The leakage out to subordinated notes

Overcollateralization (OC) tests in structured CLOs are fundamental solvency measures: they require that the ratios of a CLO's loan-portfolio value to its outstanding note balances calculated for each tranche remain above certain thresholds set at closing of the transaction. The portfolio value is calculated as the sum of several components that together define the CLO's adjusted collateral principal amount.

A breach of an OC test triggers significant consequences for the capital structure. Interests that would normally flow at payment date to the tranche failing the test—together with certain reinvestment proceeds—is diverted to the repayment of the senior notes (AAA, then AA, etc.) or used to acquire additional collateral until the breach is cured. This automatic self-correcting mechanism protects the debt stack (starting from the safest at the top) by ensuring that collateral coverage remains robust and that principal obligations can be met.

By removing the OC test for the Class F (Single-B) tranche deprives investors of a key monitoring covenant regarding the health of the asset pool. The situation is comparable to a covenant on corporate lending: a borrower may continue servicing the debt paying the interests while operating under materially weakened solvency conditions until bankruptcy event takes place. The OC tests oblige the structure to reduce the amount outstanding of the senior tranches. Most CLOs, anyway, reinstate the Class F OC test after the reinvestment period, when portfolio management becomes more constrained due to the limits and tests post RP and the need to preserve the stability of rated tranches. Out of curiosity, if we want to assess the magnitude and quantify the deterioration protection we are foregoing with this test elimination, we are dealing with a cushion equal to 2,5-3% of the CLO's total outstanding amount.

Now let's see important key points:

1) The removal of the Class F OC test alters the expected IRR profile of the F tranche, as this test is a binding constraint on cash distributions to that class under deteriorating collateral scenarios. More importantly, the spread premium for omitting the Class F OC test should be negative. The covenant does not operate only as tranche-specific credit protection; rather, it functions as a structural safeguard that enhances the stability of the entire capital stack by enforcing collateral preservation and self-correcting deleveraging from the top of the waterfall downward.

Eliminating the test and continuing to pay the interests to single-B notes therefore weakens the structural feedback mechanisms that support long-term value across all tranches (from the most senior), including Class F. This distinction is fundamentally different from the interpretation accepted by the market. At a minimum, we should evaluate the trade-off between the structural protection and the potential loss of payments when the test breaches.

Do market prices differentiate between CLOs that include the Class F OC test and those that do not? Again, no. In the primary market, pricing does not reflect this structural distinction. In the secondary market and as the transaction seasons, however, investors can directly observe the performance and any deterioration of the underlying portfolio. Consequently, spreads on mezzanine tranches (but this affects all the tranches as I wrote) will widen or tighten based on actual credit developments, not on whether the Class F OC test is present. Thus, pricing in secondary reflects real-time portfolio dynamics. Still the CLO capital stack is less resilient and the senior tranches are less protected. Ultimately, it comes down to ratings and structural stability.

2) Who truly benefits from eliminating the Class F OC test from the cashflow waterfall? While Single-B noteholders continue to receive their scheduled interest payments in a structure that does not de-lever, the removal of the test offers direct benefit to the equity holders, who avoid any interest or principal diversion that would otherwise occur following an OC breach (often the equity buyers are the same investors involved in class F and this explains everything in my opinion). In parallel, the CLO manager benefits as well, since subordinated management fees and incentive fees (assuming the Threshold IRR is achieved) can continue to be paid without interruption. Again, as written above, the issue is rating integrity, rating actions and structural durability.

What has been discussed above forms part of a broader shift toward increasingly equity-friendly CLO structures, a trend I have previously highlighted in relation to the recent France downgrade and concentration-risk dynamics. The discipline imposed by ongoing structural tests—and the portfolio adjustments they require—has been a key contributor to the historically strong performance of the CLO asset class. The upper part of the capital stack receives its ratings precisely because it is protected by OC and other structural tests, which ensure coverage, stability, and timely corrective measures when collateral quality deteriorates. Investors should therefore consider these protections, along with many other technical elements that can impact both cash flow expectations (in quantity and for timing) and portfolio composition, when selecting both the CLO platform and the vintage they wish to purchase.

With insight into the key drivers and structural assumptions of CLOs, investors can make more informed judgments about the asset class's future performance. To the extent permitted by rating agency review, CLO documentation can provide insights into the structure as well as the manager's preferences and strategic style. These considerations ought to be reflected in pricing (and equity performance).