Thomas Majewski
Founder & managing partner
Eagle Point Credit Management

Some CLO managers aren't blocking loan amendments with insufficient credit spread adjustments

Libor's time as the primary underlying benchmark for floating rate investments globally is finally coming to an end, with the Secured Overnight Financing Rate, or "Sofr", set to take over by 1 July.

The Alternative Reference Rates Committee (ARRC) of the Federal Reserve and NY Fed was not only commissioned to identify a new benchmark, but also to calculate credit spread adjustments (CSAs) to ensure market participants received adequate compensation from the replacement rate. But we have been disappointed by the failure of some CLO collateral managers to ensure that CSAs are implemented as intended.

The importance of spread adjustments

Libor relies on rate quotes from the interbank lending market, while Sofr sits atop the much more liquid treasury repo market. As a result, Sofr will include a lower risk premium over time. Therefore, CSAs were calculated by the ARRC (with assistance from Isda) for Libor tenors ranging from one week to one year.

The CSAs were provided in regulatory directives in 2021 to ensure issuers would include them as appropriate. The most important for CLOs and loan issuers are those in relation to the one-month, three-month and six-month tenors, with a borrower generally able to choose one consistent with its selected payment frequency. These CSA values were set at +11.448 basis points, +26.161bp and +42.826bp, respectively.

Today, the CLO market is overwhelmingly consistent in its usage of ARRC language other than in a few seasoned, amortising transactions (a substantial amount of which can rely on the Libor Act to implement the ARRC fallbacks if no replacement language exists at all). It is working diligently to convert CLO liabilities to Sofr plus the ARRC CSAs.

But the broadly syndicated loan market continues to capitulate to issuers, even against ARRC-specific directives, as loan managers wilt in the face of amendment pressures. And some CLO collateral managers have complained about the administrative burden of amendments, though they clearly have the resources to deal with them.

Some of the largest CLO collateral managers in the world have passed over abilities to object to benchmark rate amendments with CSAs well below the ARRC suggestions, in some cases with no adjustment whatsoever.

From our seat, we see the fear of sponsor or underwriter retaliation and the potential to lose future allocations causing CLO collateral managers to think twice. But the CLO market is more than 60% of the loan market — so managers are not alone in this fight. The size of the ETF or otherwise agnostic loan investor is significantly less today than historically. Together, the CLO collateral manager universe can ensure loan issuers implement the ARRC's recommended CSAs — so long as we hold the line.

Disappointingly, we still see certain CLO collateral managers, who are implementing +26.161bp pursuant to their CLO indenture language, watching as "no consent" amendments pass across their desks at substantially lower CSAs for their underlying broadly syndicated loans.

These managers are asleep at the wheel and surrender economics without so much as an objection, let alone an angry call to the sponsor. This makes them complicit in an entirely unintended reduction in available interest proceeds to cushion debt service coverage tests, which reduces payments to equity investors. To us as CLO equity investors, this lack of focus is equivalent to CLO collateral managers increasing their fees by 20% or more due to an inability to do their jobs as stewards of our CLO equity capital.

> Some CLO managers are asleep at the wheel and surrendering economics without any objection

There is seemingly no justification for loans to use a basis below the ARRC rate, especially as swap rates on all three to seven-year maturity credit (which comprises most of CLO portfolios) basically match the ARRC-recommended CSAs for one, three and six-month resets. CLO collateral managers that do so are in major need of an attitude adjustment. They must recognise their fiduciary duties and push back.

copyright material