Demystifying Collateralised Loan Obligations (CLOs)

BlackRock.

Key Takeaways

CLOs are a segment of securitised fixed income markets which offer investors steady, consistent and diversified income.

Today, more investors are allocating to CLOs as their floating rate coupons can offer potential protection from interest rate volatility, as well as higher yields compared to similarly rated corporate debt. This also allows for lower correlations relative to other traditional areas of fixed income.

Due to CLOs' unique characteristics, an experienced portfolio management team may be beneficial to leverage when choosing to invest in this asset class.

ETFs can offer an efficient way to access CLOs, whether it be through a multi-sector strategy or through CLO-focused ETFs.

The CLO market has grown steadily over the last few years,[1] yet historically, direct investor participation in this market was primarily restricted to institutional and qualified investors. However, this landscape is changing with the introduction of CLO-specific exchange-traded funds (ETFs), which provide a broader investor base with access to the potential benefits of this asset class. Likely as a result of this increased accessibility, there has been a surge in interest from investors seeking to understand the intricacies of CLOs and how to effectively incorporate them into diversified investment portfolios. The introduction of CLO ETFs has democratised access to this asset class, allowing more investors and institutions to invest in these securities through the efficiency of the ETF wrapper.

Today, CLOs are becoming a less "niche" market, having matured to a $1.2tn market globally. Putting this into context, the Global High Yield Bond market is $1.8tn in size. As a result, just as investors may allocate a portion of their portfolios to other non-core sectors, CLOs are becoming more of a "core" income component of today's expanded fixed income toolkit.

What are CLOs?

A CLO, or Collateralised Loan Obligation, is an investment vehicle backed by a pool of predominantly senior secured loans made to corporate borrowers that is typically actively managed. A CLO is split into tranches based on risk and return. The senior secured nature of the underlying loans typically benefit from being prioritised from a payment perspective in the event of an insolvency.

The structure of a CLO and subsequent risk and return varies by tranche. With the higher quality tranches – such as AAA rated – lowest in credit risk and also lowest in potential returns.

1.Source: BofA Global Research. CLO market size in January 2019 was $1.20Tn, CLO market size in January 2025 is $1.38Tn

Understanding the structure of CLOs

What differentiates an investment in a CLO from a bank loan fund is the investor's exposure to adverse credit events (e.g. defaults) in the pool of loans. In a bank loan fund, all investors have the same exposure to credit events. In a CLO, exposure to credit events depends on where in the CLO capital structure an investor chooses to be, ranging from highly rated (e.g. AAA-rated exposures) securities to lower rated – yet higher yielding ones (e.g. BBB-rated and below).

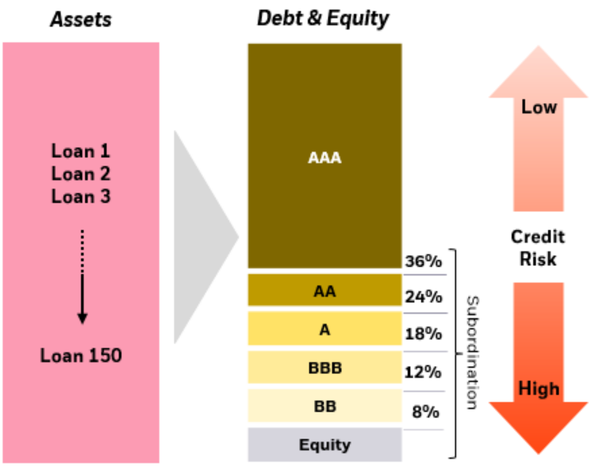
The varying risk exposures within a CLO stem from its capitalisation structure. To acquire the loans, the CLO issues securities, known as tranches, each offering different levels of exposure to the underlying loan risks as seen in Figure 1.

