HORIZON
from
SKADI

Nicolas Corry   **Damian Taylor**

February 2024 Edition

In this month's HORIZON:

- **CLOs** – Are Collateralised Loan Obligations enjoying a boom? Or setting up trouble ahead?
- **CRE –** Commercial Real Estate – is your collateral up to scratch?
- **Culture risk** – if decision-making forums say one thing, but communications say another.

CLOs

Issuance is great business for banks. The perception is that fee income is quality income. It is low risk. In reality, fee income comes with considerable risk attached. Most lead managers will know that, once a deal goes live, the deal moves to hard risk. If you make the decision to launch, you need to be pretty sure that the deal will succeed. Otherwise, it is likely that you will be wearing it.

Exciting business is where leads are so confident of success, they actively employ capital and balance-sheet, underwriting so-called "**bought deals**". The increased fee income on a bought deal, as well as the attractive terms which the bank will buy the deal are commensurate with the increased risk that is taken.

If press reporting is correct, then some lead managers are underwriting the Equity[1] portions of Collateralised Loan Obligations (CLOs). As the Global Financial Crisis disappears in the rear-view mirror, now over 15 years ago (oh my, I am old....!), there are concerns that this could represent exuberant lead manager behaviour.

CLOs represent a multi-stage fee earning proposition. Well before the CLO is sold to investors, banks that are arranging CLOs offer loans to collateral managers to construct the portfolio of loans underlying the CLO. Then, when the CLO is sold on to investors, arrangement fees can be earned. This means there are possibilities for prudent **reserving** of fee income, which can protect the bank, if they have underwritten portions of the CLO.

Whilst the Equity is recognised as the riskiest tranche of a CLO, the Equity tranche holders possess a valuable **call** right over the entire CLO, so in this sense they have a quasi-ownership. This protects Equity holders, in that should the yield on the

[1] Whilst referred to as an Equity tranche, all tranches of a CLO are debt. The Equity tranche is the most subordinated portion. After all other tranches are paid, the equity holders receive what's left. This can be lucrative, or, if there is insufficient income, can result in receiving nothing! Leads seem to be underwriting around a fifth of the Equity tranche on selective CLO deals.

portfolio of loans held by the CLO fail to meet its obligations to the tranche holders, the structure can be terminated. On termination the underlying portfolio is sold and capital returned to tranche holders. There is also the option to restructure the CLO. For the Collateral Manager, who earns fees from managing the CLO, they are protected by a non-call period. During this time, they can actively manage the portfolio underlying the CLO without worrying that the Equity holders can call the CLO.

Whilst the call feature of the Equity tranche has value, it is unlikely that banks helping to arrange CLOs would want to retain holdings in Equity tranches for long due to the punitive cost of capital. It is also in the interest of Collateral Managers to be Equity tranche holders, to have some control over their own destiny. An area of risk could be where banks struggle to sell the Equity tranche holdings they have. Particularly on deals closing in the second half of the year. The business may be tempted to recognise fee income earned, "kicking the can down the road" on the Equity tranche holding they may be left with. Independent price verification processes may not be effective if they fail to recognise that pricing for the Equity tranche will likely come from the same desk that is holding the paper.

Another consideration has to be on the power of the call option Equity tranche holders possess, and how this could be misused. In broad terms the Equity tranche comprises about 10% of the deal. Consequently, there is control over the remaining 90% of the structure, once the non-call period ends. For **money launderers** a CLO collapse offers the possibility of a mass cleaning event. The risk could be heightened in nonperforming CLOs, where holders are all too happy to sell to a willing party. From the launderer's point of view, the non-performance can be considered a cleaning fee. Once a majority stake in the Equity tranche is acquired, connected parties could work to acquire all tranches price insensitively, exercise the call, and receive funds which appear fully legitimate.

We don't want to over-egg this risk, but point out that the possibility exists. Those who have attended SKADI's Money-Laundering through Wholesale Markets **training** will recognise this scenario, amongst other ways, that Launderers could misuse the Wholesale Markets.

For control staff at Wholesale Financial firms, we feel the following areas should be considered:

- Fee recognition vs warehoused risk: Are finance and the business exercising prudence around underwriting of Equity tranche holdings. Are retained positions held as part of the trading book, or are these held on separated out books? Do Market Risk have sufficient line of sight over positions to be able to identify those which have been acquired as a result of underwriting. Has reserving fee income been considered as well as the ageing of positions?
- Approvals: When proposed deals are brought before origination committees, are considerations being given to concentration risks both inside the firm, but also in the broader market? At the approvals stage, are there any restrictions being placed on follow on issuance? If so, how would risk and the business monitor these restrictions?

- Independent Price Verification: Do IPV staff recognise that the business holding a large Equity tranche may well be the underlying price provider when sourcing pricing? Are steps being taken to review pricing on a relative basis within the sector?
- Money-Laundering through Markets Risk: Are Front Office staff sufficiently aware of the potential risk a CLO collapse represents?

Commercial Real Estate (CRE)

Returning to a theme we have talked about in previous issues of Horizon, there have been several headlines this month regarding problems in the Commercial Real Estate (CRE) sector. Notable headlines came from Deutsche Pfandbriedbank AG (Deutsche PBB), who **increased provisions** to EUR215m from EUR44m the previous year. This, along with problems at Signa Group (for which Julius Baer have been forced to increase provisioning) and other headlines such as "Office Tower Deal for $1 Reveals Anxiety Among Long time Buyers" [Bloomberg, 27-Feb], mean that CRE will continue to remain an issue whilst interest rates remain "higher for longer".

