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What is structured credit?

Understanding this complex and diverse asset class.

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The structured credit marketplace has exploded in recent years—with most estimates around $3 trillion[1]—as investors seek to achieve equity-like returns with limited interest rate risk. While this diverse marketplace has gained in popularity, it is undoubtedly complex. Investment professionals can greatly benefit from an understanding of the unique characteristics of this market.

A basic understanding of the characteristics of this market, how securitization works, and the risks and potential rewards of each financial instrument will serve investors well in making informed decisions about how structured credit may fit into their portfolio. Structured credit investment vehicles are pools of fixed-income assets (such as loans, mortgages, and bonds) that are bundled together and securitized to offer a variety of income-bearing assets. Investors purchase structured credit investments to customize their access to the income stream generated by the principal and interest payments of the underlying collateral. Structured credit instruments generally have floating interest rates (a fixed spread plus the secured overnight financing rate), which can be particularly attractive when interest rates are rising but will also have lower yields when interest rates fall.

The key to understanding structured credit products is familiarity with the securitization process. For the purposes of reviewing this concept, we will use collateralized loan obligations (CLOs) as our case study. (CLOs represent a significant portion of the structured credit market, with estimates as high as $1 trillion as of the end of 2023.2) The securitization "structure" is similar across other structured credit vehicles.

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[1] "Wall Street titans are betting big on insurers. What could go wrong?" *The Economist*, January 23, 2024.
[2] BofA Securities

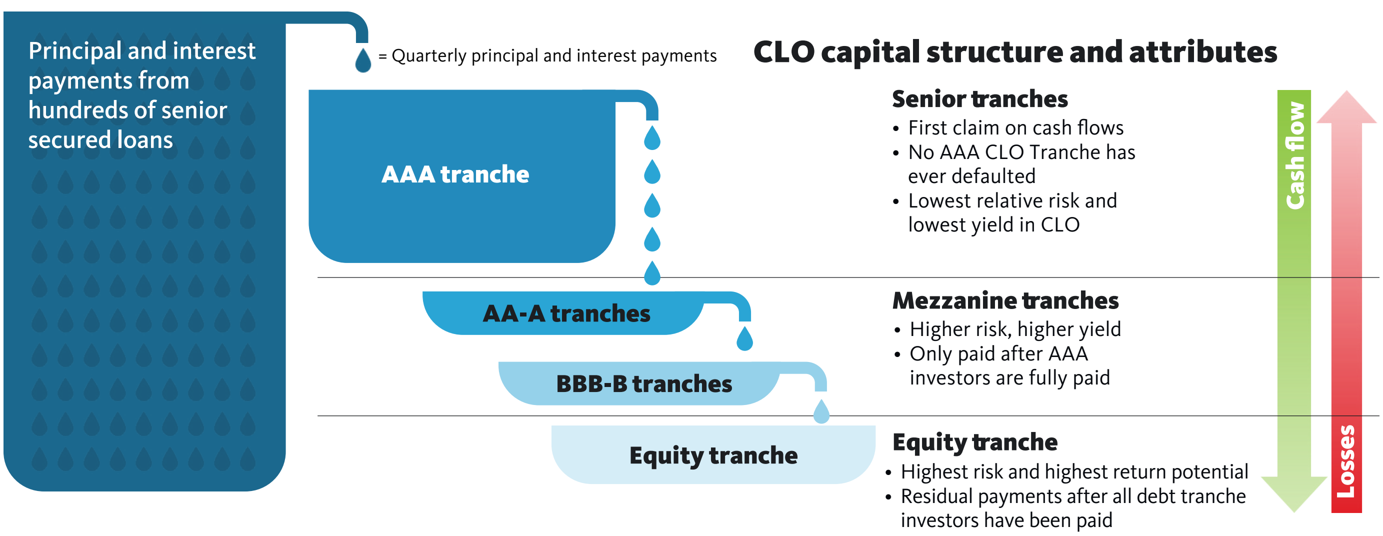
Securitization

How corporate leveraged loans become collateralized loan obligations.

Think of a CLO as a simple corporation (referred to as a special purpose vehicle) that purchases hundreds of leveraged loans (below investment grade) issued by corporate borrowers. The borrowers are household names such as American Airlines. These loans are the corporation's "assets," which are financed by various debt tranches (French for "slice") issued by the structure. Ratings agencies such as Moody's or S&P evaluate and rate these tranches based on the quality of the underlying collateral and the tranche's priority in the receipt of principal and interest payments. Some securities of the CLO are rated as AAA investment grade, some rated AA, A, and so on down the spectrum to B-rated non-investment grade and equity tranches. As with other rated fixed-income investments, the higher the rating, the lower the potential risk and the lower the yield. A typical CLO is structured such that the higher-rated tranches receive interest and principal payments ahead of lower-rated tranches. As a result, the lower-rated tranches absorb defaults before higher-rated tranches. It is worth noting that this structural subordination provides risk mitigation for the most senior tranches. To date, no AAA-rated CLO tranche has ever defaulted—even during the global financial crisis in 2008.[3]

Exhibit 1: Understanding CLO structures

CLOs purchase and bundle corporate senior secured loans into structures that are divided into tranches and sold to different investors depending on their risk-reward appetites.



