

Incentives of Fund Managers and Precautionary Fire Sales

Discussion

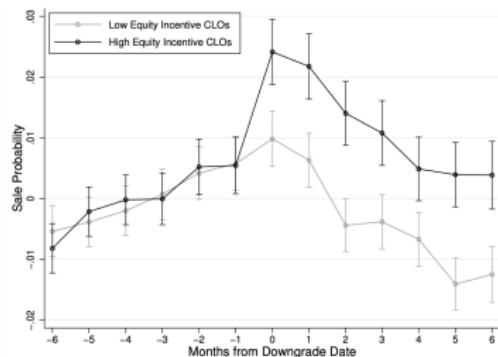
Kunal Sachdeva

May 24, 2022

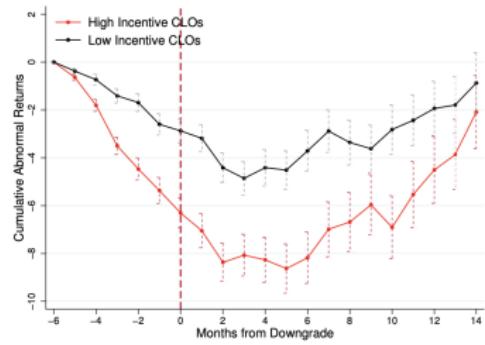
Summary of Paper

Precautionary Selling and Price Impact on Loans

Question – How does precautionary trading behavior of fund managers induced by a higher junior fee component in their compensation structure affects prices of downgraded loans in the leveraged loans market?



