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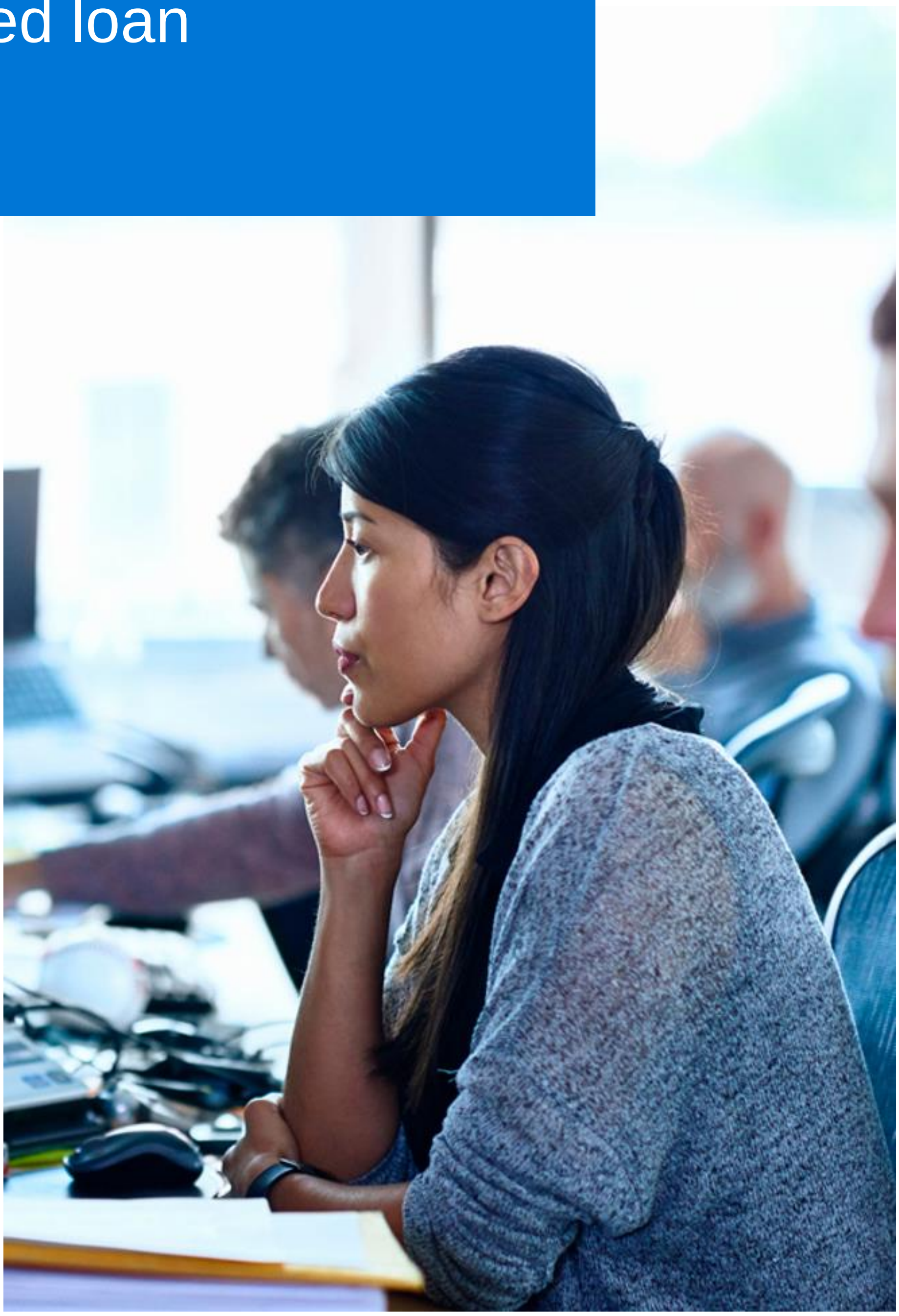
For Professional Clients only. Capital at risk.

The loan arranger

What are the potential benefits of collateralised loan obligations?



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What are CLOs?

The world of finance is filled with jargon and acronyms, and CLOs (collateralised loan obligations) are a part of that 'alphabet soup'. In simple terms, CLOs are a pool of loans, housed within a special purpose vehicle (SPV), with credit enhancement features that could potentially make different parts of the securitisation structure attractive to different investor types.

