



MANAGEMENT & CORPORATE GOVERNANCE

GUIDANCE NOTES FOR BOARD MEMBERS

COLLATERALISED LOAN OBLIGATION (“CLO”)

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Management & Corporate Governance

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INTRODUCTION - COLLATERALISED LOAN OBLIGATION (“CLO”)

A collateralised loan obligation (“**CLO**”) is a single security backed by a pool of debts. CLOs are often backed by corporate loans with low credit ratings or loans taken out by private equity firms to amongst others conduct leveraged buyouts. These loans are then bundled into a portfolio.

The portfolio or pool is then typically securitised by the issuance of several tranches of Notes, categorised as Senior, Mezzanine and Subordinate (junior note or equity piece)

The different tranches offer investors a variety of credit risk and maturity characteristics. The tranches are relevant in the calculation of the so-called “Waterfall”, which is representing the priority ranking of the payment order. The more senior a Note is ranked, the more certainty it will have to receive repayment of principal and interest from the generated cash flow. In return for higher chances of being served, these Notes typically bear a lower return on investment. In return, lower rated Notes will have a higher risk of not being (fully) repaid or receiving interests but have a chance of higher return if the performance of the structure is as expected or better.

Therefore senior tranches carry typically offer a predefined interest rate whilst subordinate or junior notes on the other hand are first to take the losses. But they also take the residual amounts as interest in priority of payments in case of over-performance (usually no pre-defined interest). The Investment Manager can take “*skin in the game*” by a horizontal or vertical slice (via the subordinated notes only) to honour their minimum risk retention obligations under **(EU) Securitisation Regulation**.

These mechanics work hand in hand with two core principles for most securitisation structures, i.e. the limited recourse nature of the Notes and the non-petition rules.

It is quite common in CLOs to apply for a rating from one or more of the major Rating Agencies. The rating of the Notes does allow investors to have a better understanding of the associated risks.

The assets securing the Notes typically consists of a portfolio of secured senior loans, secured senior bonds, second lien loans, mezzanine obligations,

high yield bonds, corporate rescue loans and unsecured senior obligations.

It is important in CLOs, due to high volume of daily trades and activity, for the Board of a Financial Vehicle Corporation (“**FVC**”) to understand the transaction mechanics and the roles and functions of various parties involved and how they interact. Some key parties and their responsibilities in CLO transactions are mentioned below:

INVESTMENT MANAGER

Usually an Investment Manager (sometimes also called Collateral or Asset Manager) actively builds and manages the portfolio of assets underlying the securitisation. The Investment Manager is appointed by the Board of the FVC. The Investment Manager will provide services that will include amongst others:

- Determining the specific assets that will make up the asset portfolio within investment guidelines and eligibility criteria as defined in transaction documentation and offering circular;
- Negotiating and entering into agreements for the acquisition, management and sale of the portfolio items;
- The active management of the portfolio, including selling or purchasing positions;
- Dealing with hedging arrangements relating to the portfolio;
- Dealing with valuations in relation to the portfolio;
- Monitoring of the portfolio valuations;
- Continuous monitoring and assessment of the portfolio and portfolio investment compliance and guidelines;
- Daily cash position reconciliation and analysing re-investable cash;
- Maintaining the relations and contact with Investors, Regulators, Rating Agencies, the FVC Board members, Security Trustee, etc.;
- Complying with reporting requirements relating to the asset portfolio.

For the execution of their portfolio management duties, the Investment Manager does not usually require Board approval for each investment or trade decision. In fact, they operate within the limits of the powers delegated by the Board and as provided for in the transaction documents (discretionary authority).

The transaction documentation included parameters and tests (such as compliance rules, investment restrictions, eligibility criteria etc.) which are to be complied with by the Investment Manager.

Breaches of these tests must be reported and may lead to a so called “Event of Default”. These are trigger events that may lead to “repair” actions or worst case to the immediate acceleration of the Notes.

