

Legal Update

Blended Benefits: LIBOR Replacement Provisions in CLOs

Transactions in the collateralized loan obligation ("**CLO**") market have generally included some form of LIBOR replacement provisions for over a year, stemming from the announcement in July 2017 by Andrew Bailey, the head of the UK Financial Conduct Authority ("**FCA**"), that the FCA intended to phase out LIBOR in its present form by the end of 2021. Recently, a new iteration of LIBOR replacement mechanics has debuted. This latest iteration adapts language from the Alternative Reference Rates Committee's ("**ARRC**") May 31, 2019 recommended fallback language for new issuances of LIBOR securitizations,¹ resulting in these CLO provisions being viewed by some as "hardwiring" a replacement reference rate (based on a limited array of prioritized options) into CLO documents. However, while this approach does have an element of hardwiring, in that it specifies a fallback waterfall of particular replacement rates that can be implemented in the CLO without investor consent, the rate produced by the fallback waterfall—at least in the relevant CLO transactions in which Mayer Brown has been involved—is not automatically implemented as "pure" hardwiring would dictate. Rather, the approach in these CLOs preserves discretion for the collateral manager, with the consent of specified classes of investors

(typically a majority of the controlling class and frequently also a majority of the equity), to implement a replacement rate other than the rate produced by the fallback waterfall. Because the rate produced by the fallback waterfall (i.e. the "hardwired" rate) does not *automatically* replace LIBOR as the reference rate following a trigger event, this latest iteration blends a "hardwiring" approach with an "amendment" approach. We therefore refer to it as the "**Blended Approach**."

In our view, the Blended Approach achieves two positive outcomes for the CLO market: On the one hand, it signals an acceptance of SOFR as the preferred successor benchmark to LIBOR while, on the other hand, it preserves flexibility for the collateral manager to implement a different replacement reference rate with streamlined investor consent requirements following a disruption to LIBOR, a flexibility that can help avoid a basis mismatch with the reference rate prevailing in the CLO's portfolio at the time. We discuss these benefits in more detail below. Before doing so, we briefly look at how the Blended Approach updates the LIBOR replacement provisions otherwise prevailing in the CLO market and how the Blended Approach addresses value transfer and basis risk concerns.

The Amendment Approach to LIBOR Replacement in CLOs

The LIBOR replacement mechanics in CLOs that do not utilize the Blended Approach typically institute a reduced investor consent threshold for a supplemental indenture to change the reference rate applicable to the CLO's liabilities following a trigger event—including a complete elimination of investor consent if certain conditions are satisfied, as described below—with the collateral manager being the party responsible for selecting a replacement reference rate.² While there has been variation across the CLO market in some particulars of this approach, for simplicity we will refer to this approach as the "**Amendment Approach**."

Under many versions of the Amendment Approach, if the collateral manager selects a replacement reference rate that satisfies certain specified criteria (a "**Specified Rate**"), no investor consent is required to implement that replacement reference rate. The collateral manager may also select a replacement reference rate other than a Specified Rate, but the use of that other rate requires consent from a majority of the controlling class plus, frequently, consent from a majority of the equity.³

The primary evolution embodied in the Blended Approach is the replacement of the Specified Rate concept with a fallback waterfall of replacement reference rates based on the ARRC's fallback waterfall for new issuances of LIBOR securitizations (the "**ARRC-Based Waterfall**") that specifies a SOFR-based reference rate in the first and second instances as the replacement rate that can be implemented without investor consent,⁴ while preserving the flexibility of the collateral manager (subject to a streamlined set of investor consents) to select a rate other than the one resulting from the ARRC-Based Waterfall.

Value Transfer and Basis Risk Considerations

Two of the central concerns that LIBOR succession mechanics aim to address are value transfer and basis risk. Based on current information about the loan market and the future of LIBOR, at this time we believe that the Blended Approach addresses these concerns in a way that, for CLO transactions, is superior to a "pure" hardwired approach that would automatically implement a predetermined successor reference rate following a trigger event.

