CLO Commentary

Refinancing Poses Limited Additional Credit Risk to CLO Combination Notes

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Morningstar Perspective

Morningstar Credit Ratings, LLC believes that refinancing risk does not present significant additional credit risk for a typical collateralized loan obligation combination note. A combination note is backed by the cash flow from several tranches of a CLO and often includes some junior notes and equity. Combination notes are typically zero-coupon securities, so interest and principal payments on the underlying notes pay down the combination note balance. Because of this feature, one of the risks for these types of securities is that refinancing of a tranche that is part of the combination note may reduce the cash available to pay off the note. The combination note investors may choose not to acquire the newly refinanced notes. This would result in an immediate paydown of the principal and would eliminate future interest payments from the underlying notes.

Refinancings for CLO tranches must be initiated by the majority vote of the equity holders, and CLO indentures prohibit refinancings before the end of the noncall period, which usually lasts two years. Equity investors would consider a refinancing if the interest savings outweigh the costs of a refinance. Lower coupons on the underlying notes would be likely only in a benign economic environment with low default rates. To obtain reduced pricing for CLO tranches through refinancing, the manager would likely have to demonstrate satisfactory performance for that transaction. These circumstances are consistent with a much more innocuous scenario than the investment-grade stress scenarios that Morningstar expects a combination note to withstand.

CLO tranche refinancings have historically targeted the largest and most senior class first, and this note is rarely included in a typical combination note. For a performing CLO the resulting savings from a reduced coupon on the senior tranche would be passed on to the equity tranche as a distribution of excess interest proceeds on each payment date. This increases cash flows to the combination note, of which equity makes up a significant portion.

Some junior tranches, which often are included in a combination note, are issued at a significant discount, making these notes less desirable candidates for refinancing. This decreases the likelihood that a tranche included in the combination note will be refinanced. If the issuer of the combination note participates in the refinancing and collects a lower coupon for the refinanced component, that reduction is likely to be offset by additional equity cash flow. Alternatively, if the combination note issuer turns down the terms of the refinancing, that tranche is repaid at par and used to pay down the outstanding balance of the combination note.

Investors in combination notes usually hold significant, and sometimes controlling, positions in equity and other tranches of the CLOs, and have longstanding relationships with CLO managers. It is unlikely that a refinancing would take place that would be clearly detrimental to their interests.

Refinancing is typically not allowed during the first two years of the combination note, resulting in significant paydown of the note in all but severe scenarios. Furthermore, because of the low probability that tranches included in the combination note would be refinanced, and that such refinancing will significantly reduce cash flows from a tranche included in the CLO without an offsetting benefit to equity, Morningstar believes that CLO refinancing does not create significant additional credit risk under lower investment-grade rating scenarios. Depending on the structure of a combination note and the target rating, Morningstar may model stresses to reflect the risk or consider mitigating deal terms in the indenture.