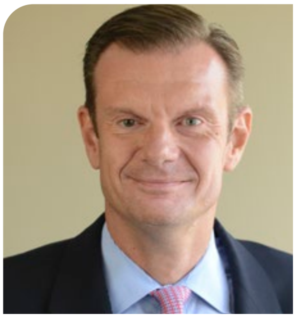

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Volcker rule amendments could protect CLOs from losing out to distressed funds in a restructuring

Distressed exchanges offer pathways to recapture value that others are trying to take from CLOs

Recently, we've been part of market discussions on the utility and potential risks associated with swapping or exchanging discounted/defaulted assets. Some have gone so far as to say that these exchanges are novel and represent a trend towards less secure CLO documentation. The truth, however, is that these provisions have been a part of all managed CLOs since the 1.0 era and they offer benefits for both debt and equity investors.

Distressed or bankruptcy exchanges present themselves in a variety of different forms in CLO documentation. They are often called 'swapped defaulted obligations', or 'work out obligations' and have been part of standard rating agency criteria for some time. These provisions allow CLO collateral managers to exchange defaulted loan assets for restructured securities other than loans issued by the same obligor.

In many cases, workout assets provide the potential for a greater ultimate recovery versus an immediate sale. Indeed, in the limited number of bankruptcies we've seen, some distressed funds, looking for any last way to make money, have tried to steer corporate restructurings in ways that take value for themselves and away from CLOs.

To protect against misuse, CLO indenture terms ring-fence risks with percentage-use limitations, collateral-quality consistency requirements and collateral manager certifications on the likelihood of better recovery. Without these provisions, collateral managers may have to accept discounted amounts of cash in lieu of new securities.

CLOs are handicapped in restructurings

Proposed revisions to the Volcker rule will hopefully soon again allow CLOs to purchase securities, such as preferred equity, from recovery proceeds in restructurings. Without these provisions and the proposed regulatory amendments, in some cases, CLOs could be disadvantaged in restructurings where newly created non-loan securities are involved. For example, in the Acosta restructuring, preferred equity investment was a prerequisite to participation in the debtor in possession facility.

As a strong protection for CLO debt investors, CLOs generally treat these kinds of securities as zero for over-collateralisation purposes, so we see only an upside for them, as the worst possible outcome is factored into the OC test until such time as the asset is ultimately liquidated.

Discount swaps enhance portfolio quality

When the price of an eligible asset already owned by a CLO falls without default or significant downgrade occurring, the collateral manager has a meaningful disadvantage if it does not have the ability to swap. A sale at that time, for a price lower than the asset's ultimate value, will require the collateral manager to crystallise a par loss in the CLO.

The discount swap provisions (commonly referred to as 'swapped non-discount' in CLO indentures) allow the collateral manager, without an immediately realised over-collateralisation haircut, to swap the discount asset for another CLO eligible asset with an equal or greater market value and rating. In the end, though you may be changing the individual asset, you are not impairing the portfolio's credit quality. In fact, you are likely improving it.

Skilled collateral managers use these swap provisions to build par value by shedding assets they believe are on their way down for those headed in the opposite direction. Rating agency requirements ensure that collateral managers use these provisions solely in efforts to improve portfolio quality and significantly limit their use over the life of a CLO so that the application is selective.

Work out obligations and discount swap provisions have long had a place in CLO documentation and prudent CLO collateral management. They ensure that CLO collateral managers are not disadvantaged compared to manages of less restricted entities in dealing with distressed assets by offering controlled and reasoned pathways to recapture value that others are trying to take away from CLOs. These provisions are not new or novel, but rather have been a driver in the long-term success of many CLOs.