Value transfer. First, automating the implementation of the replacement benchmark at the CLO level before the identity of the replacement benchmark is known at the underlying asset level may produce value transfer, because the replacement benchmark at the CLO level may favor either debt investors or equity investors relative to the rate being earned on the CLO's portfolio, and no class of investors will be able to prevent this value transfer because no class of investors will be entitled to consent rights in relation to the replacement benchmark (nor will the collateral manager have any ability to prevent implementation). The Blended Approach mitigates this problem because the collateral manager is not required to implement the rate produced by the ARRC-Based Waterfall but can implement another rate with investor consent. Nevertheless, the risk is not completely eliminated because value transfer could still result if the collateral manager elects to use the rate resulting from the ARRC-Based Waterfall, which the collateral manager is entitled to do without investor consent.⁵

The Blended Approach also mitigates value transfer as compared to the Amendment Approach in that the Blended Approach more precisely weds the selection of the spread modifier (often referred to as the "benchmark

replacement adjustment") to the selection of the replacement base rate, thereby ensuring that the modifier and base rate are appropriately paired to create a rate that most closely approximates LIBOR.

Basis risk. Second, automating the implementation of the replacement benchmark at the CLO level before the identity of the replacement rate is known at the underlying asset level may produce basis risk because, if the fallback waterfall at the CLO level results in a replacement benchmark that is different from the one that is prevailing in the loan market at the time, there will be a mismatch between the interest rate that the CLO earns on its assets and the interest rate it must pay on its liabilities, which could reduce returns to the CLO's equity investors and potentially also adversely affect payments to one or more classes of the CLO's debt investors. Although current indications are that the consensus replacement benchmark in the loan market will be some form of SOFR (which would be consistent with the initial outputs of the ARRC-Based Waterfall), at this stage it remains unknown whether and, if so, when, SOFR will ultimately be the prevailing rate in the loan market.⁶

The Blended Approach mitigates basis risk by permitting the collateral manager (with specified investor consents) to implement a rate other than the rate produced by the ARRC-Based Waterfall, which the collateral manager could be expected to do if the loan market had adopted a different rate than the one produced by the ARRC-Based Waterfall. Since CLOs repackage loan exposures, there is a risk for CLOs in getting out in front of the loan market on benchmark replacement and committing to a specific replacement rate before the loan market does. And even if the replacement rates in the CLO market and the loan market ultimately end up being the same, a difference in the timing of the transitions in the respective markets could produce basis

risk during the transition period. We believe that, in and of itself, favors the flexibility afforded by the Blended Approach.

To fully benefit from the mitigation of basis risk provided by the Blended Approach, we further recommend that market participants adopting the Blended Approach include a trigger event that occurs if a specified percentage (e.g., more than 50% by principal amount) of the loans in the CLO's portfolio use a benchmark other than LIBOR (an "**Asset Replacement Percentage**" concept), which is not uniformly included as a trigger by CLOs using the Amendment Approach. The Asset Replacement Percentage trigger can help to mitigate basis risk in the event that the loan market adopts a replacement benchmark before there has been a disruption to or cessation of LIBOR. In general, it would, of course, be a desirable outcome for the financial markets if the loan market adopts a successor benchmark before a LIBOR disruption occurs, but at the CLO level that would introduce basis risk if, due to the absence of a relevant pre-disruption trigger event, the CLO cannot respond through a streamlined amendment process to implement a benchmark replacement.

Conclusion: Benefits of the Blended Approach

While automatic implementation of a hardwired replacement rate following a disruption to LIBOR will undoubtedly be a desirable outcome in the CLO market in the future when there is certainty and complete information about the benchmark that will replace LIBOR in the loan market, the current environment is one of imperfect information. We believe that, in these circumstances and at this time, the Blended Approach for CLOs strikes a workable balance between signaling support for a SOFR-based replacement reference rate and preserving flexibility to

mitigate basis risk and value transfer related to the replacement of LIBOR.

First, the Blended Approach signals to the CLO and loan markets an acceptance of SOFR as the preferred benchmark rate to replace LIBOR. It is desirable for the stability of the financial markets that they coalesce around a single replacement for LIBOR, and the Blended Approach indicates that the relevant CLO investors are comfortable enough with SOFR to accept it as a replacement rate at the CLO level without a requirement that investors give consent at the time of the transition. In fact, to be more specific, the Blended Approach signals that a SOFR-based benchmark will be acceptable to the relevant CLO investors as a replacement reference rate even if term SOFR is not available at the time of the transition. The fact that the Blended Approach is being adopted in some CLOs at a time when term SOFR is not currently available (other than as an indicative rate) demonstrates investor acceptance of the possibility that compounded SOFR, the second option in the ARRC-Based Waterfall after term SOFR, may be implemented in the CLO without investor consent.⁷ This is a meaningful indication that SOFR is the preferred LIBOR replacement, even if term SOFR never materializes.

