

# the brave new world of CLOs

story by  
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**Global issuance of collateralised loan obligations has reached record levels. And with two Australian banks bringing epic deals to market over the last 12 months, investors are beginning to embrace the structure. But some still express reservations.**

**A**NZ Investment Bank (ANZ)'s head of structured product sales, Nick Fyffe, has noted an about-turn in institutional investors' attitudes towards synthetic collateralised debt obligations (CDOs). But he questions whether their enthusiasm was based on the fact that so many wanted the opportunity to invest in his bank's recent synthetic balance sheet collateralised loan obligation (CLO) offering – and were therefore keen to express their commitment to the market in general.

In September, ANZ and National Australia Bank (NAB) issued two huge, fully funded synthetic CLOs, both selling about A\$2 billion (US\$ 1.5 billion) into the market. Both enjoyed strong demand and ANZ ended up doubling its original size at launch.

Unlike synthetic CDOs, which are linked to a pool of credit default swaps, the CLOs were referenced to real underlying loans. In comparing the two, Fyffe says: "Synthetic CDOs are reproduction furniture – they're well built and are perfect if what you want to do is use them. CLOs, on the other hand, are more like the genuine antique. Because of their scarcity value their price may go up over time. If you want to trade, you buy antiques. If you want income to maturity, a CDO may be better."

## Diversification appeal

For the Australian market, which is awash with financials, property and Kangaroo issuers, the offer of

exposure to a range of corporate borrowers – some which might never choose to issue physical bonds – undoubtedly held considerable appeal.

Last year, when NAB launched its inaugural Australian deal, Martin Halloran, head of capital markets structuring at nabCapital, predicted that there would be many more deals to come.

He was right. Globally, about A\$20 billion has been issued this year to date, from issuers including Barclays, BNP, Royal Bank of Scotland, Standard Chartered and Sampo Commerz. All of the deals have used synthetic structures, similar to Australian CLOs, although Halloran points out that not all were fully funded capital structures.

For ANZ, its Resonance Funding Series 2006-1 represented its first synthetic balance sheet CLO deal. Starting at A\$975 million, the bank doubled its offering to A\$2.1 billion to meet institutional demand for the notes.

Similar to NAB's first deal back in November 2005, the issue was backed by 110 equally weighted investment-grade corporate loans issued by ANZ. More than 80 per cent of the reference entities were domiciled in Australia and New Zealand.

About A\$2 billion of the credit-linked notes were rated triple A – typical in these deals where the super senior tranche tends to represent a good 90 per cent of the offering. There were seven tranches ranging from A\$1.4 billion of Class A1 notes through to

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A\$12 million of double B-rated Class G notes. ANZ will retain the first loss exposures of 2.5 per cent. The Class A notes were offered at 20 basis points over swap.

Toward the end of September, NAB issued its global Southern Cross 2006-1 series through Script Securitisation Pty Ltd. The bank offered about US\$1.48 billion of multi-currency notes which were linked to a replenishable portfolio of international and Australian corporate loans, a small portion being sub-investment grade.

The deal offered five classes of notes, which went from triple A down to double B+. NAB has exposure to credit losses of up to 3.43 per cent of the total portfolio amount, or US\$53 million. All classes were offered in euros, US dollars and Australian dollar tranches.

The deal had a maturity of 4.75 years, and at 17 basis points over swap for the super senior notes, it was also priced inside NAB's earlier 3.5-year deal and ANZ's three-year issue.

ANZ's global head of securitisation, Alison Gray, says her bank's deal was driven by regulatory capital requirements. The loans, prior to the securitisation, would have attracted an 8.0 per cent risk weighting. Following the securitisation, and with ANZ holding the first loss, the capital position goes down to 2.5 per cent.

### More to come

Mei Lee Da Silva, director, structured finance ratings at Standard & Poor's, says there is likely to be quite a few more deals of this type in preparation for Basel II, including offerings from some of the smaller banks.

"We expect several deals, not only smaller banks getting into the action but also smaller corporate (small to medium enterprise) portfolios that are being risk managed," she says.

"Banks are more conscious of Basel II as the implementation date draws closer. And it's not just about lower regulatory capital – the economics may make sense too."

Gray agrees. Basel II will make all banks more actively manage their capital positions – to decide which assets they want to retain and which assets they want to sell. I think we'll see a real change in securitisation in the Australian market going forward."

But NAB's Halloran disputes the perceived motivation behind the banks' issuance of these deals. He points out that structures such as NAB's earlier issue and ANZ's inaugural deal only include investment grade corporates. Given such loans are lower risk weighted under Basel II, there is little point in including them for such capital management purposes.

Instead, Halloran believes they make much more sense for some of the banks that are investing in these deals. "They wouldn't buy non-effective Basel II bonds," he points out.

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The CLOs attracted a wide range of institutional investors, both domestic and from overseas, including Europe and Asia. ANZ says about 50 investors participated in its deal, including fund managers, industry funds, middle market investors, banks and structured investment vehicles. Halloran says NAB's deal included high end investment managers, boutique high yield fund managers and specialised capital funds, including hedge funds.

### Investor reservations

There are investors who express some reservations about CLOs. One concern relates to the fact that because credit derivatives were used to transfer the risk, rather than a special purpose vehicle as in traditional securitisations, the banks didn't have to disclose the corporate names behind the loans.

According to Perpetual Investments (Perpetual)'s senior portfolio manager, Darren Langer, while the senior triple A-rated pieces are reasonably secure, it becomes a more problematic investment the further down the capital structure you go. "You're talking about a blind portfolio. You just don't know what's there."

Ky Van Tang, portfolio manager, fixed income, at Aberdeen Asset Management, expresses similar concerns. "It's not something that we'd pile into. Presumably you're investing in the banks' ability to assess their loans. But unless you see the names, you don't know the right price for it."

Halloran says his bank tried to counterbalance this with a high granularity of information – more than some synthetic CDOs, he notes.

He also points out that the names in the pool are not able to be hedged in any case. "There's not an active individual credit default swap market for these names so it's not a matter of being able to manage your exposure through hedging."

But Langer has another concern. While these CLOs offer diversity in the Australian context, they still cannot compare to offerings. "Offshore banks' CLOs have less likelihood of an overlap with our existing portfolios, but the blind portfolios are still problematic." ■