COLLATERAL ADMINISTRATOR

The Collateral Administrator will be appointed by the FVC to act as its agent in relation to administration of the portfolio collateralising the securities. Its duties include amongst others:

- Run performance tests;
- Run Hypothetical trade testing;
- Provide monthly investor and interest payment date (“**IPD**”) reports on the underlying assets;
- Prepare and file **STS/ESMA** Reporting;
- Obtain valuations of the underlying assets
- Calculate payment and receipt requirements
- Open and administer the bank accounts
- Direct payments to be made in accordance with the transaction documents

The Collateral Administrator will usually be a Bank, independent of the other participants in the transaction. Typically, the Collateral Administrator will also provide additional roles to the structure, such as Principal Paying Agent (“**PPA**”) or Security Trustee.

SECURITY TRUSTEE

The role of the Security Trustee (usually just called Trustee) is to represent the noteholders in a transaction.

The Trustee is the safeguard for the Noteholders to ensure that all parameters defined at the beginning of the structure are respected and not altered.

In case of an Event of Default, the Trustee can take control over the assets and the bank accounts to protect the Noteholder interests.

Whilst the Trustee should be a passive observer, it has access to all reports and information to ensure to be able to take the control when needed. The Trustee is appointed by the Board but will only take direction from the Noteholders.

CORPORATE SERVICE PROVIDER

The corporate service provider will often assist with the incorporation of the FVC (typically as an orphan structure). It will also usually provide the Board members to the FVC.

It will provide the FVC with a registered office and support the general administration, the bookkeeping, the accounting and finally provide support with the mandatory audit.

It will also prepare or support the preparation of reporting to the various authorities, e.g. to Tax authorities (**VAT – CIT – FATCA - CRS – DAC 6**), to national central banks (**ECB** reporting) and Regulators.

It will also ensure monitor the filing of the STS/ESMA reporting.

BOARD MEMBERS

Whilst the CLO transactions are largely designed to be “autopilot” and should leave little reasons for discretionary decisions by the Board, the Board is ultimately responsible for all management decisions and operations of the FVC.

Hence, the Board members should be duly experienced and qualified to ensure proper governance and oversight.

The Board does also have significant responsibilities with respect to the valuation of the assets. Therefore, the ongoing monitoring of the transaction parties, including ongoing due diligence on internal processes, respect of Chinese walls etc. are critical.

Management duties consist of amongst others of ensuring regular board meetings (as often as necessary to ensure proper management decision-making and typically at least on a quarterly basis), reviewing the portfolio, maintaining relationships with the Investment Manager, the Collateral Administrator, the Trustee, the auditors, tax and regulatory authorities and the other transaction parties.

The Board has the obligation to always keep the CLO in good legal standing and in compliance at all times.

It is important to note that whilst the Board members are often employees of the corporate services provider, their obligations as Board member are distinct and must be executed in the best corporate interests of the FVC.

COMMON REPORTINGS IN CLOs

- **Monthly investors' and IPD report**

This report has become a more or less standardised format which includes a large set of performance indicators (tests and statistics). It typically includes data about:

- Portfolio (including details of its composition from various perspectives (Country, Sector, Obligor, Ratings, etc))
- Bank accounts
- Hedge transaction
- Coverage tests, collateral quality tests, profile test, overcollateralisation tests etc.
- Defaulted assets and rating migration of the underlying assets
- IPD calculation (on periodic basis, this provides priority of payment calculation based on the waterfall criteria)

The IPD calculation is a key document for the FVC Board members. Special attention is required to the settlement of invoices that may not have been shared with the FVC, so that these can be included in the accounting records. Equally important is the assessment of the VAT treatment of such costs (consider reverse charge mechanisms and the fact that the UK has left the EU).

Some of the tests mentioned above provides necessary information for governance and monitoring of investment performance by the board of these vehicles. Some of the key (compliance) tests include the following:

- **Overcollateralisation (“OC”) test**

Ratio of the par value of underlying assets vs. the various outstanding balances of the issued Notes tranches. In general, when a test fails (starting with Junior OC test) interest or equity distributions and fees relates to these junior tranches may be stopped or delayed.

