Asset Securitization Report

Adapting CLO documentation in the midst of COVID-19

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The stresses of the global financial crisis of 2007-2009 exposed an array of unanticipated deficiencies in "CLO 1.0" documentation.

With the benefit of hindsight, these limitations have largely been addressed. The generation of "CLO 2.0s" that followed have generally had more robust structures, increased credit support and shorter reinvestment periods than their CLO 1.0 precursors. CLO 2.0s have also afforded managers with enhanced flexibility to avoid or cure overcollateralization (OC) test failures.

As with the 2007-2009 financial crisis, the severe market challenges experienced in the wake of the global COVID-19 pandemic will have lasting effects on CLO documentation and have already highlighted numerous deficiencies that will need to be addressed or more fully addressed in the next evolution of CLO documentation.

Managing Distressed Collateral

The recent COVID-19 related wave of workouts and restructurings has many CLO market participants struggling with the question as to why, with such a significant number of CLO lenders in the related lender syndicates, the terms of such workouts and restructurings are in many cases so disadvantageous to CLOs.

Many CLO market participants suspect that the answer to this question may in part be that opportunistic distressed investors now have a better understanding of the limitations and restrictions in the underlying CLO documentation. CLOs are generally prohibited from providing additional funding in restructurings or workouts of distressed loans unless the package of assets being funded satisfies strict eligibility criteria.

Importantly, such restructured assets must constitute "Collateral Obligations", i.e. loans that are rated above specified minimum levels, are not deferring interest and have other attributes indicative of credit quality that are often not satisfied in a restructuring scenario.

Any such additional funding must also satisfy all applicable CLO investment criteria, which generally preclude CLOs from extending new capital in exchange for equity securities or other non-conforming assets. These provisions are largely intended to protect the overall credit quality of CLO portfolios.

In today's distressed environment, however, they often operate to disadvantage CLOs relative to non-CLO lenders in loan restructurings and workouts.

Fortunately, with creative drafting, investor cooperation, and forthcoming amendments to the Volcker Rule, there would appear to be a means for addressing this funding conundrum.

Alternative funding sources

There are two general approaches that can meet the objective of enabling CLO participation in the funding of otherwise prohibited restructured assets in order to avoid the CLO's original investment from being negatively impacted vis-à-vis participating lenders:

- Excess Interest Collections. This approach involves utilizing excess interest collections that would otherwise be payable to the CLO equity investors to fund asset restructurings and workouts. This can be accomplished by establishing a supplemental reserve account into which such excess interest proceeds can be redirected immediately prior to making any payments to CLO equity investors. For greater flexibility, this approach can be structured such that amounts on deposit in the interest collection account equivalent to the anticipated excess interest proceeds for the next succeeding payment date may also be used to fund restructurings and workouts when amounts on deposit the supplemental reserve account are insufficient.

- Optional Cash Contributions. This approach involves the funding of asset restructurings and workouts by existing CLO investors (or with certain structures, unrelated third parties) through cash contributions on an as-needed basis.

Crucially, both approaches could be structured to be utilized both during and after the CLO's reinvestment period, and without regard to whether the funding of the subject restructured assets would satisfy the CLO's eligibility requirements and investment criteria.

While there are pros and cons to both approaches, they are certainly not mutually exclusive. The excess interest collections approach, for example, includes the operational convenience of accessing interest proceeds through the CLO waterfall. This apparent administrative benefit, however, must be weighed against the unpredictability of the optimal amount to be maintained in the supplemental reserve account and the risk that a CLO would be unable to replenish such account or utilize the excess interest collections in the then-current quarterly payment period in the event of an OC test failure.

Furthermore, while the excess interest collections approach would only enable funds to be replenished on quarterly CLO payment dates, the optional cash contributions approach would enable funds to be contributed at any time, based on the monetary needs of the related restructuring or workout. It, therefore, may be prudent to always include the Optional Cash Contribution approach.

There are also regulatory hurdles to funding the types of restructured assets that CLO documentation ordinarily prohibits. Fortuitously, it is anticipated that recent amendments to the Volcker Rule will, upon their anticipated Oct. 1, 2020 effective date, provide CLOs with the additional flexibility to fund new capital to acquire equity securities, bonds and other non-loan assets. In any event, care must still be taken to ensure that any such funding will not cause the CLO to be treated as engaging in a U.S. trade or business for federal income tax purposes, thereby jeopardizing its favorable tax status.

Solving for existing CLOs

Perhaps the most significant obstacle to incorporating these funding approaches into existing CLOs is obtaining the requisite level of investor consent.

Any proposed modification that would amend the CLO priority of payments either to redirect interest collections or to reimburse contributing equity investors prior to any distribution to all equity investors would typically require the consent of 100% of the subject equity. Moreover, the terms of documentation for many CLOs may require the consent of one or more classes of senior securities.

A variation on the optional cash contributions mechanic currently being incorporated into new-issue CLOs could serve to very significantly minimize the level of required investor consent. This alternative approach utilizes separate accounts for the contribution and remittance of funds earmarked for specific restructurings and workouts. This approach neither positively nor negatively impacts the CLO's collateral quality tests, OC tests or concentration limitations, in respect of the assets, or portions of the assets, funded by the contribution.

Those features could obviate the need for such consent or, at a minimum, mitigate any basis for investor objection. Under this approach, such contributions and remittances would be made solely by and to contributing parties outside of the CLO waterfall, subject to certain trigger events designed to protect senior investors.

