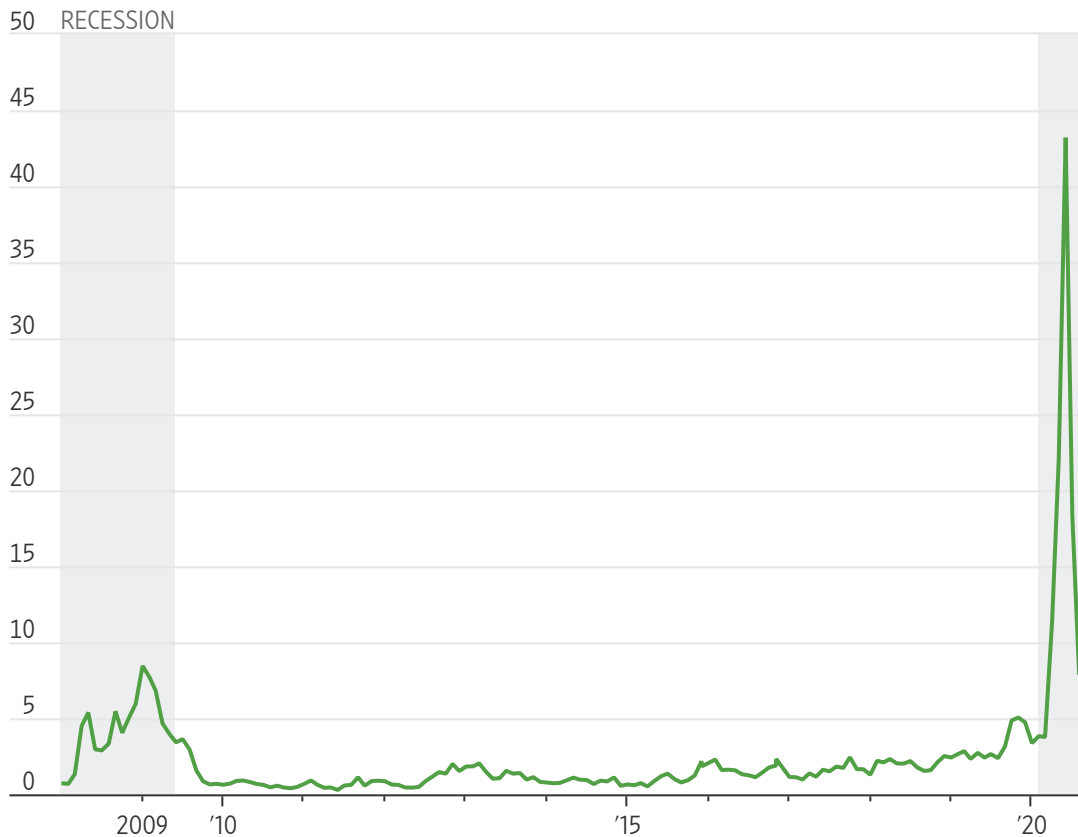
Rival S&P placed a much smaller number of CLO bonds on review for possible downgrades—about 630, according to figures from the firm. S&P has also concluded reviews for about half of that portfolio, downgrading 237 bonds, or about 38% of the U.S. and European CLO securities it placed on watch for possible downgrades.

Fitch Ratings put 290 bonds issued by CLOs on watch for possible downgrades, mostly in Europe. The firm has so far downgraded around 12% of those securities and is continuing to watch more than 70% for possible downgrades.

Across just U.S. CLOs, S&P said it has downgraded about three out of every four bonds it has finished reviewing, moving the grades lower by approximately 1.4 rungs on average. No triple-A securities were affected, Moody's, S&P and Fitch said.

S&P pinned the downgrades on deteriorating conditions in the market for risky corporate loans that underpin CLOs. Known as leveraged loans, these obligations saw a massive wave of downgrades this spring as the coronavirus pandemic shut businesses. At their peak, leveraged loan downgrades outpaced upgrades by a ratio of about 43-to-1, according to LCD, S&P Global's loan research arm. That has slowed to about 8-to-1 as of July.

