Asset Securitization

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A new way to refinance CLO securities

At a time when much of the CLO market's creative energy has been concentrated on developing structures to facilitate compliance with the U.S. risk retention rules, another innovation has emerged: Applicable Margin Reset (AMR), a mechanic designed to address certain inefficiencies in traditional CLO refinancings.

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Traditional CLO refinancings

The right to direct—or, in certain cases, approve—the refinancing of one or more classes of rated CLO securities after a specified noncall period through the issuance of replacement securities at market-clearing interest rates is a fundamental structural feature of the most subordinated class of CLO securities (commonly referred to as the CLO "equity"). Fueled by compressing spreads and increased investor demand for floating rate debt, refinancings of this "traditional" nature have risen to unprecedented volumes in 2017.

Despite their prevalence and value to equity investors, traditional CLO refinancings are not without structural shortcomings. The replacement securities issued pursuant to a traditional refinancing, like the original securities being replaced, must be structured, newly offered and rated, thereby requiring the re-engagement of an underwriting bank, rating agencies and legal counsel. Traditional refinancings are document intensive, time-consuming and costly, with transaction expenses typically hovering in the mid six figures.

Moreover, it is generally accepted that issuing replacement securities pursuant to a traditional refinancing constitutes an "offer and sale of asset-backed securities by an issuing entity," thereby necessitating compliance by the related CLO manager with the retention and disclosure requirements of the U.S. risk retention rules. Consequently, traditional refinancings occurring after the Dec. 24, 2016, effective date of the U.S. risk retention rules are generally required to comply with such requirements, including in cases where the original CLO to which the refinancing relates was itself in compliance with the rules on the original closing date.

The AMR alternative

Conceived by Sancus Capital Management as a means of repricing certain rated CLO securities while reducing the time and cost of a traditional refinancing, AMR mechanics allow for the reset of the coupon of one or more designated "AMR Classes" of rated securities after the noncall period through a Dutch auction. To facilitate the auction process, Sancus established the first AMR auction service provider platform, which was subsequently spun off to an independent company.

AMR procedures may be initiated at the direction of a majority of the CLO equity and/or the CLO manager, or, if permitted by the underlying indenture, may occur automatically, subject in each case to certain objective conditions precedent. The indenture specifies each date on which an AMR auction may be conducted.

AMR procedures generally operate as follows:

- Prior written notice of each AMR date is given by the CLO trustee to the holders of each AMR Class and certain other transaction parties, which notice includes, among other things, the auction procedures.
- The auction is convened on a platform established by an AMR auction service provider for the submission of bids by platform member broker-dealers, which are also preapproved trading counterparties of the AMR settlement agent.
- Communication of confidential bids representing a commitment to purchase up to a specified principal balance of a particular AMR Class at a spread (margin) to Libor not higher than a predetermined maximum margin are facilitated by the auction service provider.
- If sufficient bids not exceeding the maximum margin are received, the lowest margin at which such bids fully account for the aggregate principal balance of all securities (other than securities held by holders of risk retention interests), i.e., the "clearing rate," of the relevant AMR Class becomes the new applicable margin for such AMR Class.
- After the new applicable margin is established, the securities comprising each relevant AMR Class are mandatorily tendered pursuant to DTC protocols (in the

case of book-entry securities) to the CLO securities intermediary, who in turn free delivers such securities through DTC to the winning bidder(s).

- If bids are insufficient to establish the clearing rate for an entire outstanding AMR Class, the auction fails and the applicable margin remains the same, it being understood that a failed auction for one AMR Class does not impact the new clearing rate of any other AMR Class for which the auction was successful.
- On any subsequent AMR date, the foregoing procedures are repeated.

To the extent that an AMR Class contains risk retention securities under the U.S. or European risk retention rules, such securities can be excluded from the AMR procedures, with the clearing rate being applied to such securities automatically.

The structural efficiencies of AMR procedures are numerous. Unlike a traditional CLO refinancing, AMR procedures obviate the need for engaging an underwriting bank or procuring a rating for new securities. Moreover, the AMR auction process is both transparent, with the results being made publicly available, and fundamentally democratic, providing access to investors who might otherwise be excluded from a traditional refinancing underwriting.

