
2008-08-21

PRESS RELEASE

Agency problems in structured finance - a case study of European CLOs

by Joachim Keller

NBB Working Paper No 137 - Document Series

The current turmoil in the credit markets has led to a debate about the desirability of securitisation and the viability of the "originate-and-distribute model" of banking. One of the concerns among market observers is that participants along the various links of the securitisation chain face incentive, or agency, problems. In other words, they do not have appropriate incentives to act prudently but rather seek to engage in self-serving strategies that are detrimental to investors and other participants in the chain.

This article focuses on potential agency problems in leveraged loan securitisation, which has seen enormous growth in recent years due to the boom of leveraged buy-outs and the associated ample supply of leveraged loans. Specifically, the article analyses the agency problems facing the management of collateralised loan obligations (CLOs). CLOs are the most important type of special purpose vehicles used in leveraged loan securitisation, and their managers appear to have considerable discretion in their actions and impact on performance. The article is a case study that analyses the presale reports and prospectuses of European CLOs.

The article identifies the different dimensions in which agency problems may occur. The analysis reveals that CLO managers may engage in adverse strategies related to the build-up of the portfolio, ongoing loan-trading decisions and to the treatment of impaired loans (work-out decisions). The article also describes the various mechanisms that have been put in place to mitigate these problems and assesses whether they are working effectively. Although the mechanisms, which include structural provisions, financial incentives and reputational concerns, should work fairly effectively, the analysis reveals some gaps which may allow managers to engage in certain adverse strategies. Specifically, there are concerns about the reliability of constraints on overall portfolio risk and about the effectiveness of reputation as a disciplining device. Both concerns are related to the benign market conditions until the summer of 2007 which – at least until now – prevented, any "stress-testing" of CLOs and differentiation between managers.

Evidence on CLO transactions in which managers buy/hold a portion of the equity tranche is also discussed. Although retention of the equity tranche is only one of several incentive-aligning mechanisms and not a general requirement, the analysis reveals that factors related to agency problems can explain why, in certain cases, managers buy/hold a portion of the equity tranche. Specifically, first-time managers and managers of a risky transaction buy/hold a portion of the equity tranche more frequently. Furthermore, competitive effects and the passage of time play a role: the results show that the share of CLO transactions where the manager buys/holds a portion of the equity tranche has decreased over time, pointing to a possible deterioration of lending standards in the market. This result supports one of the article's findings, namely that the way in which agency problems are dealt with is in some cases subject to market trends.