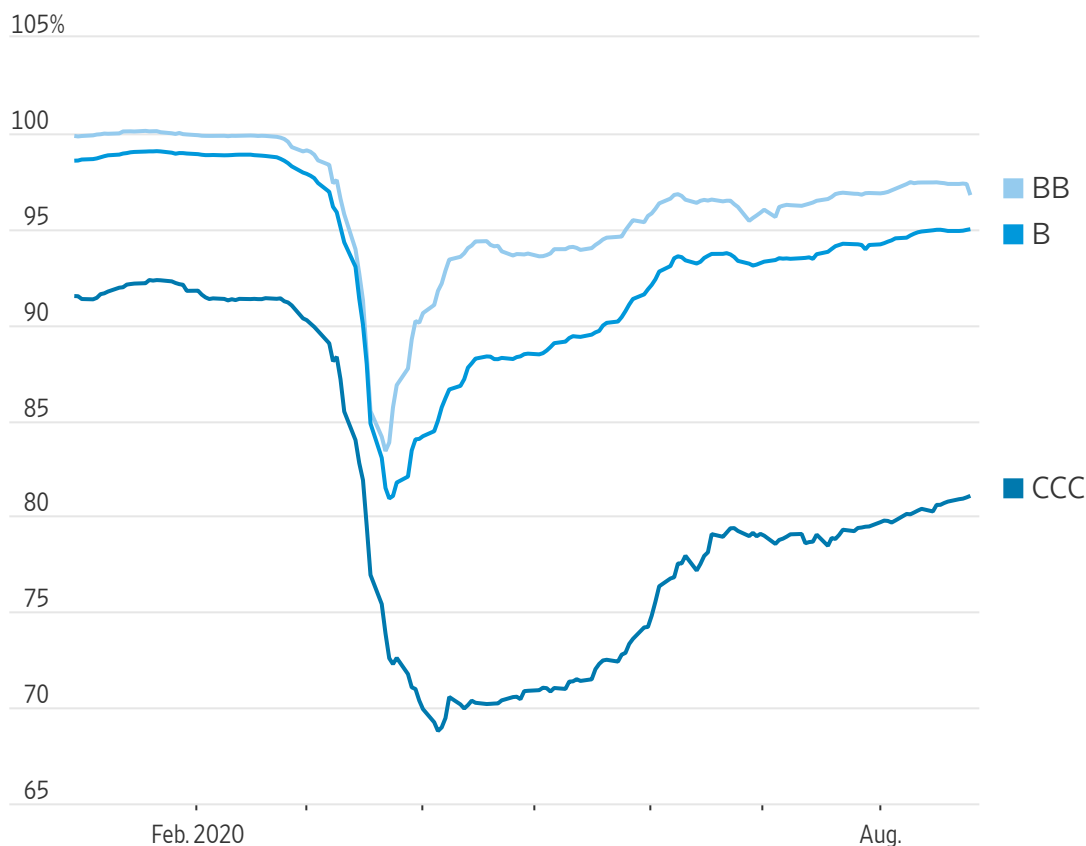
Rolling three-month ratio of downgrades-to-upgrades in the S&P/LSTA Leveraged Loan Index



Source: LCD, a unit of S&P Global Market Intelligence

As downgrades slowed, prices for corporate loans have also recovered, giving CLOs more breathing room. Most CLOs enable their managers to trade loans in to and out of CLO portfolios. The rising market enabled managers to clean up their books by selling lower-rated triple-C loans at higher prices, or cashing in on loans they bought at a discount earlier this year.

Prices on loans by select credit ratings. CCC rated loans are riskiest, BB less risky.



Note: Composite bid prices expressed as percentage of face value

Source: Solve Advisors

The market hasn't entirely recovered yet. CLO issuance is still down significantly, with \$48 billion of deals sold so far in 2020 versus about \$81 billion in the same year-earlier period, Wells Fargo estimates. CLO equity investors may also question their desire to invest in new deals if returns don't improve, according to Poh-Heng Tan, an independent CLO analyst.

"They need to see that the returns are there, otherwise the market will be slowing down a lot," said Mr. Tan, a former CLO trader at Blackstone who now runs CLO Research Group Limited in London.

Worries also persist over whether ratings accurately reflect the risk that investors are taking on when they buy CLO debt. A review published in the Journal of Structured Finance found that ratings firms are inconsistent in how they apply their methodologies to CLOs and may be deviating from the criteria, which govern how grades are supposed to be assigned.

"What do the ratings mean when the ratings firms are not following the methodologies?"

report. “It can become very difficult for a user to make heads or tails of it.”

Elsewhere in debt markets, the yield on the benchmark 10-year Treasury note settled Friday at 0.727%, down from 0.744% Thursday, according to Tradeweb data.

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