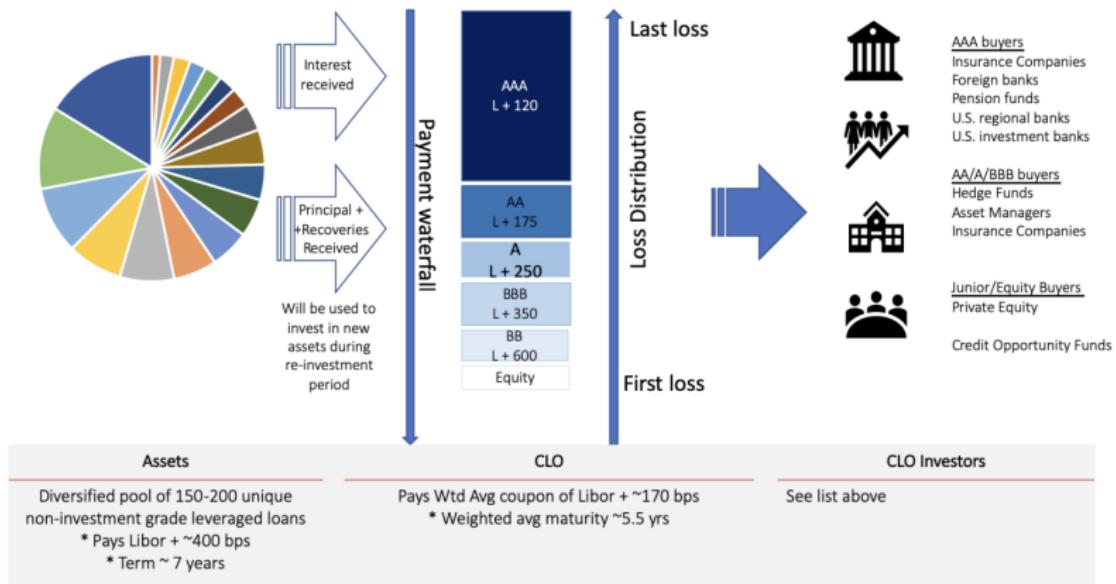
[A] Differential trading



[B] Negative CAAR

Focus on CLO Structure of Loans

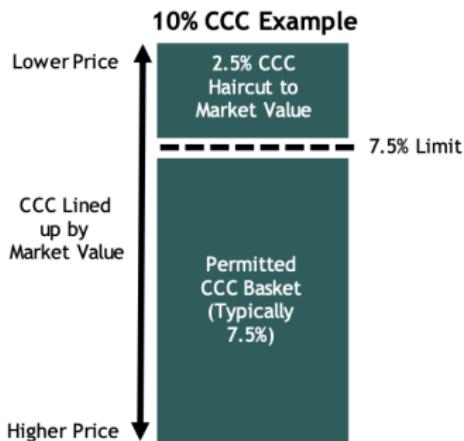
Lower Rated Loans



Over-Collateralization Covenant

Permitted CCC Basket

OC Covenenat Intended to Improve The Credit Quality of CLO



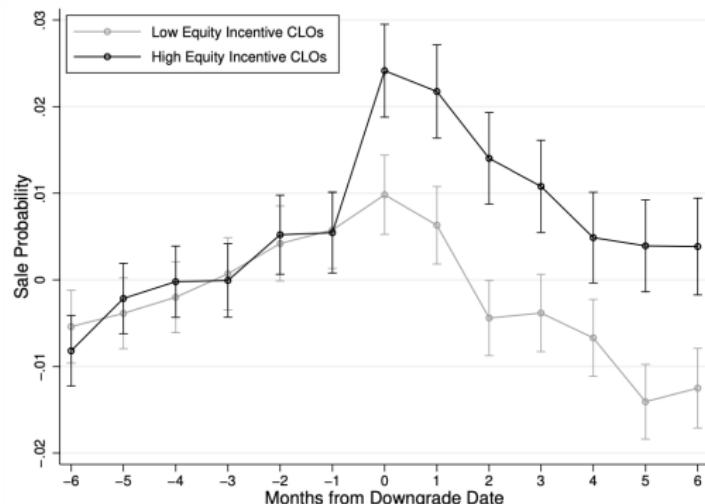
- CCC loans above limit are subject to haircut
- Monthly tests of over-collaterlaization
- *If covenant is triggered – Junior fees to manager is suspended and divert interest to restore the CLO's credit quality*
- **Clear economic incentive for CLO managers**

[A.] Precautionary Selling

Compares the same firm between CLOs

Precautionary selling by CLO managers:

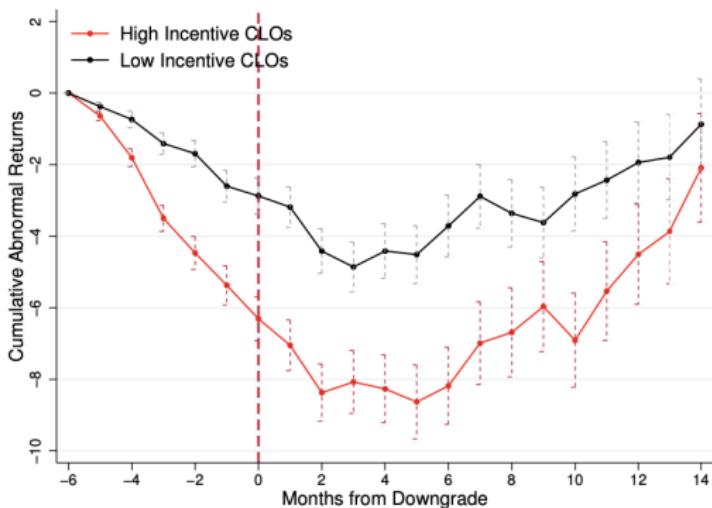
- Study loans that are downgraded to speculative grade
- Focus on loans not downgraded to CCC or below
- SD increase in fee ratio → 4% increase in propensity to sell loan



[B.] Negative Cumulative Returns

Selling results in negative abnormal returns for loans:

- Focus on firms held by CLOs with high incentives
- Excess selling demand lead to fire sales
- An additional 35% to 60% decrease in price for firms held by high incentive CLOs



Perspective on the Paper

What are

Thoughts about the paper:

- Clear economic incentive for fund managers to respond
- Thoughtful analysis of the CLO market, likely channel affecting trading decisions
- Filled with robustness tables to show that these results are not sensitive to a given specification

Focus of Comments:

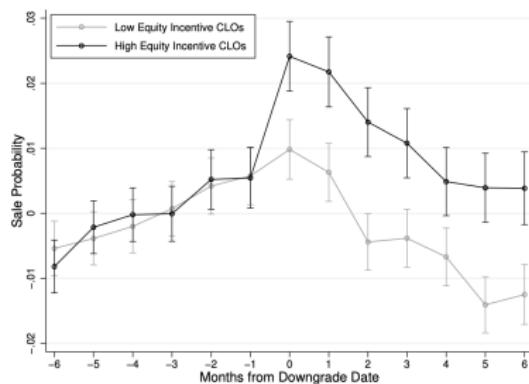
- Helping pin-down if the fees are actually driving these result
- Other tests that would ensure internal consistency
- Focus on contribution – what we can learn more

Comment 1

Could other incentives of CLO Managers drive these results?

