Return of the Refi: CLO Rate Adjustment Transactions After COVID-19

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This article examines refinancings, resets, and other mechanisms for adjusting collateralized loan obligations ("CLOs") funding costs and deal terms ("Rate Adjustment Transactions") and the typical rationales for and constraints on Rate Adjustment Transactions. It also takes a closer look at the vintages of CLOs that could experience Rate Adjustment Transactions during the rest of this year.

Many observers of the market for U.S. collateralized loan obligations ("CLOs") are forecasting significant refinancing and reset activity in 2021. Although estimates of issuance volume vary among researchers, forecasts commonly cite continued improvement in CLO market fundamentals, particularly the continued tightening of liability spreads from the wide levels encountered in the market during the second quarter of 2020, and a large supply of legacy transactions that will be eligible under their governing documents to be refinanced or reset in 2021 as the main catalysts for these types of transactions.[1]

In this article, we examine refinancings, resets, and other mechanisms for adjusting CLO funding costs and deal terms ("Rate Adjustment Transactions") and the typical rationales for and constraints on Rate Adjustment Transactions. The article also takes a closer look at the vintages of CLOs that could experience Rate Adjustment Transactions in 2021.

Types of Rate Adjustment Transactions

Although CLO market commentary tends to focus primarily on refinancings and resets, the market has developed several different mechanisms by which liability costs and deal terms can be adjusted from time to time throughout a CLO's life cycle.

Refinancings

Most CLOs issued since the financial crisis of 2008–2009 permit the holders of a majority of the junior-most tranche (or the CLO "equity"), either with or without the consent of the collateral manager, to refinance one or more tranches of rated debt after the expiration of a specified "non-call" period.[2] The debt tranches that have been "called" are redeemed using the issuance proceeds from replacement debt

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tranches that will accrue interest at lower spreads over LIBOR or a replacement reference rate (in the case of floating rate tranches) or lower stated interest rates (in the case of fixed rate tranches).[3] Although the CLO indenture is amended in a refinancing to effect the issuance of the replacement debt tranches at lower spreads/rates, the other terms of the original transaction generally remain the same.

Resets

A reset is similar to a full refinancing in that all outstanding debt tranches are redeemed and replacement debt tranches are issued at current market spreads/rates. However, a reset also involves an extension of the maturity profile of the original CLO through revisions to the stated maturity date, the reinvestment period end date,[4] and the weighted average life test. The terms of the original transaction may change in other significant respects as well. Resets frequently involve modifications to the original deal's capital structure to optimize the cost of financing in the current market (through the addition, combination, or removal of debt tranches) and changes to required overcollateralization ratios, interest coverage ratios, and collateral quality tests.

Additionally, negotiations among the collateral manager, investors, and rating agencies often result in revisions of the original deal's portfolio eligibility criteria and concentration limitations. While many resets are similar to refinancings in that the size of the asset portfolio is not increased as a result of the transaction, others involve the addition of new assets funded by additional CLO liabilities and/or equity.

Reissues

A reissue differs from a refinancing or a reset in that it involves optionally redeeming all the debt tranches of a CLO and transferring that CLO's assets, along with the directing equity's interest in the CLO, to a newly formed SPV. The transfers frequently take place through a merger of the original CLO issuer with and into the new CLO issuer. Reissues developed originally as a means of resetting CLOs that had previously carried out refinancings in reliance on the Crescent no-action letter, the supplemental indentures for which contained prohibitions on further refinancings of the previously refinanced tranches.[5] Reissues have also proven an effective means of resetting a CLO transaction when less than 100 percent of the equity elects to participate. As with resets, significant modifications to the original terms of a CLO transaction are possible in reissues.

Re-pricings

Re-pricings, another CLO 2.0 structural innovation, can be thought of as cashless refinancings. Through a re-pricing, a CLO issuer can reduce the spreads/rates on one or more outstanding debt tranches to current market levels without incurring the administrative and transactional costs of redeeming those tranches and issuing replacement tranches. The holders of the debt tranches designated for re-pricing need not consent to the new spread/rate, but non-consenting holders are required to transfer their interest in the re-priced debt tranche to existing or new holders that consent to the new spread/rate. As with refinancings, the changes to CLO indentures in re-pricings are limited to those required to affect the reduction in relevant spreads/

rates, with the other terms of the original transaction generally remaining the same.[6]

Supplemental Indentures

With the exception of reissues, which involve the effective creation of new CLOs using existing portfolios, each other type of Rate Adjustment Transaction requires the adoption of a supplemental indenture to legally effect the spread/rate reduction on the affected debt tranches and any other permitted changes to deal terms. That said, it is possible under most CLO indentures to adopt a supplemental indenture on its own (i.e., outside the context of one of the other Rate Adjustment Transactions) to reduce the CLO's funding costs, subject to two important qualifications.