Second, it is a positive outcome for the CLO market, in our view, if the rate resulting from the "hardwired" ARRC-Based Waterfall is not automatically or necessarily implemented by the collateral manager. While the stability of the financial markets is a goal shared by CLO market participants, until there is greater certainty around the actual replacement benchmark that will be adopted by the loan market, we are concerned that committing CLOs to automatic benchmark replacement with a specified rate could produce an opposite, destabilizing result by causing a basis mismatch with the CLO's assets if the

loan market has not yet transitioned to a successor rate or, worse, has implemented a different replacement rate. We believe that, to minimize basis risk, it is beneficial for CLO indentures to continue to include flexibility for the CLO to amend its reference rate to match the successor benchmark that ultimately prevails in the loan market.

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Endnotes

¹ The ARRC's recommended language is at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Securitization_Fallback_Language.pdf.

² In the absence of such mechanics, a change to the reference rate would generally be expected to require the consent of 100% of the holders of every class of securities.

³ In many CLOs using the Amendment Approach, the Specified Rate is defined as the rate recognized or acknowledged by the Loan Syndications & Trading Association or ARRC, the rate used by 50% or more of the floating rate assets in the CLO portfolio or the rate used by 50% or more of new issue CLO liabilities issued over a specified lookback period.

⁴ The first replacement benchmark specified by the ARRC-Based Waterfall of replacement reference rates used in the Blended Approach is term SOFR (plus a spread modifier). If term SOFR is not available, the next replacement benchmark specified is compounded SOFR (plus a spread modifier). Since spot SOFR already exists, compounded SOFR already exists as well, making it unlikely that any of the other benchmarks included in the ARRC-Based Waterfall will come into play.

⁵ Market participants could consider modifications to the Blended Approach in order to further mitigate the risks of value transfer and basis mismatch. For example, the CLO indenture could grant an objection right to one or more classes of investors that applies if a specified percentage (e.g., more than 50% by principal amount) of loans in the CLO's portfolio are accruing interest based on a benchmark rate that is different from the rate resulting from the application of the ARRC-Based Waterfall. Alternatively, in lieu of investor objection rights, the ARRC-Based Waterfall could be modified to provide that if a specified percentage of loans in the CLO's portfolio are accruing interest based on a benchmark rate that is different from the rate that would otherwise result from the application of the ARRC-Based Waterfall, the rate prevailing among the loans in the CLO's portfolio would instead be the benchmark that could be implemented by the collateral manager without investor consent. Another possibility is that the collateral manager could be given discretion not only to implement a replacement rate other than the rate produced by the ARRC-Based Waterfall but also to defer implementation of a replacement rate until a specified percentage of loans in the CLO's portfolio were accruing interest based on a benchmark rate other than LIBOR.

⁶ Unlike some forms of traditional securitization that may be more suited to automated benchmark replacement provisions, CLOs have little control over the benchmark that will apply to the CLO assets, which, in the case of most CLOs of broadly syndicated loans, are purchased in the open market from third parties. Credit agreements in the broadly syndicated loan market have not yet implemented hardwired benchmark replacement mechanics that will prescribe SOFR as the successor rate to LIBOR but instead are generally adopting an amendment approach that requires lender consent to implement a replacement. To the extent that CLOs hold minority positions in loan facilities, CLOs will not necessarily be able to control the identity of the replacement rate selected by lenders if replacement does not require the unanimous vote of the lenders. Additionally, new information may arise or new developments may occur that could cause the loan market to implement a consensus replacement benchmark other than SOFR.

⁷ Presumably, a reputable collateral manager would not implement compounded SOFR if a SOFR-based benchmark were not prevailing in the loan market at the time, but the fact remains that under the Blended Approach, investors do cede control in relation to the implementation of the rate produced by the ARRC-Based Waterfall. If the collateral manager is unable to garner approval for a given alternative rate from investors at both the top and bottom of the CLO capital stack, investors could be stuck with SOFR even if a better alternative were available at the time.

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