Does the threat of losing junior fees income drives precautionary sales?

- Back of the envelop calculation suggests \$300,000
 - $\$500 \text{ million} \times 30 \text{ bp} \times 20\% \text{ probability of failing OC test}$
- Is this large enough to induce selling loans by CLO managers?



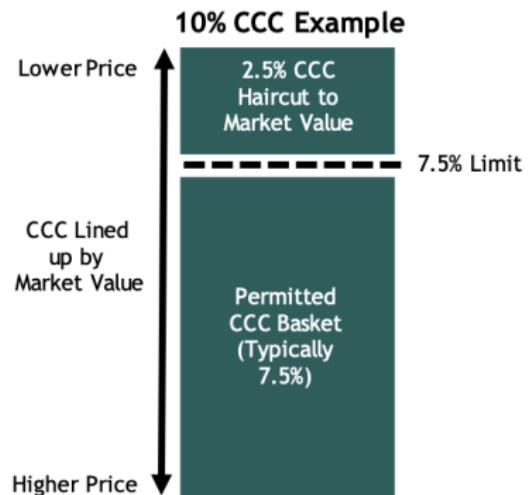
Are there other potentially reasons that are equally or more important?

Comment 1 (cont...)

Could other incentives of CLO Managers drive these results?

Overcollateralization Gap

- Is there an interaction between the junior fee and the remaining OC gap?
- Studying the junior fee is a partial explanation
- Current study focuses on the ratio of the junior to senior fee

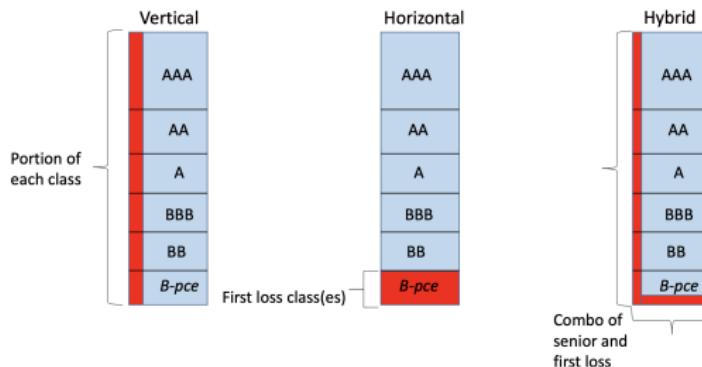


Comment 1 (cont...)

Could other incentives of CLO Managers drive these results?

Risk Retention of CLO

- Does their risk retention relate to junior fees?
- Risk retention? From 2014-18, implementation of the Dodd-Frank rule (Section 15G)
- Consider those with a 5% vs. those that hold the junior tranche?



Comment 2a

Do CLO Managers Anticipate Future Downgrade?

Provide more support to the main channel put forward

Predictive of future downgrades

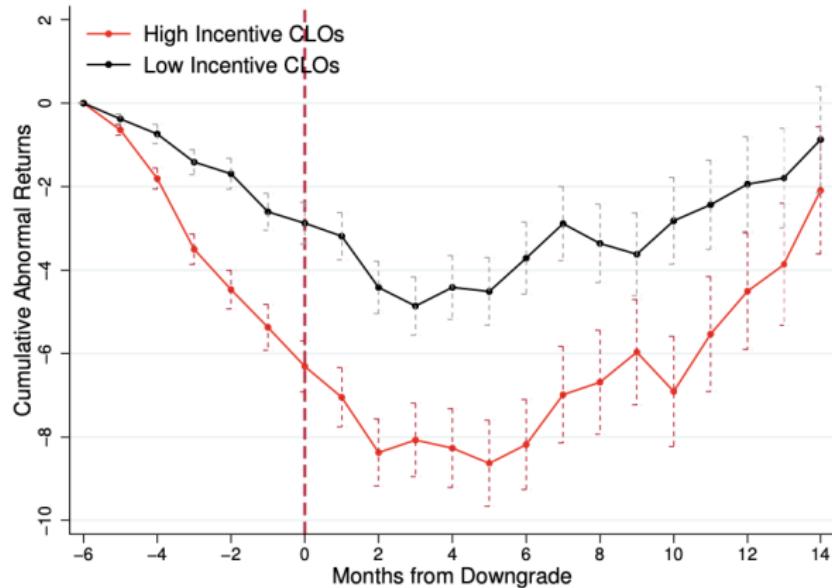
- The sale should be linked to the future downgrades to CCC+ or below
- Look at loans that were downgraded to B- or above, see if they have a higher propensity for future downgrades vs. those held

