MARCH 2014

Q&A

ANGEL OAK CONSULTING GROUP

Collateralized Loan Obligations (CLOs) in Bank Investment Portfolios

Conversation with Berkin Kologlu,
Senior Portfolio Manager of Angel Oak Capital Advisors, LLC

Q Collateralized Loan Obligations (CLOs) have increased in popularity in bank investment portfolios. What are CLOs and why has there been an increase in bank interest?

Kologlu: Yes, according to SNL, U.S. banks held approximately \$69.81 billion of CLOs at the end of Q3 2013, up from approximately \$52.64 billion as of Q4 2012. CLOs are a form of securitization backed by a pool of secured bank loans to non-investment grade companies in a special purpose vehicle. A cash-flow waterfall is used to create different tranches. The seniority of a CLO tranche is determined by its position in the waterfall, which provides structural credit enhancement. In our opinion, the credit enhancement in CLOs is robust, especially in CLOs issued after the crisis and helps protect investors from defaults in the underlying loan portfolio. The availability of different CLO tranches enables investors to pick their investment class based on their risk tolerance and return targets. We are seeing increased bank interest in CLOs at the top of the cash-flow waterfall due to their demand for high quality floating rate credit risk as opposed to interest rate risk. CLOs offer high current floating rate yields, can be purchased at a discount, and have compelling risk-weighted capital requirements.

Q How do CLOs differ from broadly syndicated bank loans and why does the Angel Oak Capital Advisors team prefer investing in CLOs over bank loans in the current environment?

Kologlu: Some of the main differences between CLOs and bank loans are diversification, prepayment risk, LIBOR floors and liquidity. First, diversification is a key difference between the two. Bank loans can carry individual borrower risk and industry risk. CLOs, in our opinion, offer investors a clear advantage because they provide

BERKIN KOLOGLU

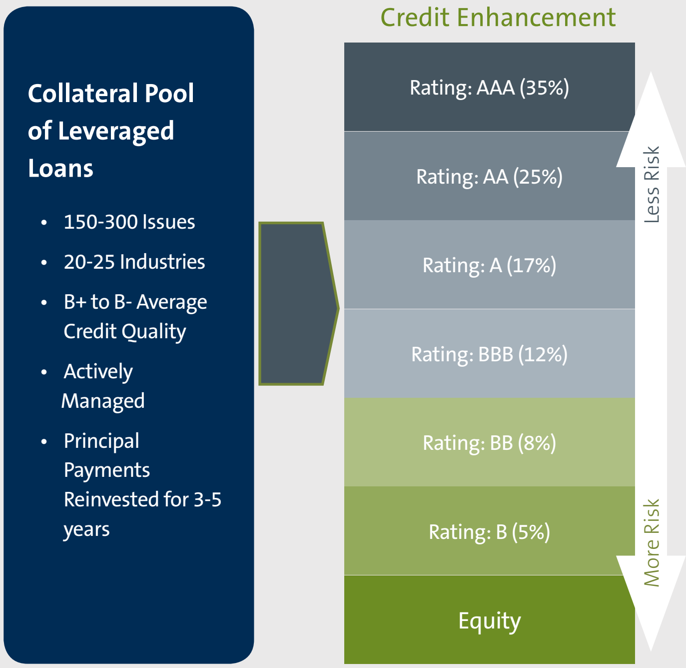
Mr. Kologlu focuses on building and managing strategies within the Collateralized Loan Obligations (CLO) market, in which he has been involved for 11 years.

Immediately prior to joining Angel Oak, he served as an Executive Director at UBS covering structured products and client solutions for six years. Previously, he worked for Bank of America, focusing on the structuring and marketing of CLOs and synthetic Collateralized Debt Obligations (CDOs) backed by corporate credit.

Mr. Kologlu received his MBA from Duke University Fuqua School of Business in 2002.

TYPICAL CLO STRUCTURE

Cash flow from the loans trickles down in a waterfall: each capital tranche receives payments only when the tranche above has received its full share of income and principal.



exposure to a diversified portfolio of bank loans – typically 150 to 300 credits. Also, they are required to maintain high levels of diversification among individual credits and industries. To put things in perspective, one of our CLO holdings will generally be diversified among more than 150 different credits, across multiple industries, and will have the added benefit of credit enhancement that helps protect investors from defaults in the underlying bank loan portfolio.