This hybrid side-pocket variation on the optional cash contributions approach would also be structured, absent the occurrence of certain trigger events, without modifying the priority of payments. The risks and rewards of asset performance would be borne exclusively by the contributing parties, thereby preventing non-contributing investors from receiving an unfair windfall.

The CLO, however, would avoid being negatively impacted by its inability to fund additional amounts vis-à-vis participating lenders. In workouts or restructurings where a portion of an existing loan in the CLO's portfolio is "rolled over" into a new loan being funded by optional cash contributions, the portion of such loan of the CLO so rolled would be of a better credit quality and would continue to be taken into account for all purposes of the CLO's OC tests, collateral quality tests and concentration limitations.

Exchange transactions

So long as no new capital is funded, CLOs are generally permitted to exchange an existing distressed loan for another loan or package of non-conforming assets, provided that certain restrictions and requirements set forth in the CLO documentation are fully satisfied.

Unless the assets received constitute permitted "Collateral Obligations" (in which case such assets would generally be carried at par), such assets are frequently required to be carried at zero for purposes of the CLO's OC tests.

Often the collateral package received by a CLO in a restructuring or workout will not meet the mandated criteria for collateral obligations. And yet CLO managers are generally required to determine that such collateral package has a greater likelihood of recovery or is of a better quality or value than the loan being exchanged. Marking restructured assets to zero in such circumstances can be unduly punitive, particularly from the perspective of subordinated CLO investors.

A number of newly-issued CLOs have sought to address this inequity by waiving various collateral obligation criteria (e.g. requirements relating to minimum ratings, stated maturity, and non-deferral of interest) in such asset exchange scenarios. These waivers are typically subject to an overall cap and contingent upon the assets being received in the related exchange having a better expected internal rate of return than the original loan being exchanged.

While narrower in scope than protective funding, mechanics of this nature provide CLOs with another means for flexibility in distressed situations.

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Opportunities in dislocated markets

While distressed market conditions often lead to diminished credit quality, they can also provide CLO managers with opportunities to acquire high-quality loans at discount prices. This is another circumstance where supplemental reserve accounts can contribute to CLO portfolio value.

Some recent CLOs have been structured such that excess interest collections that would otherwise be distributed to equity investors under the priority of payments may instead be remitted to a supplemental reserve account, to be utilized to purchase discounted eligible loans in accordance with the subject CLO's investment criteria.

The conditions and circumstances under which CLOs are permitted to redirect such proceeds, however, tend to differ in accordance with the risk appetites of the relevant CLO investors.

Avoiding OC test triggers

During periods of sustained market unrest, loan rating downgrades and price dislocations can apply substantial pressure upon a CLO manager's ability to satisfy OC tests. While the par amounts of the loans in a CLO portfolio are generally used to calculate OC test compliance, unfavorable loan rating and price events can introduce market value elements and other "haircut" values into the computation. Such events reduce the theoretical collateral cushion as it relates to the principal amount owed to CLO investors.

The rapid and widespread rating downgrades that accompanied the early stages of the COVID-19 pandemic caused many CLOs to exceed their concentration limits for CCC rated loans, triggering a feature requiring such "CCC excess" (computed by using the lowest market values among all such loans in the subject portfolio) to be marked to market for OC test purposes.

Participants in newly-issued CLOs are attempting to reduce this OC test pressure in a couple of ways. One is by attempting to raise the CCC threshold limit above market standard levels. Another involves a bifurcated approach to CCC concentration limitations. Under this approach, such limitations are set at the market threshold for purposes of concentration limitations which trigger restrictions on new loan purchases, and at an increased threshold for purposes of triggering the CCC excess haircuts alluded to above. The latter method protects the integrity of the portfolio by limiting new CCC rated assets from being purchased, but also provides some flexibility to address sudden and prevalent rating downgrades.

Loans purchased by CLOs at prices below certain predetermined percentages of par are considered "Discount Obligations" and carried at their purchase price for purposes of measuring OC test compliance. While loans acquired at these deeply discounted levels are likely to be distressed under normal market conditions, circumstances may arise where the pricing assumptions used to measure underlying credit quality no longer prove accurate, most significantly during periods of severe market disruption.

CLO 2.0 documentation sought to avoid situations where CLO managers might refrain from substituting a loan of deteriorating credit quality that did not constitute a Discount Obligation at the time of purchase (and was therefore carried at par for OC test computation purposes) for a higher-quality discount obligation that would negatively impact OC test compliance. This was accomplished by allowing the substituted loan in such scenarios to also be carried at par, subject to maximum substituted loan bucket sizes and other specified conditions.

The price dislocations caused by COVID-19, however, have demonstrated that the distressed pricing assumptions embedded in CLO 2.0 documentation may not have gone far enough. One solution being proffered in recent CLO issuances affords CLO managers the option during times of market distress to determine whether a loan is "discounted" based on purchase price as it relates to a loan index (instead of par). Under this mechanic, a substitute loan or even a new loan would only constitute a Discount Obligation if it is trading below a certain percentage of the index. This approach would enable a CLO to invest in performing credits that are dislocated as a result of overall market distress.

As illustrated by the CLO industry's response to the lessons learned from market turmoil caused by 2007-2009 financial crisis, can give rise to useful innovation. In these uncertain times, there is hope that the structural changes brought about by the COVID-19 pandemic will in turn bolster CLO resiliency, thereby enabling market participants to better weather the next economic storm.