First, any such supplemental indenture likely would require the consent of 100 percent of the holders of each debt tranche designated for spread/rate reduction.[7]

Second, the scope of any such supplemental indenture likely would need to be limited to only those changes necessary to implement the spread/rate reduction on the designated tranches, lest the consent rights of the holders of other CLO tranches be triggered.

Typical Rationales for and Constraints on Rate Adjustment Transactions

The type of Rate Adjustment Transaction selected by a CLO's equity investors and collateral manager will depend on a number of economic and non-economic considerations.

Rationales

Each type of Rate Adjustment Transaction is an avenue for reducing a CLO's funding costs and, by extension, improving CLO equity returns. The debt tranches issued in a CLO tend to be relatively long-dated (typically with maturities of 10 to 12 years), and they effectively provide the equity tranche with non-mark-to-market, term financing of the CLO portfolio on a non-recourse basis.

If, by the time the relatively short non-call period expires, market rates of interest have moved in borrowers' favor, CLO equity investors can enhance the "arbitrage" (or the difference between the yield on a CLO's assets and the funding costs of a CLO's liabilities) they enjoy by re-striking the spread/rate on outstanding debt tranches. This is particularly true when it comes to spread tightening of AAA-rated debt, since that tranche typically represents 60 percent or more of the issued liabilities in a CLO.[8]

Certain Rate Adjustment Transactions offer the prospect of improved equity returns independent of any reduction in CLO funding costs. For instance, many CLO 2.0 indentures allow the collateral manager to recharacterize excess portfolio par as interest proceeds when a CLO is refinanced in full and to cause such proceeds to be distributed to the equity tranche (commonly referred to as a "par flush"). By directing the full refinancing or reset of a CLO in which the collateral manager has built excess portfolio par and by receiving a par flush distribution, equity investors can monetize trading gains in the CLO, in addition to adjusting liability expense.

Resets provide the same potential cost-savings as refinancings and re-pricings, but they also enable equity investors and collateral managers to extend the life of a CLO. The benefits of such extensions become particularly perceptible as a CLO approaches the end of its reinvestment period.[9]

Through a reset, equity investors can lengthen the period during which distributions of excess spread might be received and collateral managers can lengthen the income streams of their management fees. Even in the case of a reset that does not produce a meaningful reduction of the CLO's funding costs, equity investors nonetheless might calculate that the potential investment value gains from the changes to a deal's time periods and other terms make a reset worthwhile.[10]

Some collateral managers may want to use a Rate Adjustment Transaction to combine multiple existing CLO portfolios. Others, mindful that extensive procedural and consent requirements can make it difficult to amend legacy CLO indentures for other than ministerial purposes, may consider a Rate Adjustment Transaction as the most expedient way to update a CLO indenture with state-of-the-art provisions, such as the adoption of Alternative Reference Rates Committee-recommended LIBOR fallback language and the inclusion of re-pricing auction rate mechanics, to name just two.

A detailed discussion of the types of updates being made to CLO indentures in the current market environment is beyond the scope of this article. That said, several developments in the CLO market (in addition to the disruption caused by the COVID-19 global pandemic) that unfolded during 2020 have already prompted market participants to incorporate certain changes in new-issue CLO indentures and to propose certain amendments to legacy CLO indentures. These developments include the amendments to the "loan securitization exclusion" of the Volcker Rule regulations that became effective on October 1, 2020 and the adjustments by Moody's to the treatment of debt obligors with a negative outlook or whose ratings are on review for downgrade for purposes of assessing Moody's Default Probabilities Ratings that became effective on December 7, 2020. In addition, in several recent and noteworthy workouts/restructurings, CLOs holding senior secured loans have been "primed" or otherwise disadvantaged relative to non-CLO holders of such loans, highlighting the need for indentures to provide CLOs with increased flexibility to participate in distressed asset scenarios. Debt investors may also have an interest in making modifications to legacy CLO indentures in the course of a Rate Adjustment Transaction. These could involve, for example, changing asset quality and diversification requirements to lessen the likelihood of portfolio exposure to COVID-19-affected industries and obligors.

For these reasons, resets and reissues, the supplemental indentures for which generally accord a wide latitude of substantive changes, often hold particular appeal.

Constraints

The decision to initiate or participate in a Rate Adjustment Transaction, and the determination of the timing and type of Rate Adjustment Transaction, is not simply a matter of assessing the yield curve. Rather, equity investors and collateral managers frequently must evaluate constraints on Rate Adjustment Transactions by answering a number of questions. These include:

- *Is there agreement among the parties that have direction rights?* To the extent the ownership of a CLO equity tranche is broadly dispersed among several unaffili-

ated investors, it can be more difficult to find a controlling percentage of investors to agree on the type, preferred terms, and most opportune timing of a Rate Adjustment Transaction (stemming from, among other things, disagreements over whether there is further room for spread tightening).

