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Corporate credit downgrade storms have been weathered before, but this one has come out of season

ately, it seems financial media reports about the CLO market have warned every day of the impending doom from the slew of triple C downgrades and defaults within CLOs. With over-collateralisation (OC) test cushions eroding, pundits have criticised CLOs as another excess generated by Wall Street. We have yet to read an article that recognises that OC tests are relevant only on quarterly payment determination dates; and, more specifically, only at the close of business on those dates.

Loans typically make their payments around the end of each calendar quarter. Elegantly, well-structured CLOs have their payment determination dates five to 10 days after the start of a calendar quarter. This allows CLOs to collect loan payments and distribute them promptly to CLO security holders, as idle cash in a securitisation dilutes returns.

CLO payment calendars are well organised

What was perhaps historically under-appreciated about determination dates is the time isolation they usually have from many of the rating agencies' actions on corporate loans.

Changes to loan ratings (upgrades or downgrades) often happen shortly after a company's earnings are released. Earnings season typically runs 20 to 50 days after the start of a quarter — comfortably after CLOs have already had

We've observed loan downgrade storms many times before — but this time many of the loan rating actions took place directly in CLO determination date season, something I don't recall happening previously.

In some cases, the day before a given CLO's determination date, CLO collateral managers calculated that their CLO was comfortably passing its OC tests — only to find more loans downgraded to triple C overnight, so their CLO was failing OC tests on the morning of the actual determination date.

In a number of cases that we are aware of, CLO collateral managers actively traded their portfolios on the determination date to maintain compliance with OC tests. You could easily describe those days as hand-to-hand combat for loan traders at CLO collateral managers.

Trading counts — now more than ever

We can hope that such unfortunate timing of rating actions does not occur again — but these events highlight the need to understand the approaches of different CLO collateral managers when trading within their CLOs. If your CLO portfolio didn't see an increase in turnover during March and April, investors might be wise to ask why not.

Looking forward to the next determination date season in early July, things could get more

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their determination date for that quarter. So if a loan portfolio faced a surge of downgrades, CLO collateral managers historically had 45-plus days to trade. In many cases, this allowed them to prudently reposition their portfolios and maintain compliance with OC tests.

Enter covid-19. Faced with a pandemic at a scale not seen in over 100 years, and the resulting unknown economic consequences, rating agencies were quick to downgrade (or put on negative watch) many loans held in the CLO universe. In fairness, while their actions were plentiful and may have seemed harsh, it was difficult to find fault with the overall magnitude or timing of the downgrades, even if the agencies have responded more expeditiously now than in other economic downturns.

interesting. Whereas, April was filled with rating actions, July could see the coronavirus era's first wave of actual loan defaults.

Even though the market has assessed companies and priced in near-term default risk, markets are imperfect and there are always some surprises — both positive and negative. A potential wave of loan payment defaults into July's determination date season would be something else new for the CLO market. Hopefully loan traders are well rested.

There is one silver lining in all this upheaval — thanks to the covenant lite nature of most of the loan market, while we can debate the potential magnitude of payment defaults, we won't be too worried about companies failing maintenance covenants.