Higher mark-to-market for loans retained

- Conditional on being held and downgraded to CCC, loans should have a higher market value than those sold and subsequently downgraded to CCC
- Testing this may be difficult based on how the sample is currently constructed

Comment 2b

Do CLO Managers Anticipate First Downgrade?



→ Does this include negative/positive guidance?

Comment 3

What more do we learn from this paper?

What more can we learn from this paper?

1. Fund managers respond to compensation contracts

2. Precautionary selling + downward sloping demand curves lead to fire sales

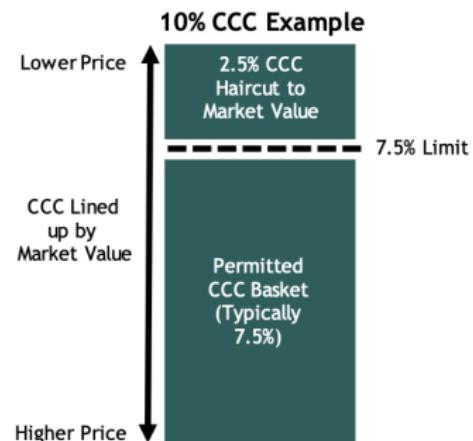
Comment 3 (cont...)

What more do we learn from this paper?

What was the original reason for the junior OC limit?

Possible Interpretations:

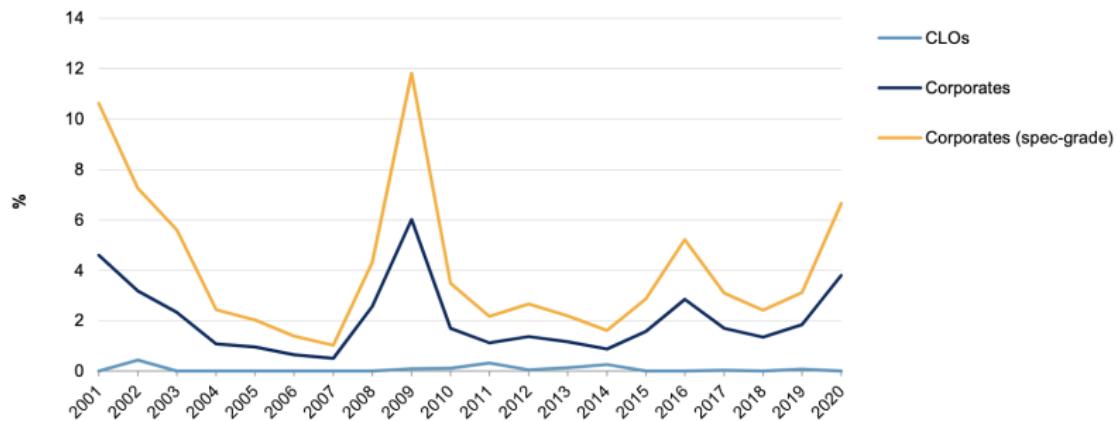
- Precautionary selling self serving for managers
- Reduces risks of CLO, ensure managers sell loans likely to default
- Increase tail risk due to common holding across CLOs
- (something else...)



Comment 3 (cont...)

What more do we learn from this paper?

Annual U.S. Default Rates (CLOs vs. Corporates)



Default rate for "CLOs" and "Corporates" includes all U.S.-rated entities. "Corporates (spec-grade)" includes only companies rated 'BB+' and below. Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®.

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Very Interesting Paper!

Thoughtful and Convincing Analysis

- Increasing and important to understand how contractual terms translate to trading activity and risk in the economy
- The empirical analysis is convincing that the pattern exists, push the paper to pin-down this channel
- Does this contractual term lead to greater or less risk? How do we think about this?