- *What kinds of consent or other documentation constraints exist?* The requirements set out in CLO indentures for effecting refinancings or re-pricings and for entering into supplemental indentures, including the thresholds for consent from holders of CLO debt and/or equity tranches, can be elaborate and complex. These potentially overlapping requirements may limit the ability to make certain changes to deal terms, to refinance certain tranches, or to otherwise alter a CLO's capital structure.

- *Is additional equity capital needed and available?* A CLO that holds too many defaulted assets, has suffered trading losses, or otherwise has a poorly performing portfolio may require an infusion of additional equity capital to be an economically viable candidate for a reset or reissue (since additional equity may be necessary to increase the subordination of the debt tranches in order to obtain desired ratings).

- *Is there a lower cost alternative to a preferred type of Rate Adjustment Transaction?* The transaction costs involved in a Rate Adjustment Transaction, including arranger, rating agency, and legal fees, tend to vary by type. Amendments and re-pricings generally have the lowest such costs; resets and reissues generally the highest (with reissues generally costing more than resets, given the need in the former to establish a new SPV and transfer the existing portfolio to it); and refinancings generally fall somewhere in the middle.

Supply of Deals for Rate Adjustment Transactions in 2021

For different reasons, CLOs that came to market in different years (or "vintages") may be good candidates for a Rate Adjustment Transaction in 2021.

2020 Vintage CLOs

The travel and economic lockdowns that government authorities first imposed in the early months of 2020 in response to the COVID-19 global pandemic led to significant disruption to the CLO market, as manifested by deteriorating portfolios, spread widening, and reduced issuance. By contrast, the last few months of 2020 saw a marked improvement in CLO market conditions, with strengthening portfolios,[11] spread tightening,[12] and a resumption of issuance composed of both new-issue transactions and Rate Adjustment Transactions.

In the intervening period, however, most new-issue CLOs came to market with a structure that reflects an ostensibly provisional compromise between debt and equity investors: shorter reinvestment periods of one, two, or three years (or, in some cases, static asset pools), which limits the period that principal collections may be reinvested instead of used to amortize outstanding debt tranches (to help allay debt investors' fears of economic weakness and portfolio performance); and

shorter non-call periods of one year or less, which brings forward the date after which the equity may direct a refinancing or re-pricing of the CLO's debt tranches (to incentivize equity investors to commit capital in a relatively expensive market environment).

This compromise means that a considerable proportion of 2020 CLOs—deals that priced when liability spreads generally were wider than current market levels and whose non-call periods were set at one year or less—will become eligible for a Rate Adjustment Transaction during 2021 (or have already become so eligible).[13] By our estimation, at least 70 percent of the roughly 200 new-issue CLOs from 2020 will exit their non-call periods before the end of 2021.[14]

Earlier Vintage CLOs

Earlier vintages of CLOs may also provide raw material for Rate Adjustment Transactions. As noted above, before the COVID-19 market disruption, most CLOs were issued with a two-year non-call period. We estimate that over 85 percent of the approximately 250 new-issue CLOs from 2019 offered two-year non-call protection,[15] and that at least 160 of those transactions will exit their non-call period during 2021.

CLOs whose non-call periods expired in 2020, a cohort that consists primarily of 2018 vintage and earlier deals, constitute a backlog that could add to the volume of Rate Adjustment Transactions in 2021. Rate adjustment activity ground to a halt in March 2020 as market volatility (including periods of wide spreads and thin demand for debt tranches) made it uneconomical or otherwise disadvantageous for equity investors and collateral managers to direct Rate Adjustment Transactions of older vintage deals.

Beginning in August 2020, rate adjustment activity resumed, although this was primarily limited to partial refinancings of fixed rate tranches to take advantage of a flattening swaps curve. Those fixed rate refinancings aside, few of the approximately 225 new issue CLOs from 2018 that we estimate exited their non-call periods in 2020 have experienced Rate Adjustment Transactions.

It should be noted that, although new-issue CLO spreads have steadily tightened since May 2020, year-end 2020 pricing remained wide compared with the market levels at which many pre-COVID-19 vintage CLOs priced, especially those from 2018.[16] Therefore, certain of these vintage CLOs may remain "out of the money" for Rate Adjustment Transactions unless there is further spread tightening in 2021.

Final Thoughts

This year, a number of market factors have lined up to produce favorable conditions for Rate Adjustment Transactions. Determining the type and timing of a Rate Adjustment Transaction can require complicated assessments of deal terms, investor sentiment, and other considerations.

NOTES:

[1] *See, e.g.*, Robin Armitage, "CLO 2021 outlook: back to the 'old' normal with volumes, spreads and structures to revert to pre-covid levels," *Creditflux*, December 18, 2020, citing the CLO market forecasts of several sell-side institutions.