A CLO manager bundles together loans issued by banks to companies through the process of securitisation via an SPV. The bundle of bank loans is then split into tranches with different credit ratings, from an equity tranche (at the bottom of the capital structure which can offer the highest potential return, but also absorbs potential losses first) to the most senior AAA tranche, which is the first to receive cashflows from the underlying loans and the last to absorb any losses.

Background

CLOs have been around since the late 1980s. They were developed as a way for banks to package leveraged loans together and transfer the credit risk to investors, creating investment vehicles with varied degrees of risk and return to suit different investor objectives. Since their introduction, they've grown from a niche asset class into a significant market. The US CLO market alone totals $1.1 trillion*, reflecting the increasing acceptance and integration of CLOs into mainstream investment portfolios.

CLOs have been through multiple cycles including the global financial crisis (GFC) of 2007-2009. The financial crisis severely impacted investor appetite, despite AAA and AA tranches not experiencing any impairments.

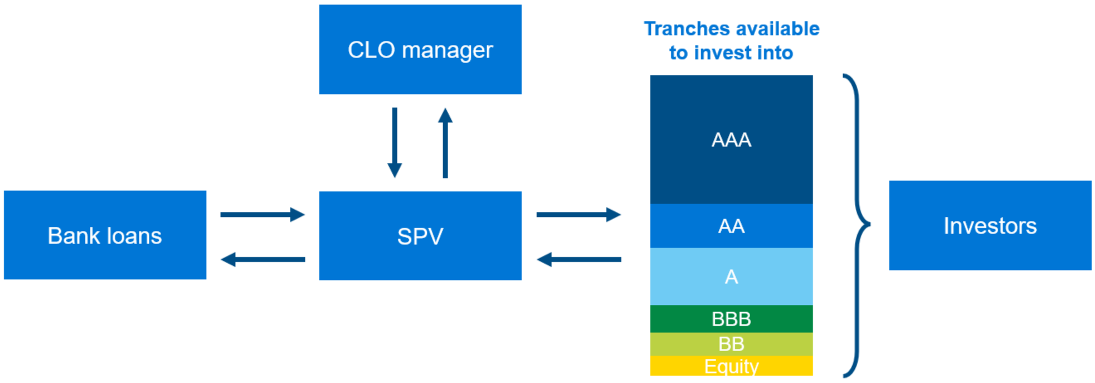
Since the GFC, the investor base has broadened, driven by regulatory changes to enhance transparency and risk management. The investor base is diverse. CLOs are widely held by banks, insurance companies, pension funds, asset managers and hedge funds, which is an important consideration when investors are seeking liquidity.

What is the CLO process?

The bank loans underlying a CLO portfolio are typically rated BB+ or lower (i.e. sub-investment grade). The CLO capital structure is then divided into different investible tranches:

* Source: Bank of America, as at 31 December 2024.

CLO structure illustration



Credit enhancement is key to the securitisation process and is an important concept to understand. It helps to protect senior bondholders against potential losses in the underlying assets. The process of securitisation is not 'investment alchemy' in which low-quality credit assets magically 'transform' into higher-quality assets. Instead, it's a risk transfer technique that seeks to mitigate losses in stressed scenarios for risk-adverse investors holding senior tranches. The most senior tranche, with a AAA credit rating, is the first to receive underlying loan repayments and the last to incur losses from defaults. The equity tranche is the last to receive underlying loan repayments and the first to incur losses from defaults. As a result, the more senior the tranche, the lower the potential return and risk for the investor. By structuring the SPV into tranches, issuers can cater to different investor risk appetites.