Second, prepayment risk is quite different between the two. Broadly syndicated bank loans are typically issued with a 6-12 month soft call, which means the loan can be prepaid at any time with a small penalty in the first 6-12 months, but can prepay without a penalty thereafter. Bank loan investors are at risk of refinancing and re-pricing, which could lower the expected return of their investment. In the first quarter of 2013, a majority of the bank loan deals being brought to market were re-pricing transactions, which meant borrowers were taking advantage of the capital inflows into the bank loan market to reduce their cost of borrowing.

Conversely, CLOs are typically issued with a two-year hard no-call, so the prepayment risk is less than bank loans. For our bank clients, we like the AAA, AA, and A-rated tranches because the risk of principal or interest loss is minimal and they are almost always issued at a discount. So, any call scenario gives our investors the potential to be paid out at par in a much shorter time frame, resulting in the opportunity for additional gains for our holdings.

Third, bank loans may benefit from current LIBOR floors, which pay the higher of LIBOR or the floor. CLOs do not have LIBOR floors, so CLO returns should increase if LIBOR increases, allowing banks' assets to reprice if the Fed begins tightening. Today, average LIBOR floors on broadly syndicated bank loans are approximately 100 bps (1.00%) and three-month LIBOR is around 25 bps. So, bank loan investors are receiving that 75 bps benefit from LIBOR floors, which enhances the total income. The flip side, however, is that bank loans aren't really a floating rate instrument as their returns will not increase until LIBOR exceeds 100 bps. This can take 6-9 months from the point at when LIBOR starts to increase, based on what is implied from forward curves.

When looking at liquidity, broadly syndicated bank loans are generally more liquid than CLOs. This is because of the availability of two-way markets on a large subset of the bank loan market and a larger overall market size – total CLOs outstanding are about \$285 billion versus \$640 billion outstanding for bank loans. In a normal market environment, liquid bank loans trade with a 0.25 to 0.50 point bid-offer spread whereas CLO AAA and AAs typically trade with a 0.5 to 1.0 point bid-offer spread.

Q How does Angel Oak evaluate CLO investments for their bank clients?

Kologlu: The four main variables we examine when evaluating a CLO investment are structure, manager, portfolio and investor landscape. First, we look at the structural features of the deal and how they stack up to competing transactions. We feel credit enhancement is the most important metric. Higher levels of credit enhancement might help CLOs withstand greater losses in the portfolio. We analyze the payment waterfall and how cash can be diverted to support our investment. We feel analyzing the deal's documentation is key. We want to make sure the manager is held to strict guidelines on what they can do and ensure there aren't conflicting interests that can harm our investment.

Second, is manager due diligence. In our view, this is one of the most important aspects of investing in a CLO. It is increasingly important as you go down the capital structure into the lower-rated tranches. We look at the manager's overall platform, their high yield credit business and how CLOs fit in. We want to understand their motivation for doing deals and the direction of their firm going forward. Evaluating the issuer's track record is critical, and we have many relevant data points from credit downturns during 2008-2009 to see how managers performed during periods of distress.

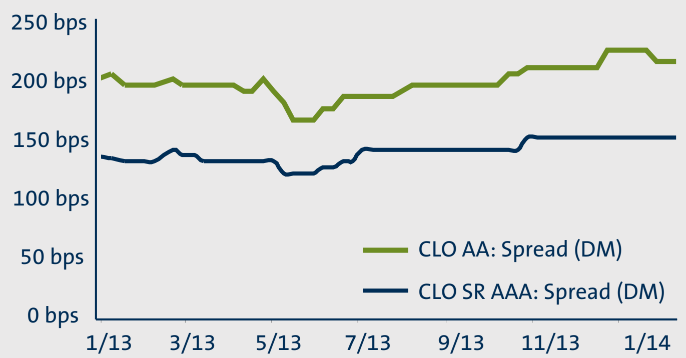
Third, the portfolio composition of bank loans is another variable we analyze. We believe deals with warehoused assets (loans already made) provide more clarity on what the actual portfolio will look like. Others only have model portfolios (loans to be made) that have been identified but might carry execution risk since certain portfolio metrics must be achieved for the deal to become effective. We also analyze the overall portfolio, and look more closely at the riskier credits in the pool. We seek to limit credits that are on our watch lists.