- **Interest coverage test**

Certain ratios are to be met if interest on Notes etc. are to be distributed by the FVC. In principal interest and fees will be deferred on more or less similar approach as with failing OC tests until the test has been improved/repaired.
- **The portfolio profile test**

Usually it provides that on each specified date either “at least” or “not more than” certain specified percentages of the aggregate collateral balance shall consist of particular categories of collateral debt/loan obligations including senior secured loans, senior secured bonds, mezzanine obligations, high yield bonds etc.
- **Collateral quality test**

This test checks if various ratios (e.g. minimum weighted average rating, spread or coupon test, industry concentration limits, minimum weighted average coupon test, recovery test, diversity tests etc.) are satisfied as per deal documentation. Once a test is breached or triggered the manager needs to maintain at a minimum or improve the quality of portfolio when acquiring new loans/bonds.
- **Collateral file**

This is a monthly excel file produced by the collateral administrator which provides extensive details about the portfolio as at that date including, interest, rating, industry, geography, etc and is helpful in producing periodic accounts and filing European Central Bank Reporting (BCL reporting).
- **Transaction file**

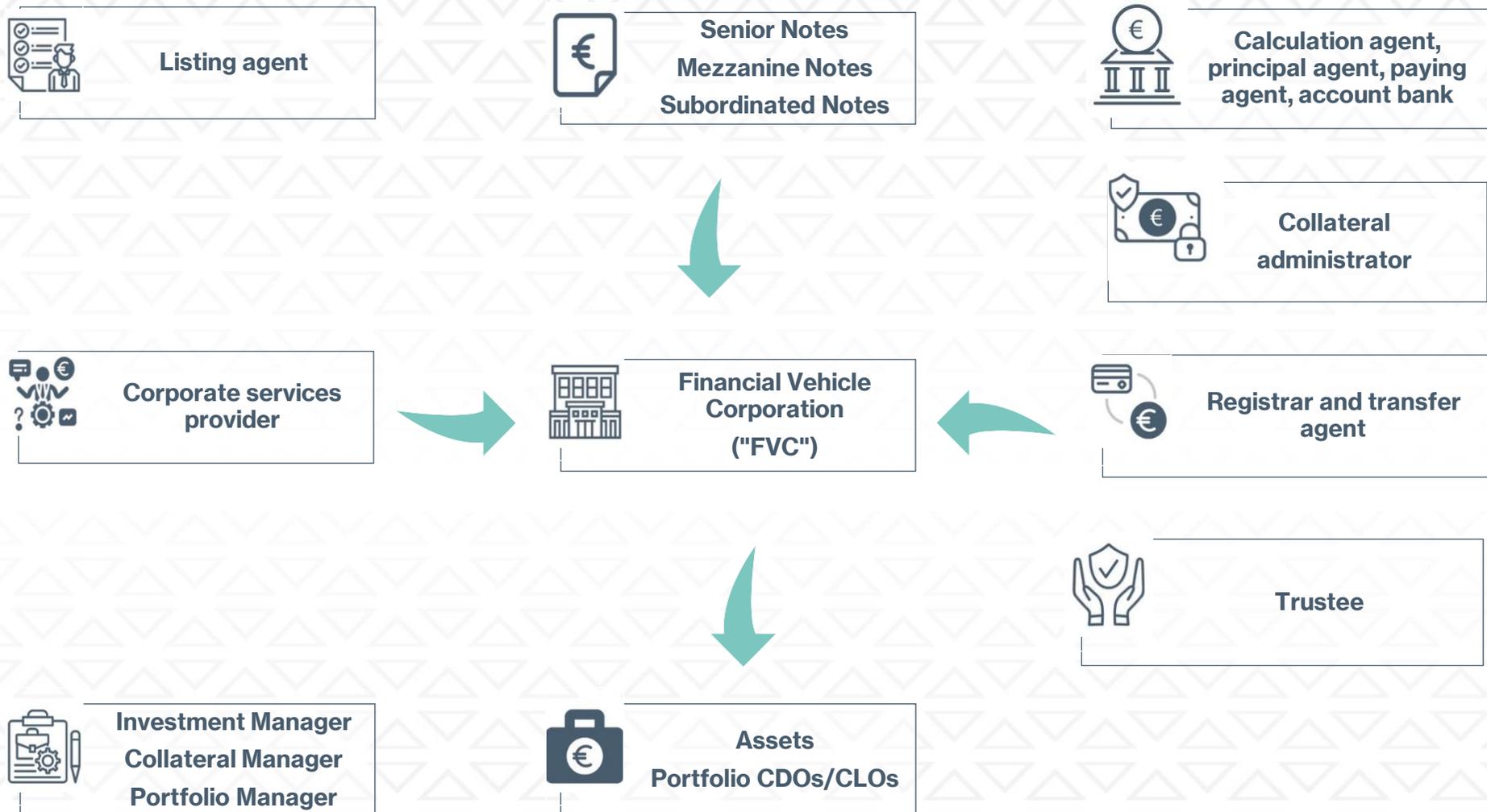
This is also an excel file produced by the collateral administrator which provides extensive details of the daily transaction of each month including principal interest cash flows of buying and selling activity. This file can be used to prepare various reporting (monthly accounts, BCL reporting etc).
- **Mark to market file**