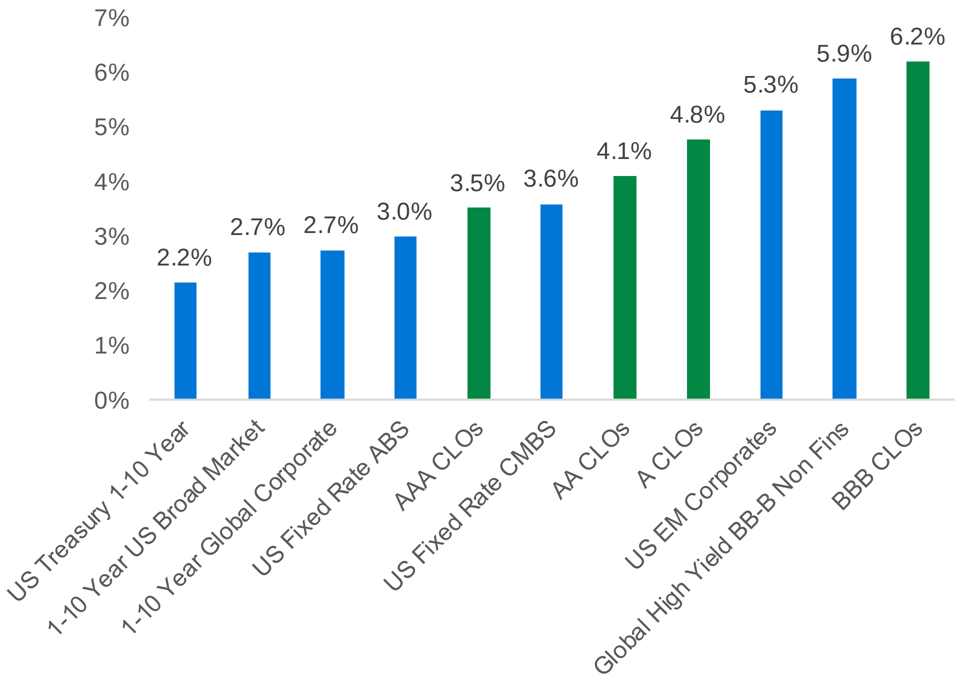
The CLO manager actively manages the pool of underlying leveraged loans during the CLO's reinvestment period, where the manager reinvests loan principial repayments by purchasing new collateral.

What makes CLOs potentially attractive investments?

1. Risk / return characteristics

CLOs generally offer higher yields compared to many other credit assets, despite having stronger credit ratings. As you can see in the chart below, BBB CLOs have a similar yield to high yield bonds which are typically sub-investment grade (i.e. below BBB-). This is largely attributable to the relative complexity of the CLO asset class.

Monthly average yield to worst data



Past performance is not a guide to the future.

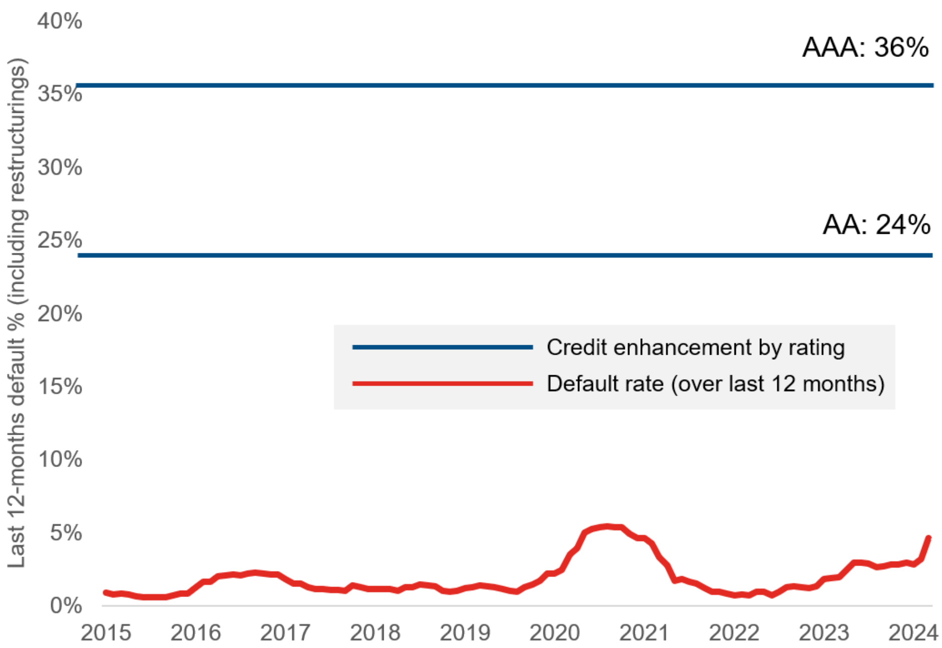
Source: Bloomberg Bank of America Merrill Lynch indices and JP Morgan CLOIE indices, as at 31 December 2024.

2. Credit enhancement

Credit enhancement is a key concept to understand. There are three main types of credit enhancement: subordination, over collateralisation, and excess spread. Subordination is the process of dividing the SPV into tranches whereby the most senior tranche is the first to receive loan repayments and the last to incur any losses from defaults. Over collateralisation is the process of providing collateral that exceeds the value of the tranches issued. Excess spread refers to the difference between the interest received from the underlying loan pool and the interest paid on the CLO debt tranches to investors.

