OAKTREE INSIGHTS

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A DEEPER DIVE INTO STRUCTURED CREDIT

OAKTREE

333 S. GRAND AVE 28TH FLOOR, LOS ANGELES, CA 90071 | (213) 830-6300 | WWW.OAKTREECAPITAL.COM

A DEEPER DIVE

INTO STRUCTURED CREDIT

KEY POINTS

- The structured credit asset class can be quite complex even as it has become a well-established segment of the fixed income market.
- To help deepen investors' understanding of the asset class, we at Oaktree have set out to further develop a discussion that we kicked off in July with *Structured Credit Then vs. Now*, a piece that covers the ways in which the asset class has shifted over time, particularly since the Global Financial Crisis (GFC).
- The following is an edited excerpt of a recent conversation with Oaktree's Structured Credit co-portfolio managers, Brendan Beer and Justin Guichard. It highlights the value of the asset class in the real economy; offers Oaktree's perspective on structured debt analysis; and provides a comparison of leveraged loans with subprime mortgages.
- It is our view that structured credit offerings, when underwritten and managed appropriately, can serve as an attractive alternative to traditional fixed income investments. In addition to yield, structured credit products provide the potential to improve risk-adjusted returns and serve as an important diversification tool.

Q: Oaktree Insights *Structured Credit Then vs. Now* dealt with the evolution of structured credit. That has prompted us to look at other questions that investors may have about the asset class. We'll start with this: Structured credit still carries the connotation of being "nichey." Is that fair? How would you characterize the structured credit market today?

Justin Guichard: Some may view structured credit as a little-known niche market, but at roughly 17% of the total U.S. debt market, it's not an insignificant segment.[1] The absolute size of the structured credit market stands at more than $11 trillion, with about $7 trillion of it accounted for by mortgage-backed debt guaranteed by an agency of the U.S. government. For comparison, the global high yield bond and leveraged loan markets add up to about $3 trillion.

Q: Some market participants may believe that structured credit was fashioned and fueled by Wall Street to generate fees. Is that right? Or does it have some real value for the markets and investors?

Brendan Beer: Structured credit has the potential to provide value to financial markets and its participants. Securitization — the process by which a group of non-tradable financial assets such as loans or receivables is converted into a structured credit product — creates tradable securities with greater liquidity than the original assets. This can help improve market liquidity and efficiency.

Securitization can also be valuable to banks and ultimately improve the availability of capital to the markets. The process removes loans from banks' balance sheets and thus allows banks to originate, monitor and collect loans at a scale greater than what may have been possible if the banks were limited to activities they could finance with their own deposits and capital. I'm reminded of a 2011 report by the Joint Forum, which is a group representing various international financial regulators.[2] This report highlighted that re-establishing securitization markets — *sustainable* securitization markets, to be sure — was high priority after the financial crisis. It credited these markets with having the potential to support provision of credit to the real economy and improve banks' access to funding. This emphasizes the constructive role of securitization in the context of banking and the greater economy.

Q: What about the benefits to market participants, aside from the implied advantage of increased market liquidity and efficiency?

JG: Both investors and issuers can find value in securitization. Investors can benefit by having access to relatively liquid investments and payment streams that might not have been available if all financing had been performed through traditional banks. They can also gain the ability to customize their risk exposure with risk/return profiles and liquidity terms that are most appropriate for their investment objectives. For instance, fewer investors may be willing to invest in real estate or car loans directly, but more could invest in tradable securities backed by such debt. In addition, investors can benefit from the diverse pools of assets within each securitization. The assets also are shielded from the bankruptcy of other entities thanks to the bankruptcy-remote nature of the special purpose vehicles that are used to issue the securities.

"Investors can benefit by having the ability to customize their risk exposure with risk/return profiles and liquidity terms that are most appropriate for their investment objectives."

– Justin Guichard,
Managing Director and Co-Portfolio Manager, Structured Credit

Issuers can certainly benefit from access to structured credit as a financing tool. These are entities ranging from corporate borrowers to specialty finance companies, and they can utilize securitization as an alternative means of funding their business, alongside issuance of bonds, preferred equity or common equity. Securitizing some of a company's cash flow-generating assets can be cheaper than issuing a corporate bond. The quality of the securitized vehicle's payment streams may be higher than the quality of the underlying business itself, thus allowing the issuer to tap into lower interest rates reserved for borrowers of higher credit quality.

Q: What are some ways structured credit products can be analyzed? Is this task best suited for quants who specialize in statistical models?

BB: Statistical analysis, which relies on broad assumptions on rates and borrower performance, has long been the norm for evaluating structured credit investments. But we at Oaktree would argue that, in order to avoid undesirable investment outcomes, a traditional evaluation of creditworthiness and asset value must accompany such a statistical approach. Underwriting each loan or mortgage (i.e., each company or property) allows investors to better understand the risks of each securitization. It should be noted that for some types of products within structured credit — such as credit card asset-backed securities (ABS) and student loan ABS — the detailed information that would allow for such scrutiny is not always available.

Q: This next question has surfaced rather prominently, along with the strong growth experienced by the leveraged lending market in recent years: Are leveraged loans, the basis for collateralized loan obligations (CLOs), the new subprime mortgage? Aren't there similarities to the mortgage frenzy that preceded the GFC?

