Explaining the Qualified CLO

The Qualified CLO creates six overlapping restrictions that meet a number of the agencies' objectives: It supports strong underwriting, it ensures a continuity of credit, it aligns the incentives of the managers and the investors, and it protects investors. In effect, for a CLO to become a Qualified CLO, its governing documents would have to include requirements and restrictions around (1) asset quality; (2) portfolio composition; (3) structural features; (4) alignment of the interests of the CLO manager and investors in the CLO's securities; (5) transparency and disclosure; and (6) regulatory oversight.

For asset quality, the CLO must invest at least 90% in cash and senior secured loans to companies (and only those that are subject to an annual audit); it cannot purchase ABS interests, derivatives, loans in default, margin stock, or equity convertible notes; loans must be held by three or more investors or lenders unaffiliated with the CLO manager; and no more than 60% can be covenant lite loans. In effect, the asset quality tests require the CLO to purchase high quality leveraged loans that have a low expected loss.

The next layer of protection comes from the composition of the portfolio. Not only must the CLO purchase higher quality leveraged loans, but it must do so in a diversified manner. To wit, no more than 3.5% can come from any one loan and no more than 15% can come from any one industry. With robust diversification, the whole portfolio should be stronger than the sum of its assets. To the extent that a CLO falls out of compliance with the portfolio or asset quality criteria, it can trade only to maintain or improve – not worsen – the test.

The next layer of protection comes from the CLO structure itself. In order to provide additional protection for the Qualified CLOs' debt tranches, the Qualified CLO equity must be at least 8% of the face value of the CLO assets. To add further protection for the debt tranches, the CLO must be subject to interest coverage and overcollateralization tests that divert cash to pay down the notes if the portfolio underperforms.

Next, the Qualified CLO ensures the alignment of interests between the manager and its investors. First, it must be an Open Market CLO, not a balance sheet CLO. Next, the equity investors must have the ability to remover the manager for cause. In addition, the majority of the managers' fees must be subordinated to the rated CLO notes. Moreover, the manager must purchase and retain 5% of the CLO equity. These protections – the ability to fire the manager, subordinating most of the income of the manager, requiring funded retention that is not paid out upon closing – align the interests of the manager and investor. In addition, the CLO managers' discretionary trading is limited, and U.S. CLO holders must be Qualified Investors.

That last point ensures that CLO holders are sophisticated and can make informed judgments about their investments. The next protection in the Qualified CLO – transparency and disclosure – ensures that the investor has enough information to make such a judgment. To be a Qualified CLO, the manager must provide a monthly report that provides significant information on the assets (obligor name, CUSIP, interest rate, maturity date, type of asset and market price where available) and on the portfolio (the aggregate balance, the adjusted collateral principal amount, and the percentage of adjusted collateral represented by each name). In addition, the report must detail each Overcollateralization and Interest Coverage test and their status, all purchases, repayments and sales, as well as the identity of each defaulted asset. With all this information, the Qualified CLO is extraordinarily transparent, unlike some of the securitizations that led to the financial crisis.

The final protection is built around regulation: The Qualified CLO manager must be a registered investment advisor, with all the regulations and responsibilities – not least the fiduciary responsibilities – that go along with this.

With these six overlapping protections, a Qualified CLO will have a sound structure, will invest in higher quality leveraged loans in a diversified manner, will ensure alignment of interests between the CLO manager and investor, will ensure the investors are sophisticated and will ensure that these sophisticated investors receive all the information they need to make informed judgments.