The overall impact of credit enhancement can be illustrated in the chart below. The collateral pool would need to experience losses in excess of 24% for AA tranche investors to incur any losses and 36% for AAA tranche investors to incur any losses.

CLO default rate versus credit enhancement



Past performance is not a guide to the future.

Source: Bank of America through April 2024.

In fact, no AAA or AA rated tranche has ever defaulted during the asset class's existence since 1993. The table below details the breakdown of impairments by original rating and region of issuance from 1993 to 2023.

Exhibit 5

Material impairments by original rating and sector

Principal impairments					Interest impairments				
Original rating	US CLO	European CLO	Asia-Pacific CLO	Total	Original rating	US CLO	European CLO	Asia-Pacific CLO	Total
Aaa	0	0	0	0	Aaa	0	0	0	0
Aa	0	0	0	0	Aa	0	0	0	0
A	1	0	0	1	A	0	0	0	0
Baa	23	3	1	27	Baa	0	0	0	0
Ba	36	15	0	51	Ba	3	0	0	3
B	19	0	1	20	B	4	0	0	4
Caa	0	0	0	0	Caa	0	0	0	0
Total	79	18	2	99	Total	7	0	0	7

Source: Moody's Ratings

Past performance is not a guide to the future. Source Moody's, Impairment and loss rates of global CLOs: 1993-2023.

CLOs are unique as the only securitised asset class that is actively managed. The risk of losses in CLOs is minimal due to the active management of the loan pool by the CLO manager. In contrast, other securitised transactions (with the exception of some types of asset-backed securities) involve static pools, meaning the collateral remains unchanged from issuance.

Please read our other paper *Securitised credit enhancement: credit where it's due* for more information.

3. Floating payments

Most corporate bonds have fixed coupon payments, meaning the coupon amount is predetermined. In contrast, CLOs feature floating-rate coupons that 'float' above a benchmark interest rate. Consequently, when interest rates increase, the coupon payments from CLOs also rise. This characteristic makes CLOs less sensitive to interest rate fluctuations compared to traditional corporate bonds with fixed coupons, which tend to decrease in value when interest rates rise (and vice versa).

4. Diversification[1]

Within the asset class – Each CLO manager typically manages a pool of loans that averages 250 or more loans across 30 different industries, offering diversification by industry and issuer. CLO documents specify the maximum exposure allowed for any industry or issuer.

At Legal & General, we also invest in 25 different CLO managers in our US Securitised funds (at the time of writing), offering an extra layer of diversification for our investors.

Outside the asset class – CLOs have historically typically exhibited a lower correlation to equities and other fixed-rate bonds. They can diversify a portfolio of credit assets by offering floating-rate coupons and demonstrating less sensitivity to interest rate movements compared to other credit instruments. Additionally, CLOs can be an effective component of a growth portfolio, providing potential diversification away from equities.

5. Liquidity

CLOs are often perceived as illiquid assets; however, this is not the case. The CLO market has experienced significant growth due to its favourable characteristics, which have attracted a diverse range of CLO managers and investors. Consequently, the CLO market is supported by a robust secondary market, providing potential liquidity.

[1] **It should be noted that diversification is no guarantee against a loss in a declining market.**

An attractive investment proposition?

We believe CLOs can be a valuable investment option, potentially offering higher yields, floating-rate payments, and diversification. The active management by skilled CLO managers, combined with the support of a robust secondary market, can help to enhance their appeal and potential liquidity.

CLOs have been resilient through various economic cycles. They have evolved from a niche asset class into a $1.1 trillion market, representing about 70% of the demand for US corporate loans today. Credit tranching is central to their appeal. By structuring the CLOs into tranches, issuers can cater to different investor risk appetites and enhance the overall credit profile of the senior tranches.

As with all forms of credit investing, security research is of paramount importance. At Legal & General, we undertake extensive due diligence and research when we invest and throughout the lifetime of our holding. And we only invest in the tranches with investment-grade ratings.

For more detailed information and personalised guidance on how CLOs can benefit your investment strategy, we invite you to reach out to us. Our specialist securitised credit team is ready to provide expert advice and support.

Securitised strategies at Legal & General Asset Management

Our dedicated team of securitised specialists is committed to selecting assets for both the US Securitised Fund and the US Securitised Plus Fund. Securitised assets are also integral to our Buy & Maintain portfolios, available in both pooled and segregated formats, catering to institutional investors such as pension schemes and insurers.

Key Risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested. Past performance is not a guide to future performance.

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