[2] Enhanced flexibility to refinance CLO debt tranches is just one of many improvements in the documentation of post-financial crisis CLOs (commonly referred to as "CLO 2.0" deals) over the previous generation of deals (commonly referred to as "CLO 1.0" deals). Before these

enhancements, CLO 1.0 equity often had to optionally redeem a transaction in full and direct the transfer of the CLO's assets to a new special purpose vehicle ("SPV") in order to take advantage of favorable movements in market rates of interest. The length of a CLO's non-call period varies depending on negotiations with investors and general market conditions, but an overwhelming majority of CLOs issued before the COVID-19 market disruption provided two-year non-call protection.

[3]In a "full refinancing," all outstanding debt tranches are redeemed and replaced with lower-yielding liabilities. In a "partial refinancing," fewer than all outstanding debt tranches are redeemed and replaced with lower-yielding liabilities.

[4]As with a CLO's non-call period, the length of its reinvestment period is a function of investor negotiations and market conditions. Nonetheless, until the COVID-19 market disruption, most CLOs issued since 2013 have featured a reinvestment period of four or five years, with five-year reinvestment periods emerging in 2017 as the prevailing market standard for broadly syndicated loan ("BSL") CLOs.

[5]In a July 17, 2015 no-action letter addressed to Crescent Capital Group LP, the SEC staff provided limited relief from then-applicable risk retention requirements under Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Risk Retention Rules") for certain CLOs that priced before publication of the Risk Retention Rules and refinanced after the effective date of the Risk Retention Rules. In a February 9, 2018 decision, a three-judge panel of the U.S. Court of Appeals for the D.C. Circuit invalidated the Risk Retention Rules as applied to collateral managers of "open-market CLOs," described by the court as CLOs that acquire their assets from arm's-length negotiations and trading on an open market.

[6]Throughout the CLO 2.0 era, relatively few re-pricings (compared with refinancings or resets) have occurred, largely due to perceived practical difficulties in utilizing the re-pricing mechanics found in most CLO indentures. However, the re-pricing of several fixed rate CLO tranches in the second half of 2020 suggests that re-pricings may be rising in prominence as an alternative to refinancings.

[7]Whether the holders of a debt tranche have any incentive to consent to a supplemental indenture that reduces the spread/rate earned on their tranche will depend on the facts and circumstances of each particular CLO transaction.

[8]Even when market rates of interest have not improved appreciably since a CLO was originally issued, it may be possible to refinance a well-performing CLO at lower spreads/rates if debt investors calculate that the quality of the CLO portfolio and the shorter duration of the transaction translate into lower investment risk.

[9]After the expiration of its reinvestment period, a CLO begins to amortize its debt tranches in order of sequential priority (i.e., it repays the tranches that have the lowest interest expense first) using scheduled repayments of maturing loan assets. This deleveraging causes the weighted average funding costs of the CLO to increase.

[10]The flexibility of CLO reset technology, which has proven capable of accommodating resets with a wide variety of fact patterns under different market conditions, has prompted some market observers to characterize CLO 2.0 deals as quasi-permanent-capital vehicles.

[11]Portfolios at the end of 2020 generally showed improvement compared with earlier points in the year as measured by the secondary market prices of leveraged loans held in CLO portfolios, the rates of rating agency downgrades and upgrades of such leveraged loans, the amount of exposure to COVID-19-sensitive obligors, and the extent to which CLO overcollateralization ratios satisfy minimum required thresholds. All other things being equal, well-performing portfolios factor positively into equity investors' determinations to direct a Rate Adjustment Transaction (particularly a reset or reissue) and also help attract new debt investors.

[12]Market spreads on CLO debt tranches steadily tightened from the second quarter of 2020 to the end of 2020 and were expected by some market observers to tighten even further in 2021. In late 2020 AAA-rated debt tranches were pricing at LIBOR plus ~135 to 145 basis points for first-tier managers of CLOs with five-year reinvestment periods, which represents a substantial improvement from the second quarter of 2020, when AAA-rated debt tranches of similarly structured CLOs were priced at LIBOR plus ~300 to 400 basis points on the secondary market.

[13]Equity investors and collateral managers may be particularly interested in using resets to convert CLOs with short reinvestment periods and short non-call periods into deals with longer horizons.

[14]The data supporting the authors' estimates of 2020 vintage CLOs and earlier vintage CLOs is derived from public and private domain sources.

[15]For simplification, we consider a CLO with a non-call period greater than 1.5 years but less than 2.5 years to be a "two-year non-call" deal.

[16]We note that AAA-rated tranches of 2019 vintage BSL CLOs issued with a five-year reinvestment period and two-year non-call period generally priced in the range of ~130–150 basis points. Therefore, a Rate Adjustment Transaction of a 2019 vintage CLO may be more economically viable than a Rate Adjustment Transaction of a 2018 vintage CLO.