JG: Notable growth in the leveraged finance market has many investors uneasy about what they view as a parallel to the subprime mortgage boom that led to the last recession. A decline in lending standards and in the covenants attached to leveraged loans is certainly a current concern. But, while investors should pay close attention to potential risks, we believe there are key differences between today's loan market and the subprime run-up to the last credit crisis that should be considered.

For one thing, the risk of systemic collapse in the financial system today is smaller than in the 2000s. Non-bank entities, such as institutional investors, that are considered "non-systemically important" have come to replace traditional large banks as the primary providers of leveraged finance. To the extent that banks do underwrite leveraged loans, they "appear well positioned to deal with these exposures," according to the latest Financial Stability Report by the Federal Reserve,[3] in good part because they are far less levered. This report says that banks have "improved their management of the associated risks" of leveraged lending, including pipeline risk, which would cause banks to hold larger portions of the loans on their books for longer than expected.

The bulk of demand for leveraged loans comes from formed CLOs. These, unlike other historically active loan-investor types, such as mutual funds and hedge funds, are closed-end vehicles without any obligation to provide liquidity to their tranche investors. Further, while it is difficult to predict how CLO debt and equity-tranche investors would react to periods of market distress, it should be noted that the CLO investor base today is more stable than in the past and has relatively stable funding, in contrast with the investment vehicles of the pre-crisis era that relied heavily on short-term wholesale funding.[4]

BB: Other important distinctions between leveraged loans and subprime mortgages are the character of the borrowers and the process involved in investors' purchase of structured products backed by these loans. Issuers of leveraged loans are operating businesses with substantial assets, which generate positive EBITDA and produce audited financial statements. Further, they are reliant on a variety of business trends in a variety of industries, as opposed to subprime mortgages, all of which were dependent on a single factor: home prices.

Professional, institutional asset managers purchase these loans on behalf of a CLO only after credit underwriting and an adversarial negotiation process with the arranger, trying to get the best terms and price for the CLO. These loans are also analyzed through detailed underwriting and monitoring. In contrast, the borrowers via subprime mortgages had little, if any, income or assets, and were evaluated based on dubious documentation at the time of borrowing while facing no obligation to report financial developments after securitization. Specifics on borrower credit profiles and details on the precise asset being mortgaged were not disclosed to investors. Also, loan originators were often highly conflicted and had little motivation to impose credit and pricing discipline upon the lending decision. In short, they were often paid for volume and retained no "skin in the game."

In addition, most CLOs allow for active management of the asset pool. This means that in the event of a credit issue, the CLO manager has the ability to exit or reduce exposure to that credit. This contrasts with other securitizations that have static asset pools and limit the manager's ability to trade out of a troubled asset.

Lastly, there is not the same kind or scale of a derivatives market sitting on top of leveraged loans today as there was leading up to the subprime mortgage crisis. Many systemically important institutions a decade ago had outsized exposures to synthetic collateralized debt obligations (CDOs), which were backed by credit default swaps. These were largely credited with helping propagate the risks from the mortgage market throughout the broader financial system. Our research indicates such a market for synthetic CDOs does not exist in relation to leveraged loans today.

JUSTIN GUICHARD

Managing Director and Co-Portfolio Manager

Mr. Guichard joined Oaktree in 2007. He is a managing director and co-portfolio manager for Oaktree's Real Estate Debt and Structured Credit strategies. In addition to his strategy management responsibilities, Mr. Guichard is responsible for investing capital for Oaktree's Real Estate Debt, Real Estate Income, Real Estate Opportunities, Structured Credit and Global Credit strategies. Prior to Oaktree, he worked for Barrow Street Capital which, he joined in 2005. Mr. Guichard began his career in Merrill Lynch & Co.'s Real Estate Investment Banking group. He received a B.A. degree from University of California, Los Angeles, where he was an Alumni Scholar, and an M.B.A. from MIT's Sloan School of Management.

BRENDAN BEER

Managing Director and Co-Portfolio Manager

Mr. Beer is a managing director and co-portfolio manager for Oaktree's Structured Credit strategy. In addition to his role within the Structured Credit strategy, Mr. Beer also assists with the arranging and optimization of Oaktree-managed CLOs. He joined Oaktree in 2017, having previously worked at Guggenheim Partners Investment Management, serving as a managing director and co-head of structured credit. At Guggenheim, he managed a team responsible for in excess of $40 billion, which performed credit analysis, trading and risk management across private label RMBS, CMBS, ABS and CLOs, with Mr. Beer specializing in CLOs and Esoteric ABS. Prior thereto, he was a vice president at Citigroup Global Markets, as a secondary CDO trader and in securitized products distribution. Mr. Beer previously spent eight years in the Navy, as a division officer aboard a fast-attack nuclear submarine and as a classroom physics and chemistry instructor. He earned an M.B.A. from the University of Rhode Island, an M.S. in nuclear engineering from the Massachusetts Institute of Technology, and a B.S. in mathematics (honors track) with distinction from the United States Naval Academy.

END NOTES

[1] Institute of International Finance. As of the first quarter of 2019.

[2] The Joint Forum operates under the auspices of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors.

[3] May 2019.

[4] Financial Stability Report, May 2019. Board of Governors of the Federal Reserve System.

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