COVID-19 and European Collateralized Loan Obligations – challenges and opportunities

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In brief…

With the world in lockdown, companies struggling to service their debt and the knock-on effects on the labour market, the prospects of company defaults loom large. Laura Ashley and Carphone Warehouse have been early victims of the economic crisis caused by COVID-19 and sectors such as aviation, gaming, lodging and leisure are feeling the pressure together with the oil and gas sector which is suffering from the freefall in oil prices. Despite the economic measures previously announced by a variety of governments and regulators, including a GBP350 billion package announced by the UK government and the Bank of England slashing interest rates from 0.75% to 0.25% and then further to 0.1%, collateral managers continue to grapple with the current credit environment.

Initially as credit conditions began to deteriorate, investors in European CLOs who were looking to sell CLO liabilities found it difficult to find buyers with a number of bids-wanted-in-competition (BWICs) failing to result in sales. This was due to, amongst other things, concerns around the market value coverage of junior CLO tranches and the fact that there were less traders in the market to create the required liquidity as they increasingly opted to work from home to avoid infection.[1] However, more recently the secondary market looks to have improved as the number of successful European BWICs has begun to rise albeit with less triple A rated bonds being sold following the establishment by the US Federal Reserve Board of the primary dealer credit facility.[2]

With this backdrop in mind, there are a number of challenges and opportunities for European CLO managers tasked with navigating this tumultuous environment.

- With the current deterioration in the business environment and the associated increase in business risks, certain CLO assets are likely to decline in credit quality and/or price or the underlying obligors may fail to meet their other financial obligations. In these circumstances a collateral manager may (depending on the where the relevant CLO is in terms of reinvestment period or if it is in a restricted trading period) have the discretion to determine that such assets constitute “credit risk” assets and look to sell to mitigate losses.
- There is a risk of the ratings of certain CLO assets falling to CCC+ (or lower) levels and thereby increasing the number of CCC rated CLO assets to above the permitted limits. The resultant excess of CCC rated CLO assets will be subject to haircuts in the determination of certain par value and overcollateralisation tests and the restrictions set out in the relevant portfolio profile tests and to the extent this causes such tests to fail, can push a CLO toward early amortisation and cause a reduction in the amounts available for distribution. Collateral managers will be keen to keep the CCC rated CLO assets within the approved limits. This is easier said than done, with recent reports suggesting that the number of CLOs breaching their permitted limits for CCC rated CLO assets (typically 7.5 percent.) set to soar from 8 percent. to around 30 percent.[3] with CCC rated CLO

assets in CLO portfolios having increased on average by 2 percent since February 2020.[4]

- Corporate defaults may lead to CLO assets being classed as *defaulted* assets. Depending on the size of the relevant defaulted position held by the CLO, collateral managers may find themselves involved in workouts or restructurings, these can result in changes to interest rates, write-downs of principal, conversion of some or all of the principal debt into equity and generally to the terms, conditions and covenants of the relevant defaulted asset. Such workouts or restructurings can be protracted and the ultimate recoveries uncertain. Unsurprisingly defaulted assets typically have limited liquidity and in the event that they are actually sold they will typically be sold at a discount or loss. Defaulted assets held in a CLO will be subject to haircuts and/or excluded in the determination of certain par value, interest coverage and overcollateralization tests, and like CCC rated CLO assets, failure of these tests, can push a CLO toward early amortisation and cause a reduction in the amounts available for distribution ultimately, if not addressed, defaulted assets can contribute to a CLO default.
- Another feature of European CLOs that could potentially exacerbate the situation are covenant light loans in portfolios, these are loans that do not contain any financial covenants or require the obligor to comply with any maintenance covenants. In the current economic climate, these reduced covenant packages mean that companies which should have defaulted earlier are actually carrying on so that when they do eventually default the recoveries will in many cases be lower.

Clearly there are a number of challenges for collateral managers in the current climate but for those collateral managers that have cash to deploy and are still able to purchase assets at a discount there could be opportunities to pick up bargains and build par. These discount assets can have less favourable treatment in a CLO initially but under certain circumstances can be treated as regular assets or in the case of so called *swapped non-discount assets*, collateral managers, under certain conditions, have the ability to purchase assets at a discount without treating such assets as *discount assets* from the outset.

It is still early days in the current corona virus environment with little certainty on how long these conditions may last and when a medical and an economic recovery might begin and what the post -corona virus economic landscape might look like. In the meantime collateral managers will have to face deteriorating credit conditions, questionable liquidity, potential work outs and restructurings while European CLO investors rely on them to maximise prices and recoveries.

Although collateral managers have the unenviable task of weathering this particular storm, it is worth remembering that CLOs are designed with structural protections in order to deal with these disruptions in performance. These features include overcollateralisation, diversification, subordination, the ability to defer interest payments and in some cases the ability to reserve funds. These features, many of which are agreed with and monitored by the relevant rating agencies, have served the CLO industry well and seen it survive and thrive through a number of economic downturns and recessions so there is every reason to believe that European CLOs are robust enough to weather this current environment.

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[1] Global Capital 16 March 2020 – Investors caught in the headlights as ABS and CLO lurch wider
[2] See Creditflux 30 March 2020
[3] According to the latest research from Bank of America – See Creditflux 26 March 2020
[4] See Creditflux 26 March 2020

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