As mentioned above, the lowest-risk tranche is typically rated AAA by at least one of the major credit rating agencies and is often referred to as the 'senior' tranche. The tranches positioned below are then categorised as 'mezzanine' tranches (and tend to receive a lower rating, ranging from AA to single-B). The lowest and riskiest tranche is referred to as the equity tranche, which bears the first losses if defaults or other adverse events occur in the loan pool. These equity tranches are not assigned credit ratings due to their higher risk profile.

In terms of expected returns, the equity tranche offers the highest potential return, reflecting its higher risk. The senior tranche, conversely, has a lower expected return but carries the least risk. The mezzanine tranches fall between these extremes, offering a balance of risk and return.

It's important to note that prior to this year, 100% CLO UCITS vehicles were not permitted under regulations prescribed by the Central Bank of Ireland. This has recently been updated to reflect the growth in the market and investor appetite where today a dedicated CLO UCITS vehicle is permitted to hold up to 80% AAA rated CLOs and a maximum 20% non-AAA rated (but investment grade).

Figure 1: The structure of a CLO



Source: JP Morgan. For illustrative purposes only. Subordination is the process of prioritizing the order in which loan losses are allocated to the various layers of tranches so that the lower rated tranches serves as a credit support for the higher rated tranches. The equity tranche is shown as first loss while the AAA tranche has the most protection. The subordination % shown are an illustration of the level of losses the underlying loans that would be needed before that specific rated CLO bond will see any losses.

The process of creating a CLO and issuing tranches to finance the acquisition of the underlying loans is known as securitisation. This process is prevalent in fixed-income markets; importantly, though, not all securitised markets share the same characteristics. For example, although CLOs and collateralised debt obligations (CDOs) may sound similar, they differ significantly in several key aspects such as their underlying assets, the diversification of their loan pools, structural features designed to help protect investors, and the active management of the loan pools.

Moreover, CLOs have a distinct history compared to CDOs, particularly in the context of the Global Financial Crisis (GFC) where CLOs experienced only minimal losses.[2]

Notably, no AAA-rated CLO has ever defaulted.[3] Default rates in mezzanine CLO tranches are also significantly lower than those seen in similarly rated corporate bonds. In fact, in typical CLO structures, more than half of the underlying loans would need to default before the AAA-rated tranche begins to incur losses.[4] While lower-rated tranches may experience losses earlier, the loss thresholds required to trigger default are typically higher than those encountered during most market cycles, offering an added layer of protection for investors in the senior tranches.

[2,3] Source: S&P Global; CLO default study published June 27, 2024

[4] Source: According to JP Morgan, 37% of the average CLO capital structure sits below the AAA-rated tranche. Assuming a 50% recovery rate (more conservative than the historical recovery rate), ~75% of the loans would need to default before the AAA-rated tranche would be impaired.

Figure 2: S&P 10-year cumulative default rates (%)

Credit Rating	CLOs	Corporate Bonds
AAA	0.00	0.68
AA	0.07	0.67
A	0.04	1.07
BBB	0.54	2.90
BB	2.14	10.69
B	5.26	22.18
CCC	9.16	50.64
Investment Grade	0.14	1.72
Speculative Grade	4.02	19.27
Overall	0.90	8.66

Rates are for the period 1997 to 2023 for CLOs and from 1981 to 2023 for Corporate Bonds.
Investment Grade includes AAA, AA, A, BBB. Speculative Grade is BB, B, and CCC/CC. For Corporate Bonds, S&P reports CCC, CC, C categories on a single line item. Source: S&P Global; CLO default study published June 27, 2024; Corporate default study published March 28, 2024.

Regional differences

There are a few regional differences when considering CLOs.

1) Market Size: Specifically in respect of investment grade tranches, is the size difference. The USD CLO market is approx. $950bn in size relative to EUR which is €270bn.

2) Risk Retention: Another key difference in markets is the difference in the ability for European investors to access the USD market, due to risk retention regulations. Under the regulations prescribed by the European Securities and Markets Authority, *the originator, sponsor or original lender of a securitisation shall retain on an ongoing basis a material net economic interest in the securitisation of not less than 5%*[5]. As such, in the context of a CLO, if the originator does not hold at least a 5% stake within the tranche, European investors or funds are prohibited from investment.

