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The pressure facing some banks is self-inflicted. Their portfolios lack exposure to CLOs

Fears about the stability of our banking system led to bank runs in March. In turn, this led to the failure of several regional banks — and one large, international player.

When deposit runs occur, banks are like any other investment vehicle capitalised with short-term funding: they must sell assets to meet client cash demands. Investment managers will be familiar with this — it's what they do when banks mark down the assets on their repo lines.

Considering the historic focus of banks on safe, highly-rated assets, it is surprising to see how quickly losses can rack up. A common misstep by these failed banks was that they owned principally fixed-rate securities, with durations far longer than their deposits. Had these banks had more of their assets in floating-rate CLO paper, they would have had far fewer losses and might still be standing.

The banks that find themselves in a fix

Unlike prior periods, such as the financial crisis in 2009, when many institutions held assets of dubious credit quality, today's bank assets are primarily US treasury securities and highly-rated MBS, each highly likely to pay off at par when they mature. Regrettably, the lion's share of these assets are fixed rate, and their values fell significantly as rates rose. Had these institutions held floating-rate assets, like CLO triple As, instead of facing mark-to-market losses, they would have seen their net investment income increase.

Since March 2022, the Federal Reserve has implemented one of the fastest rate hike plans in recent memory. In a short period, rates have moved over four hundred basis points, causing significant losses on long duration fixed-rate debt. With markets volatile, returns in 2022 were challenging across nearly all fixed income markets, with CLO triple As being one of the few asset classes to show a positive total return last year. By comparison, assets held by banks recorded negative returns.

CLO senior notes are floating-rate securities that reset on a quarterly basis and closely follow the dynamics of the Fed Funds rate. One might excuse the long interest-rate duration of IG corporate and Agency MBS exposures if they were significant outperformers when rates were low. However, even during such times, CLO triple As have historically been cheap on a relative basis.

It is no surprise that some of the largest, most well-managed US banks own nearly $200 billion of CLO securities in their portfolios (though even that is likely still less than they should hold), and they have benefited from increasing income and lower price volatility thanks to the floating-rate nature of CLOs.

Liquidity in CLOs is greater than it seems

In general, the argument for leaning into other asset classes has been a belief that CLOs introduce more credit risk and offer less liquidity than comparable products. Both thoughts are antiquated and patently untrue.

CLOs represent the largest floating-rate asset class within structured credit, and CLO triple As, with over $500 billion outstanding, are a scalable investment in a growing asset class. Indeed, there is often billions in weekly trading volume in the secondary market. Should a holder need quick liquidity, one can seek bids on CLO triple A positions within an hour or two. Even during times of severe distress — as in March 2020 — investment managers accessed liquidity and sold roughly $2 billion of CLO triple As in a matter of days.

The historical performance of CLO triple As is pristine. Due to the highly diversified underlying asset pool and strict concentration limitations, allied to collateral quality tests and structural subordination, no CLO triple A in the history of the asset class has ever experienced an impairment. CLO senior notes have all paid off at par, while also providing a higher total return than many other comparably rated assets.

The unfortunate bias against increasing CLO triple A exposure at some banks is misguided. How many more will fail due to rate mismatches before floating-rate CLO triple A debt becomes a staple in every bank's investment portfolio?

> CLOs do not introduce more credit risk, nor do they offer less liquidity, than comparable products

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