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CLO Commentary

Push for Higher Equity Returns Leads to Weaker Structural Features in CLOs

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Morningstar Perspective

As the returns for equity investors in collateralized loan obligations come increasingly under pressure because of tighter leveraged loan spreads and high demand for the underlying leveraged loans, CLO equity investors and arrangers continue to look for innovative ways to improve returns. Unfortunately, not all the innovations that have emerged are credit-positive for CLOs. In particular, Morningstar Credit Ratings, LLC believes that CLO managers' ability to take advantage of the way they build excess-par and their ability to recharacterize part of the excess-par from principal proceeds to interest proceeds during a refinancing pose additional credit risk for mezzanine tranches in CLOs. We apply additional sensitivity stresses, on a case-by-case basis, to transactions that incorporate potentially credit negative features.

Building Excess-Par

Excess-par in the context of a CLO is typically defined as the par value of all assets in the portfolio minus the target par balance as of the effective date of such CLO. There are a number of ways a manager can generate excess-par. Not all of these par building activities, however, improve the collateral quality of the asset pool.

Managers can build excess-par by actively trading in the secondary market, purchasing assets below par but holding them in their books at par value, or acquiring assets in the primary market at an original issue discount. If done successfully, these methods benefit both the rated debtholders through additional credit enhancement as well as the equity investor in the form of higher equity value, without incurring additional credit risk.

Alternatively, managers can par build by selling higher-quality assets and "credit-improved" assets and using the proceeds to purchase assets that are trading below par but above the discount-obligation cutoff and holding them at par on their books to increase the cushion for their overcollateralization tests. While this builds excess-par, it is at the expense of the credit quality of the portfolio and is therefore credit negative.

CLO managers usually have the flexibility to purchase assets across the credit spectrum, including discount obligations and CCC rated assets, subject to the CLO's structural protections, including the collateral quality and coverage tests, which limit a manager's ability to weaken the credit quality of the portfolio. These structural protections can haircut the par value, or the notional value, of assets that may be impaired or which exceed the specified concentration limits for certain calculations. For example, in the calculation of the overcollateralization test, the numerator applies the haircut value, not the par value, of the collateral pool, which is then divided by the unpaid principal balance of the rated notes.

Manager Flexibility in Calculating Excess-Par Could Lead to a Weaker Loan Portfolio

The use of par value, and not the adjusted portfolio balance, for calculating the excess-par amount allows a manager to give full credit to principal balances of discount obligations, CCC rated assets above the set concentration levels, or any other assets that would typically be held in the asset pool at a discounted or lower-than-principal amount for the calculation of the overcollateralization amount.

Morningstar views this method of par building as a credit-negative development because it allows managers to increase par value at the expense of asset quality, while not necessarily increasing overcollateralization or improving the collateral quality of the pool as a whole. A mitigant to this risk is the relatively more conservative calculation used in the numerator of the overcollateralization tests, where the transaction does not grant full credit to assets with weaker credit quality.

Releasing Excess-Par Through Refinancings

One common feature of post-credit-crisis CLOs is the ability to refinance the notes after a noncall period, which typically expires two years after the issuance date. Under a traditional refinancing, either all or a portion of the CLO's tranches are redeemed and new notes are issued with identical terms, except for lower coupons. Refinancing of CLO tranches are generally initiated by the majority vote of the equity investors or at the direction of the manager with the consent of the majority of the equity investors. Refinancings are typically undertaken only if the interest savings outweigh the costs of a refinance. Morningstar typically views such refinancings as credit positive, as lower coupons on the underlying notes create additional excess spread to protect against credit losses.

However, some recent CLOs include an additional feature that allows the manager, in connection with a refinancing, to recharacterize principal proceeds as interest proceeds up to the excess-par amount. This may lead to a reduction of the additional overcollateralization the transaction may have built up in the noncall period once the principal leaks to the equity holder after being recharacterized as interest. If the economic environment then deteriorates and defaults rise right after the excess-par leak, an earlier-than-anticipated tripping of the overcollateralization tests may occur, increasing the likelihood of deferring interest payments to lower-rated tranches. Morningstar views this as credit negative because it allows the manager to transfer risk from the equity investors to the rated noteholders.

While the collateral quality tests and coverage tests applicable to CLOs deter managers from weakening a portfolio in order to build par, additional features and definitions may accentuate the potential risk of weakening a portfolio when combined with the ability to release principal proceeds as interest proceeds. One such example is the use of discount-adjusted spread in the weighted-average spread test. In some cases, for assets trading below par, a manager may use the discount-adjusted spread instead of the stated spread of the asset. Because the discount-adjusted spread is calculated by dividing the stated spread by the purchase price, it is higher than the stated spread of the asset, thus overstating the weighted-average spread of the pool. While the manager gains the benefit of the discounted price of the asset for the calculation of the weighted-average spread test and for building excess-par, the asset must also be held at the discounted price for the calculation of the overcollateralization test, mitigating its effect.

Keeping an Eye on the Risks

A successful refinancing requires satisfactory performance from the manager of a transaction and a benign economic environment with low default rates. However, the ability of a manager to weaken a portfolio's credit quality to build par and the ability to recharacterize the excess-par into interest proceeds, which would leak to the equity holder, pose risks to the mezzanine noteholders after a refinancing occurs. Those risks can be exacerbated by modifications to the collateral quality tests and the failure of the excess-par definition to account for and reduce the notional balance of the assets with weaker credit quality. Therefore, these risks may limit any positive impact that an increasing credit enhancement may have on a transaction over time.

Morningstar believes that the drive to improve returns for equity holders may lead to more such credit-negative developments and further modifications of definitions and other provisions in the documents. We will continue to monitor transactions that incorporate these features and will apply additional sensitivity stresses, if needed, to test the potential impact on their credit ratings.

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