Though the regulations apply to all securitised and CLOs, given it's a European regulation typically the whole EUR denominated CLO market will meet this criteria. However, in the USD market this typically results in a smaller investable market (circa 15%) .

3) ESG: Due primarily to local investor demand, European CLOs have the data available to screen for ESG. This data is not yet available for USD CLOs.

4) Regulator: The Central Bank of Ireland – the regulator for Irish based funds - currently restricts the sale of CLO funds over 25% to professional investors only. In contrast the Commission de Surveillance du Secteur Financier – the regulator for Luxembourg funds – permits the sales to retail investors, this is more similar to US 40 Act CLO ETFs.

Similarities
Completely transparent to see underlying holdings
Primary underlying collateral being leveraged loans
Institutional investors such as insurance companies, asset managers, and pension funds dominate both markets
Overcollateralisation (OC) and interest coverage (IC) tests are standard in both markets
Active management of underlying collateral with a typical reinvestment period (usually 4-5 years).
Long history of limited impairments

Differences
Subordination levels vary with European CLOs often having higher subordination
Although both markets use major rating agencies like Moody's, S&P, and Fitch for tranche ratings, European CLOs require at least two rating agencies to rate each tranche
All European CLOs are subject to EU/UK risk retention (5%"skin in the game") whereas for US CLOs it is optional
Higher fixed rate bond usage in Europe
US CLOs tend to be more diverse given the larger underlying leveraged loan market
Single-B tranches are more prevalent in Europe and more nascent in the US market

[5]Source: www.esma.europa.eu/publications-and-data/interactive-single-rulebook/secr/article-6-risk-retention

The risks and rewards of investing in CLOs

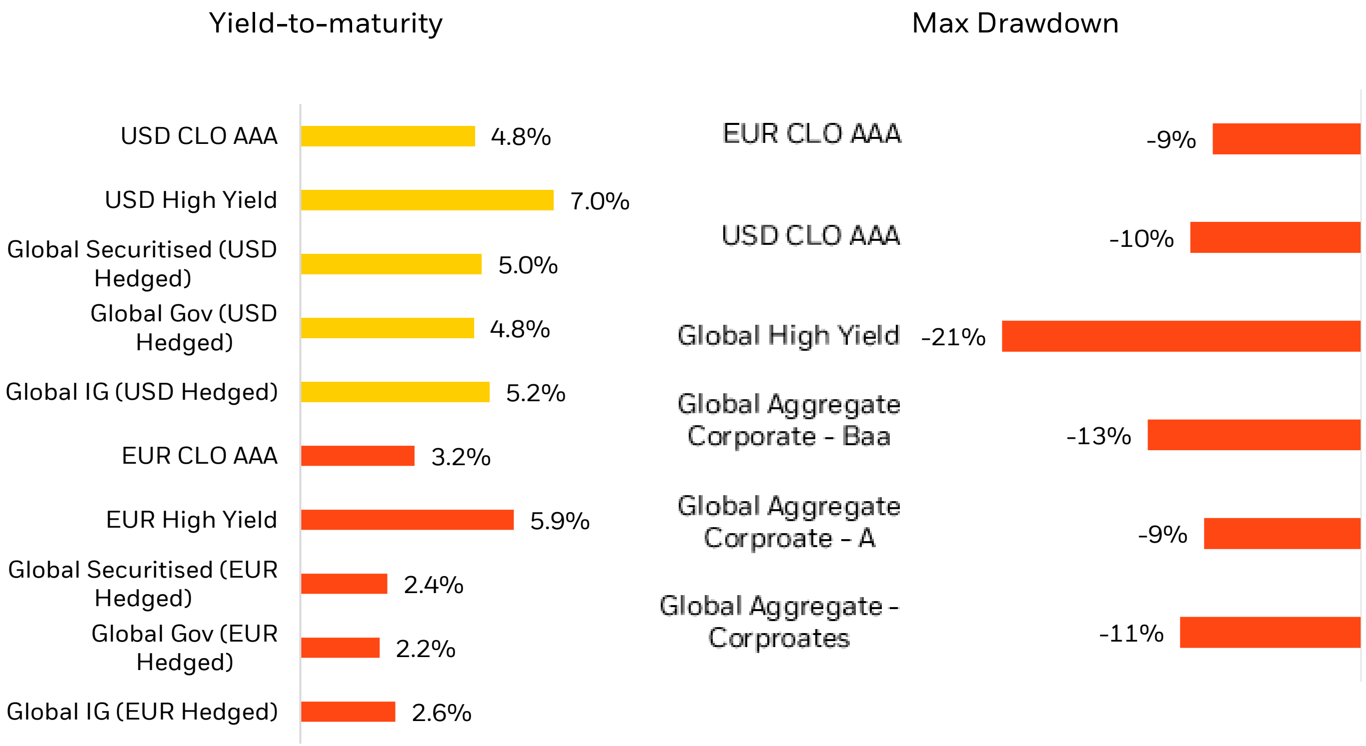
Given the complexity involved in understanding the structure of each CLO and the specialised expertise required to evaluate them, coupled with their historically limited investor base, CLOs have historically offered higher yields compared to similarly rated corporate debt.

