Covered CLOs as Robust Bank Funding

In a previous *Creditflux* article I argued that many financial institutions are inherently unsafe and unsound since they deliberately combine high leverage with debt funding that matures long before the principal repayment of the banks' underlying assets. As short-dated debt (such as commercial paper, retail deposits, and repurchase agreements) matures, a bank trusts that there will be sufficient market confidence in the firm's solvency and asset valuations to permit the bank to roll its debt. Sudden loss of market confidence, then, can be fatal since the bank cannot repay its maturing debt through asset maturities or other cash flow.

Contrast this asset-liability mismatch with the mechanics of a CLO. The CLO debt tranches do not have definite maturities because the maturity of the assets (underlying corporate loans) controls the repayment of principal on the debt. For this reason and others, I propose that banks emulate this funding structure to the extent possible by issuing what I suggest we call "covered CLOs". A covered CLO is simply a "standard" balance sheet CLO with the new feature that the issuing bank guarantees principal and interest payment for every debt tranche. Each tranche would then have credit ratings equal to or better than the bank's senior/unsecured debt rating.

European banks already make heavy use of covered bonds. A recent *Creditflux* news item notes that covered bonds constituted the majority of bank debt issuance for a week in January 2011. Covered bonds generally employ residential and commercial mortgages in the form of both whole loans and structured securities as collateral. There exists regulatory uncertainty on the question of whether all such pledged collateral will be available to covered bond investors upon the issuer's default. We consider covered CLOs to be much more robust in the quality and transparency of collateral relative to covered bonds and also to have more certainty of issuer remoteness. Default of a bank as a guarantor to a legally separate debt obligation should not give regulators access to the CLO investments under any plausible theory of "bail-in".

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Stepping back, it's easy to understand banks' addiction to short-term funding. It's cheap money. I have a knowledgeable and intelligent career banking regulatory acquaintance who romanticises bank funding mis-match as a "socially useful transformation of short-term funding into long-term informationally opaque assets" (my accurate paraphrase). I disagree – I say it's just cheap money. It gives the bank larger net spread in good times at the cost of de-stabilising liquidity risk.

The point of covered CLOs, then, is not simply to defeat liquidity risk but to do so with minimal funding cost. Investors in covered CLOs will earn yields that are less than either the freestanding CLO investments or the issuing bank's long-term senior/unsecured debt levels. In a typical transaction of the pre-crisis period, banks would issue balance sheet CLOs to reduce regulatory capital while incurring higher funding cost (since even the triple-**A** CLO tranche traded wider than bank funding). The covered CLO differs in that it does not reduce a bank's regulatory capital requirement, but the funding cost should be markedly lower.

If and when banks do issue these covered CLOs, the optimal capital structure and level of waterfall complexity will likely differ from those of typical, un-guaranteed CLOs. It may be that banks will issue some tranches – such as the equity – without the guarantee. The investor universe will likely draw from current covered bond investors rather than CLO investors. Clearly the ultimate form of this proposal will evolve to meet market demand and issuer needs. Banks need to follow "responsible lending" criteria to protect their shareholders and the financial system. Covered CLOs represent the equally important need to practice "responsible borrowing" for precisely the same reasons.

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