The NAIC's Capital Markets Bureau monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of U.S. insurance companies. Please see the Capital Markets Bureau website at INDEX.

Collateralized Loan Obligation (CLO) Combo Notes (Combo Notes) are a repackaging of all or a portion of CLOs' debt and equity tranches, often into a special p nBT/i2 75. 237.9 455s

Collateralized loan obligations (CLOs) are structured finance securities collateralized predominantly by a pool of below investment grade, first lien, senior secured, syndicated bank loans, with smaller allocations to other types of investments such as middle market loans and second lien loans. CLO debt issued to investors consists of several tranches, or layers, with different payment priorities and, in turn, differing credit quality and credit ratings. The senior-most tranche of a CLO is the most protected, in terms of credit enhancement, and, therefore, has the highest credit quality and the lowest coupon.

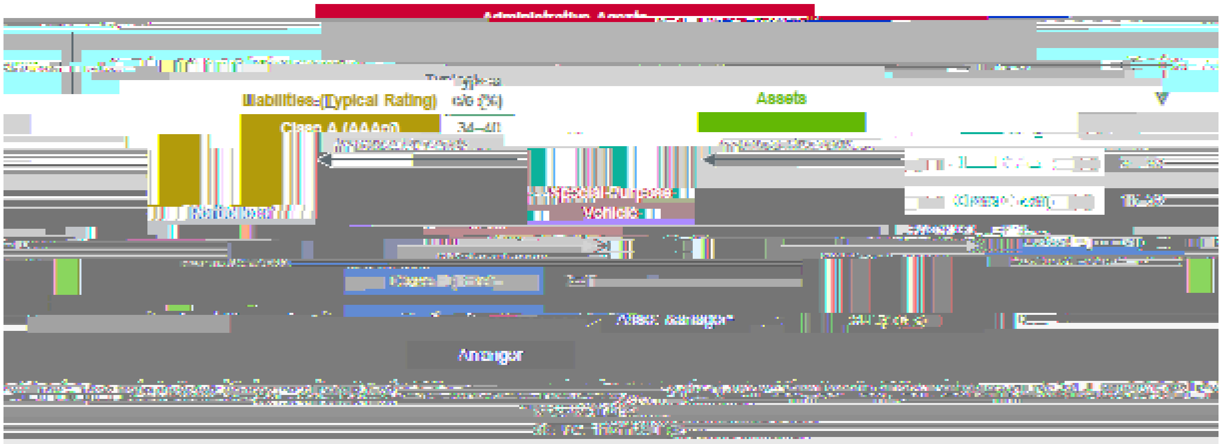
CLOs evolved out of collateralized bond obligations (CBOs), which are structured finance securities collateralized predominantly by high-yield bonds, first brought to market in the late 1980s. New issuance of CBOs has been insignificant as they proved to be volatile during the telecom/tech recession of the early 2000s. However, CLOs performed well during the recent financial crisis, so as a result, they were deemed “survivors.”

Underlying CLO Collateral

The credit risk of a CLO is dependent on the underlying assets within the portfolio. For “traditional” CLOs, the collateral pool primarily consists of below investment grade, first lien, senior secured broadly syndicated bank loans (usually at least 90% of the total portfolio), and it may include a predetermined allowable portion of other asset types such as second lien bank loans (which are highly leveraged) and unsecured debt, as well as middle market loans. Some CLOs consist predominantly of middle market loans as the underlying collateral.

The average rating of the collateral is typically about single-B, and the leveraged bank loans are typically floating rate, based on the London Interbank Offered Rate (LIBOR). A CLO collateral manager is respo l’ ŀb nlii Ŭ l’ ŀb ns twl’Ş a t l’ as Chc ying end hŐ assets wiFor “tr

An example of a CLO structure is shown in Figure 1.



Additional information on CLOs may be found in the NAIC Capital Markets Bureau's primer on [CLOs](), dated August 2018.

CLO Combo Notes (Combo Notes) are a repackaging of all or a portion of, several tranches from the same CLO, and in some cases, the CLO tranches are combined with a U.S. government bond (such as a Treasury strip) for principal protection (that is, when additional credit enhancement is needed). Combo Notes may be formed with just one or two tranches of a given CLO or several tranches of CLO, including the debt tranches and equity tranche (subordinated notes).

As shown in the example below (Table 1), the highlighted tranches (all except for the Class A-1 Notes) were placed into a combo note issued by a newly formed SPV.[1]

[1] Moody's Investors Service, New Issuer Report: 5180-2 (Combination Note) Ltd., December 2015.

Figure 2 shows the resulting combo note that was created with the aforementioned, highlighted tranches as "collateral." Note that a portion of the Class A-2A Notes and Subordinated Notes were included in the combo note.

Source: Moody's Investors Service: 5180-2 (Combination Note) Ltd.

In terms of structure, Combo Notes may be formed with any mix of a CLO's tranches. "The most common form [of Combo Notes] transforms bonds paying both principal and interest into principal-only notes."[2] Usually, a portion of the tranches with credit ratings of "A" or lower, as well as the equity tranche, are included in the combo note,[3] and it is structured as principal-only, with no stated coupon. (However, Combo Notes may be structured with a stated coupon.) Combo Notes are structured to meet an investor's specific coupon and ratings target.

NRSROs have established criteria related to assessing the credit quality and assigning credit ratings to CLO Combo Notes. The rating on Combo Notes is computed differently from CLO tranches. While similar economic and portfolio stresses may be completed upon assessing the credit quality of Combo Notes, they typically lack a regular principal balance or required interest payments, so instead, the ratings are based on ultimate payment of a notionally defined balance. The difference in the two approaches can be large.

In the example above, the average rating of the portfolio immediate paydown on its principal balance. Note that refinancing a CLO tranche is usually only permitted after its “non-call” period, or after the first two years

Historical CLOs Outstanding in the U.S. ..h

Once the reinvestment period has ended, the CLO manager pays down the debt (tranches, or CLO liabilities) following the priority of payments included in the legal documents, using bank loan prepayments or proceeds from the sale of underlying assets.

Date the underlying portfolio is fully ramped, and coverage and quality tests begin to take effect.

Structured finance security collateralized predominantly by bonds, particularly high-yield corporate bonds, investment grade corporate bonds, or emerging market sovereign and/or corporate bonds.

Structured finance security collateralized by trust preferred securities (TrUPS), asset-backed securities (ABS), residential mortgage-backed securities (RMBS), commercial real estate/commercial mortgage-backed securities (CRE/CMBS), or other CDOs or CLOs.

Structured finance security collateralized predominantly by broadly syndicated, leveraged bank loans.

Structured as a principal-

Loans by a group of lenders to companies that are typically rated below investment grade. The loans are

NAIC Capital Markets Bureau Special Report, "U.S. Insurance Industry's Exposure to Collateralized Loan Obligations as of Year-End 2018," June 2018.

NAIC Capital Markets Bureau Primer, "Collateralized Loan Obligations (CLOs) Primer," August 2018.