Source: S&P, SEI. For illustrative purposes only. Quarterly payments are made by CLO to investors within each tranche until that tranche receives its promised yield, after which the next tranche begins receiving payments. The payments cascade down from the AAA tranche to the equity tranche, much like buckets overflowing and filling the bucket underneath.

[3] S&P. As of December 31, 2023.

Tranche: A CLO is comprised of several tranches of risk. In a typical CLO, roughly 75% to 90% of the structure is created to be floating-rate senior and mezzanine debt tranches, with the remainder consisting of the equity tranche. CLO debt tranches are typically rated investment grade (most likely to be repaid) at the most senior level down to below investment grade (less likely to be repaid) by ratings agencies. The equity tranche will experience losses first, due to the payment priority structure, if any underlying loans default.

- **Senior debt tranche:** The tranche with the lowest yields, lowest risk of principal loss, and the first to receive cash flows (principal and interest payments) that come to the CLO from the pool of leveraged loans.
- **Mezzanine debt tranche:** This tranche offers higher yields than the senior tranches, but only receives cash flows after the senior tranches have been paid, so it has a higher risk of loss than the senior tranches.
- **Equity tranche:** While somewhat of a misnomer as there are no "equities" in a CLO, this tranche is named such as it is the last to receive the cash flows from principal and interest payments from the leveraged loan pool. Profits from trading may accrue here as well. Remember, a CLO is like a simple corporation governed by a hierarchy in which it must repay debt obligations (think, AAA to B tranches) and all other leftover income goes to shareholder's equity (equity tranche). In a CLO, the equity tranche is structured such that if all the loans continue to pay their principal and interest, this tranche will have the highest returns in the CLO structure. Conversely the equity tranche will also take losses first if the loans default on their payments to the CLO.

Priority of payments: Often referred to as the "payment waterfall," this refers to the sequential order in which cash flows derived from the underlying loans are allocated to the CLO fund investors. Put simply, investors in the highest-rated tranche receive interest and principal payments first, while investors in the lowest-rated tranche—typically the equity tranche—receive payments only after all investors in higher-rated tranches are paid their contracted yield. Note that investors may choose in which debt tranches they prefer to invest based on their required return and risk limits.

Economically, a CLO's equity tranche, while potentially the highest returning, is also the riskiest portion of the CLO. If some of the loans stop making payments (default), those payments will not reach the equity tranche and the equity tranche's return will be lower. The priority of cash flows and sequence of losses is shown in Exhibit 1.

As each tranche of a CLO has a different risk-return profile, investors select the security (which reflects a tranche) in which they want to invest, according to the role they want it to play in their portfolio.

But how does structured credit —and CLOs specifically—fit into a portfolio? In our next installment in this series, SEI's Chief Investment Officer, Jim Smigiel and Managing Director, Unbundled OCIO Patrick Carlevato discuss what role a CLO fund can play in your portfolio.

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There are risks involved with investing, including loss of principal. Collateralized loan obligations (CLOs) and other structured finance securities may present risks similar to those of the other types of debt obligations and, in fact, such risks may be of greater significance in the case of CLO and other structured finance securities. In addition to the general risks associated with investing in debt securities, CLO securities carry additional risks, including: (1) the possibility that distributions from collateral assets will not be adequate to make interest or other payments; (2) the quality of the collateral may decline in value or default; (3) CLO equity and junior debt tranches will likely be subordinate in right of payment to other senior classes of CLO debt; and (4) the complex structure of a particular security may not be fully understood at the time of investment and may produce disputes with the issuer or unexpected investment results.

CLOs are subject to liquidity risk. CLOs may invest in securities that are subject to legal or other restrictions on transfer or for which no liquid market exists. The market for certain investments may become illiquid due to specific adverse changes in the conditions of a particular issuer or under adverse market or economic conditions independent of the issuer. The market prices, if any, for such securities tend to be volatile and the Fund and CLO managers may not be able to sell them when it desires to do so or to realize what it perceives to be their fair value in the event of a sale. CLO portfolios tend to have a certain amount of overlap across underlying obligors.

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