Real estate is often used as collateral for various financial transactions such as loans and, as we wrote about way back in the August 2022 Horizon "Spotlight: Lessons from the last crisis"…

"Where lending agreements are backed by Eligible Collateral Schedules, Control functions should be focused on whether collateral is indeed "Eligible". Whether valuations are correct. Whether inputs to models are up to date after prolonged periods of low interest rates and relatively stable markets."

We are not going to get into a detailed discussion regarding accounting treatment of valuation approaches across various jurisdictions (Bloomberg has a good article on it here) but highlight the fact that some have external valuations quarterly, some annual, some use only transactional data as an input, others use transactions and sentiment data.

On any asset class facing bouts of stress coupled with illiquidity, the risk exists that valuations become stretched. Fair Value measurements can contain **caveats** such as where an "orderly transaction would take place between market participants". This can leave the door open to staff interpreting, and also misrepresenting, where such transactions could take place, as well as being able to argue certain observable transactions may not be representative for marking purposes.

A further area of risk is where external parties are using firms' capital to lend or source opportunities, and these joint ventures or arrangements lie beyond the sight of risk functions. This can be the case where foreign banks team up with local partners to be able to access markets. As stress continues to be evidenced in CRE, it would be timely to **revisit these arrangements** and how these are being accounted for.

For control staff at Wholesale Financial firms, we feel the following areas should be considered:

- Check robustness of methodology used to underpin valuation of illiquid assets, paying particular attention to deals and lending arrangement close to loan-to-value triggers.
- What line of sight does the business have over holdings which have covenants or undertakings calculated from real estate valuations?

Culture risk: decision-making forums

A theme we highlighted in our "SKADI Emerging Risks 2024 Outlook" publication was one around decision-making committees and forums. Within financial institutions there are a number of forums that meet to discuss customers, business proposals and the raising of capital. Information from these meetings is rarely seen or shared outside of these forums, but it is often documented. Minutes are taken which can later be used in **regulatory investigations**, litigation and disputes.

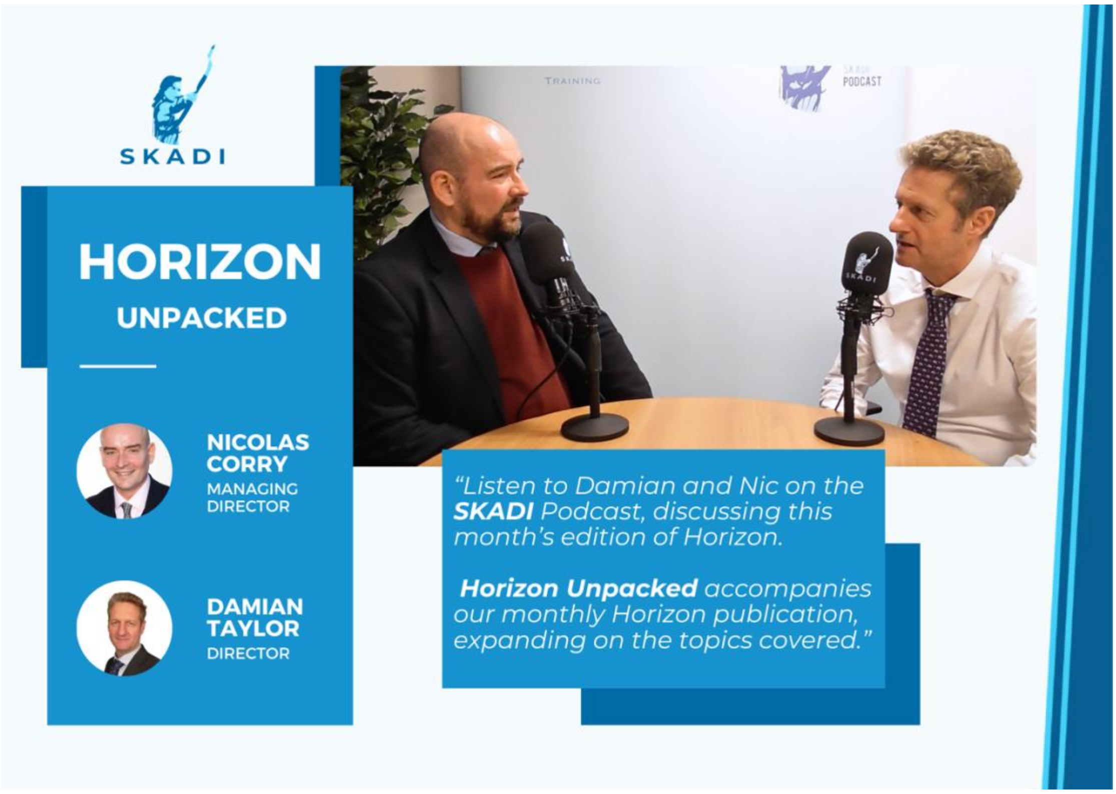
One story that re-iterated this point this month has been the case in the High Court of Frasers Group versus Morgan Stanley, which we spoke about at length in the SKADI Podcast a couple of weeks ago. Whilst we are not party to all of the details, there have been a number of press stories regarding internal communications and call logs where dealing with Mike Ashley were discussed.

What this again shows is that there is now an audit trail of many internal discussions, some which may not be expected to see the light of day, that may end up becoming part of a future investigation. One can envisage situations where banks could be accused of **misrepresentation** if customers have been given information which later does not tally with documentary evidence which comes to light.

From a control's perspective, we would encourage staff to:

- Identify and grade what confidential decision-making forums exist.
- Examine the framework and controls around documenting and sharing views from confidential decision-making forums within the institution.
- Review how information is conveyed to customers in such a way as to ensure accuracy, avoid tipping off (in the case of money laundering-driven decisions) and avoid potential future embarrassment.

Previous **Horizon** editions can be found [here]



SKADI

enquiries@skadilimited.com
www.skadilimited.com