Finally, we review the investor landscape. Using our close ties to the CLO underwriting and investment community, we look to see what kinds of investors are participating in the transactions we are evaluating. This gives us valuable insight into how the deal will be structured and how the manager might behave going forward.

Q Where are you finding value today in the CLO market and what is your outlook on the sector?

Kologlu: The top of the capital structure is the cheapest part of the capital structure and is where we prefer to invest for our bank clients. AAA-, AA-, and A-rated tranches of CLOs currently offer discount margins of approximately 150, 200, and 300 bps respectively. For example, AA-rated CLOs can have a current yield of approximately 2.25% (3-month LIBOR + 2.00%) In addition, CLOs offer an inordinate amount of credit enhancement to withstand extremely stressed default scenarios unscathed and provide attractive return potential to comparable risk

CLO AAA/ AA SPREAD



Source: Credit Suisse

assets. For example, at issuance an AAA tranche typically has credit enhancement to withstand up to 40% annual default rates without suffering principal loss while AA tranches can withstand up to 25% annual default rates. When we compare these default rates to historic average default rates of 2-3% in the bank loan universe, we believe that the credit enhancement provided by CLOs is more than enough to withstand events such as the recent credit crisis in 2009 when bank loan default rates peaked at 9.6%. In addition, the new issue CLO 2.0 structures we generally invest in offer more protection than pre-2008 CLO 1.0 structures. Our default outlook for bank loans is benign for the next two years.

We think corporate balance sheets are healthy, leverage is in check, and debt servicing costs are very low. Even in low or no growth scenarios, we think these companies can continue to service this debt and not get strained. This benign default environment and the general chase for carry and risk assets should cause further spread tightening in CLO tranches.

Q If CLOs have so much credit enhancement, why is the top of the capital structure so cheap?

Kologlu: The cheapness in CLOs is not attributable to high credit risk but to a variety of other factors. First and foremost, many investors do not look at the asset class because they paint it with the same brush as the toxic CDOs that caused losses during the credit crisis without realizing it is a completely different asset class.

Second, regulatory issues have clouded the CLO investment landscape for banks, which are the biggest natural buyer base for senior tranches of CLOs. The first regulatory issue came with the implementation of the FDIC surcharge rule that effectively adds additional surcharge to banks greater than $10 billion in assets for holding CLOs because the underlying collateral is deemed a "higher-risk asset." The second hit for AAAs came from the final Volcker Rule in December which could potentially prohibit banks from owning CLOs that do not invest solely in loans.

Q What is the FDIC surcharge rule and how did it effect bank CLO holdings?

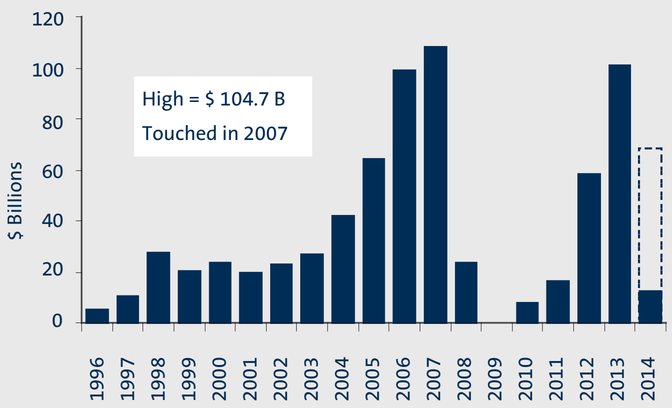
***Kologlu*:** Effective April 1st 2013, the FDIC implemented an assessment formula that applies to banks greater than $10 billion in assets. According to the FDIC, the formula uses a scorecard approach based on a bank's total asset base in order to "redefine the deposit insurance assessment base as (an) average (of) consolidated total assets minus average tangible equity." The purpose of the formulaic approach is to assess higher insurance rates for banks with "higher risk assets." It is difficult to assess the impact on banks as an industry as the scorecard approach is bank specific, but the general consensus is that it may cost an additional 20-40 bps per annum specifically for CLOs. Interestingly, the assessment does not apply to CLOs issued prior to April 1st, 2013.