Streamlining matters further, AMR procedures require neither the cancellation nor reregistration of any securities, nor are new CUSIPs required to be obtained. In contrast to a traditional CLO refinancing, a transfer of AMR securities takes the form of an uncomplicated and inexpensive secondary market transaction between buyer and seller.

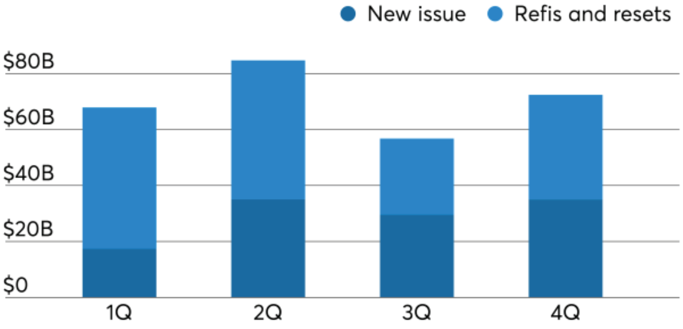
AMR and risk retention

In response to a request letter on behalf of Sancus Capital Management, the SEC confirmed in a Sept. 1, 2016, no-action letter that resetting the applicable margin of an AMR Class using AMR procedures would not constitute an "offer and sale of asset-backed securities by an issuing entity" and would therefore be unlikely to require compliance with the U.S. risk retention requirements.

Importantly, the SEC guidance applies solely to the AMR procedures outlined in the request letter, which procedures provide, among other things, that neither CLO security holders nor any other transaction party will have any discretion to call for or cause an auction date to occur. In order to minimize the chance an AMR Class reset might trigger risk retention obligations, AMR procedures must therefore be structured to adhere to the specific conditions of the request letter.

Cheaper funding

Resets and refinancings of CLOs outpaced new issuance for much of 2017



Source: Thomson Reuters LPC

For newly issued CLOs where the manager holds its U.S. retention interest in "horizontal" form by purchasing CLO equity equivalent to at least 5% of the fair value of all related CLO securities, the advantages of AMR procedures meeting the criteria set forth in the Sancus request letter can be substantial. Horizontal risk retention requires the manager to conduct a fair value analysis on its horizontal strip. Since CLO equity is likely to be lower in value after the noncall period than on the original closing date, AMR procedures not only eliminate the costly process of refreshing the closing date fair value assessment, but also avoid the risk that the manager will be obligated to retain additional CLO equity.

Notably, in cases where the manager has retained a "vertical" risk retention interest at the original CLO closing, departures from the conditions described in the Sancus request letter are inconsequential, as such manager will continue to retain its mandated 5% interest in each applicable AMR Class even if the auction is successful.

AMR and CLO repricings

Those familiar with CLO structures may recognize similarities between AMR procedures and the "repricing" feature, a widely used provision in CLO indentures that, like AMR procedures, permits a reduction in the applicable margin of one or more existing classes of CLO securities after the noncall period without the need for a new issuance of replacement securities. A number of key distinctions, however, set AMR procedures apart.

For one, while a CLO repricing is customarily subject to consent rights on the part of the affected security holders with a forced transfer if such consent is not obtained, the CLO issuer need not seek the consent of the holders of AMR Classes. Rather, to the extent that an AMR auction is successful, the applicable margin of an AMR Class resets automatically, without further action by any security holder.

Further, while repricings typically require the preparation of a supplemental indenture documenting the new applicable margin, AMR procedures require only the posting of a pricing supplement to the offering document to the trustee's website. Finally, unlike AMR mechanics structured in accordance with the Sancus request letter, there is significant market uncertainty as to whether a traditional repricing would trigger the U.S. risk retention requirements, and, if triggered, how the manager would obtain the securities necessary to comply with such requirements.

The AMR feature is an effective and efficient CLO innovation. Since the AMR procedures are relatively new to the marketplace, they have yet to gain widespread traction. Such procedures have, however, been included in a number of recent new issuances arranged by MUFG, and it seems only a matter of market education and time before they become a more commonplace CLO feature.

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