CLOs are floating-rate securities, meaning their coupon payments adjust periodically based on changes in short-term interest rates. If interest rates rise, the coupon payments on CLOs could be reset to higher rates, benefiting investors by providing greater income in a rising-rate environment. This inherent feature of floating rates offers a potential level of protection to investors, particularly in the context of today's elevated interest rate volatility, as it allows CLOs to better align with prevailing market conditions and help mitigate the impact of interest rate fluctuations on returns.

So, what's the catch? While they generally exhibit low credit risk due to the structure of the underlying loans, CLO spreads can still widen during periods of broader market volatility, changes in asset allocations by large institutional investors, or shifts in investor sentiment. These factors can cause price declines and negatively impact performance, even if the credit quality of the underlying loans remains stable.

The largest drawdown experienced by AAA CLOs in the last 10 years was in March 2020 and was -10% using daily returns and -5% using monthly returns, in line with shorter duration markets and smaller than other fixed income sectors[6].

Figure 3: Attractive yields relative to historic drawdowns



Source: Bloomberg, BlackRock, JP Morgan as of 30 June 2025. Indices are unmanaged and one cannot invest directly in an index. Indices used: Bloomberg Global Aggregate Corporate Index, Bloomberg Global Aggregate Government Index, Bloomberg Global Aggregate Securitised Index, Bloomberg Pan European High Yield Index, Bloomberg US High Yield Corporate Index, JP Morgan CLO EUR AAA Index, JP Morgan CLO USD AAA Index. Hedging costs are based on annualised 1-month forward rates.

[6]Source: BlackRock, Bloomberg, JP Morgan as of 31st January 2025. The 10-yr max drawdown and volatility of the JP Morgan CLOIE AAA Index,, Bloomberg Corporate Index, Bloomberg BBB Corporate Index, and Bloomberg High Yield Corporate Index using daily total returns were: -10.0%/1.93%, -30.0%/6.46%, -13.3%/5.97%, -15.9%/6.01%, and -20.2%/5.16%.

The importance of an experienced PM team

CLOs can differ from traditional fixed-income securities in several key aspects, including their risks, liquidity, trading characteristics, and the types of investors involved. As such, investing in CLOs requires a sophisticated and knowledgeable portfolio management team to help navigate these complexities effectively as well as navigating the changing regulatory climate.

BlackRock stands as one of the largest asset managers in the CLO market, managing over $33 billion in CLO tranches through a dedicated CLO team. Additionally, BlackRock oversees a $30 billion corporate loan investment team, which provides deep expertise in evaluating the underlying collateral of each CLO.[7] We believe our team's advantage is a rigorous investment process, developed over years of experience which includes a comprehensive evaluation of CLO structures and the underlying collateral characteristics.