We have seen a pickup in community banks allocating to CLOs as banks less than $10 billion in assets are exempt from the surcharge. We have also seen banks greater than $10 billion owning a greater percentage of AA- and A-rated tranches to offset the potentially higher assessment fees. The additional surcharge weakened the demand for the AAA tranche, creating an opportunity for AAA buyers not subject to the assessment.

Q How did the Volcker Rule impact bank CLO holdings?

***Kologlu*:** The release of the Volcker Rule was a significant change for banks investing in CLOs and TruP CDOs. CLOs and TruP CDOs were the first to reveal the unintended consequences of the rule. In short, banks are prohibited from owning "covered funds" and CLOs and TruP CDOs are considered "covered funds" in the rule. Market participants are debating whether or not the ownership

CLO ISSUANCE



Source: Credit Suisse, ABS Alert

of CLO and CDO debt tranches constitutes ownership of a "covered fund" and are anxiously awaiting clarity from the regulators. However regulators recently grandfathered all TruP CDOs purchased prior to 12/10/13, but unfortunately did not provide clarity surrounding the ownership question for CLOs.

We are optimistic CLOs will be granted some type of grandfathering as well in the weeks to come, but if the regulators do not change the treatment of CLOs, we believe the impact on community banks holding CLOs is relatively clear: banks will only be allowed to own CLOs backed entirely by loans and have until July 21, 2015 to conform with the Volcker Rule. One thing that is clear is new issuance is down due to the market's uncertainty surrounding the Volcker Rule. For existing holdings, we believe there is ample time for banks (1.5 years) to swap out of non-compliant CLO 2.0 holdings. In the meantime, we are also working with managers to bring existing CLO 2.0 holdings into conformance with the Volcker Rule by swapping securities' collateral for loans. For investors that are just starting to ramp up CLO portfolios a fresh start is possible by focusing on the new issue market where there is a broad selection of Volcker-compliant bonds.

Q What is the SSFA and is it beneficial for CLOs?

***Kologlu*:** The Simplified Supervisory Formula Approach (SSFA) is a non-ratings based method for determining risk-based capital weightings for securities formed via structured securitization transactions, e.g. CLOs, non-agency CMOs, and TruP CDOs. The SSFA was designed to apply relatively high capital requirements to the more risky junior and mezzanine tranches of a securitization and relatively low capital charges to the most senior positions. The SSFA is a favorable and appropriate methodology for structured credit instruments, especially CLOs, and reduces the likelihood of forced selling by market participants due to arbitrary downgrades from rating agencies. It also allows banks to potentially acquire a CLO portfolio with a current risk weight of 20% under both the existing ratings-based approach as well as SSFA. If elected by a particular institution, the effective date for adopting the SSFA is January 1st, 2015.

Q How do banks participate in CLOs and what do regulators expect from banks with CLO exposure?

***Kologlu*:** Banks should conduct their own in-house pre-acquisition analyses or, to the extent possible, make use of specific third party analyses that are independent of the seller or counterparty. If banks do not have the internal capability to underwrite CLOs we recommend banks use third party vendors to assist with the management of the exposure. The bank is ultimately responsible for the appropriate personnel understanding and managing the risks of the transaction, but third party vendor assistance with the necessary requirements to determine an investment grade standard independent of the rating agencies is acceptable. As stated in the FDIC's Summer 2013 Supervisory Insights, the regulatory expectation is clear: "examiners will focus less on credit ratings and more on adequacy of pre-purchase analysis, integration of various credit factors other than credit ratings, and monitoring procedures."

About Angel Oak Consulting Group

Angel Oak Consulting provides a wide range of specialized consulting to financial institutions and corporations. Leveraging an innovative approach and unique expertise, we provide value by offering an experienced practitioner's approach to balance sheet and risk model development and deployment, as well as credibility, contacts and a deep understanding of the evolving regulatory and stakeholder environment.

Our team offers significant hands-on knowledge and experience in all aspects of risk management, including the deployment, utilization and validation of models in all key risk disciplines. This experience has been developed through business cycle extremes and with organizations that have survived as well as those that have failed.

About Angel Oak Capital Advisors

Angel Oak Capital Advisors, LLC is an Atlanta-based, SEC-registered firm currently managing investments on behalf of public, private, and institutional clients. Founded in April of 2008, the firm has grown to over $3 Billion in assets under management (AUM), predominately in non-agency residential mortgage-backed securities ("RMBS").

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