This process is further enhanced by our ability to identify relative value opportunities, a key benefit of being part of a large, fixed income platform. Our deep expertise and extensive resources enable us to aim to navigate the complexities of the CLO market effectively, ultimately seeking to provide our clients with informed, strategic investment solutions.

ETF Landscape

As mentioned above, CLO ETFs have supported the democratisation of the asset class from being historically highly institutionally driven to being more broadly used within traditional investor portfolios including wealth investors.

The ETF wrapper offers secondary liquidity and unparalleled transparency to investors in a cost-efficient manner thus providing liquid building blocks. This is reflected in the growing size of the UCITS CLO ETF market which is now over $500m in size and growing rapidly.

Spreads within the UCITS CLO ETF market have ranged from 21-26bps and 21-28bps within EUR and USD markets respectively. As the market grows, as does investor appetite, we would expect these spreads to fall overtime.

The iShares ETF ecosystem provides a diversified and developed platform that supports scale and is backed by $4.2T in ETF AUM and over 1,400 products. As new investors enter new markets such as CLOs, the iShares platform offers a trusted and established ETF platform for access.

[7]Source: BlackRock, as of 30th June 2025.

Want to know more?

Visit blackrock.com

Risk Warnings

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

Collateralised Loan Obligations are subject to the same risks described for fixed income securities. These instruments may be subject to 'Liquidity Risk', have high levels of borrowing and may not fully reflect the value of underlying assets.

Important Information

Any research in this document has been procured and may have been acted on by BlackRock for its own purpose. The results of such research are being made available only incidentally. The views expressed do not constitute investment or any other advice and are subject to change. They do not necessarily reflect the views of any company in the BlackRock Group or any part thereof and no assurances are made as to their accuracy

This document is for information purposes only and does not constitute an offer or invitation to anyone to invest in any BlackRock funds and has not been prepared in connection with any such offer.

In the UK and Non-European Economic Area (EEA) countries: this is Issued by BlackRock Investment Management (UK) Limited, authorised and regulated by the Financial Conduct Authority. Registered office: 12 Throgmorton Avenue, London, EC2N 2DL. Tel: + 44 (0)20 7743 3000. Registered in England and Wales No. 02020394. For your protection telephone calls are usually recorded. Please refer to the Financial Conduct Authority website for a list of authorised activities conducted by BlackRock.

In the European Economic Area (EEA): this is Issued by BlackRock (Netherlands) B.V. is authorised and regulated by the Netherlands Authority for the Financial Markets. Registered office Amstelplein 1, 1096 HA, Amsterdam, Tel: 020 – 549 5200, Tel: 31-20-549-5200. Trade Register No. 17068311 For your protection telephone calls are usually recorded.

In Switzerland: For professional clients and qualified investors only. This document is marketing material.

For investors in Israel: BlackRock Investment Management (UK) Limited is not licenced under Israel's Regulation of Investment Advice, Investment Marketing and Portfolio Management Law, 5755-1995 (the "Advice Law"), nor does it carry insurance thereunder.

In **Latin America**, for institutional investors and financial intermediaries only (not for public distribution). This material is for educational purposes only and does not constitute investment advice or an offer or solicitation to sell or a solicitation of an offer to buy any shares of any fund or security and it is your responsibility to inform yourself of, and to observe, all applicable laws and regulations of your relevant jurisdiction. If any funds are mentioned or inferred in this material, such funds may not been registered with the securities regulators of Argentina, Brazil, Chile, Colombia, Mexico, Panama, Peru, Uruguay or any other securities regulator in any Latin American country and thus, may not be publicly offered in any such countries. The securities regulators of any country within Latin America have not confirmed the accuracy of any information contained herein. No information discussed herein can be provided to the general public in Latin America confidential and must not be passed to any third party.

BlackRock.