This file is produced by investment manager where at a specific date market value of both liquid and illiquid portfolio is provided for assessment of impairment etc. it is important for Board members of FVC to note and

document how pricing of securities are assessed especially in case of illiquid securities.

Failings in the above tests (which could result in an Event of Default) can either lead to repairable breaches, deferral of payment of fees or interests or in the worst case to an acceleration of the Notes.

TYPICAL CLO STRUCTURE ILLUSTRATION



GLOSSARY

ATAD	Means Anti-Tax Avoidance Directive and refers to the Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market
BCL	means Banque Centrale du Luxembourg , acting as National Central Bank for Luxembourg
CDO(s)	means Collateralised Debt Obligation(s), a complex structured finance product that is backed by a pool of loans and other assets and sold to institutional investors
CIT	means Corporate Income Tax
CLO(s)	means Collateralised Loan Obligation(s), a single security backed by a pool of debt
CRS	means Common Reporting Standard, the Standard for Automatic Exchange of Financial Account Information (“AEOFAI”) in Tax Matters developed in response to the G20 request and approved by the OECD Council on 15 July 2014
CSSF	means the Commission de Surveillance du Secteur Financier , responsible for the financial regulation in Luxembourg
DAC 6	means Directive of Administrative Cooperation 6 and refers to the EU Council Directive (EU) 2018/822 amending Directive 2011/16/EU as regards to cross-border tax arrangements
EBA	means the European Banking Authority , the regulatory body that strives to maintain financial stability throughout the European Union’s (EU)

ECB	means the European Central Bank , the central bank responsible for monetary policy of those European Union (EU) member countries which have adopted the euro currency
EMIR	means the European Market Infrastructure Regulation and refers to the Regulation (EU) 2019/834 of the European Parliament and of the Council of 20 May 2019 (“EMIR Refit”) amending Regulation (EU) No 648/2012, as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories
ESMA	means the European Securities and Markets Authority , the independent European Union (EU) Authority that contributes to safeguarding the stability of the EU’s financial system by enhancing the protection of investors and promoting stable and orderly financial markets
FATCA	means Foreign Account Tax Compliance Act, i.e. the tax law that compels U.S. citizens at home and abroad to file annual reports on any foreign account holdings
FVC	means Financial Vehicle Corporation as per European Central Bank definition
IPD	means Interest Payment Date, i.e. the fixed date on which an instalment of interest with respect to a Security of a particular series is due and payable
ISIN	means International Securities Identification Number, i.e. a 12-digit alphanumeric code that uniquely identifies a specific security

LEI	means Legal Entity Identifier, i.e. is a 20-digit alphanumeric code that uniquely identifies a legal entity participating in financial transactions
LIBOR	means the London Interbank Offered Rate, the benchmark interest rate at which major global banks lend to one another in the international interbank market for short-term loans
LuxCMA	means the Luxembourg Capital Markets Association , a not-for-profit association created on 1 March 2019 which represents the common interests of all stakeholders of the primary capital markets industry of Luxembourg
OC	means Overcollateralisation, i.e. the ratio of the par value of underlying assets vs. the various outstanding balances of the issued Notes tranches
PPA	means Principal Paying Agent, the one who accepts payments from the issuer of a security and then distributes the funds to holders of the security
Securitisation Law	means the Luxembourg Law of 22 March 2004 on securitisation, as amended
(EU) Securitisation Regulation	means Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation
STS	means Simple, Transparent and Standardised securitisations complying with the criteria set out in Regulation (EU) 2017/2402, as amended by Regulation (EU) 2021/557 (SECR) .
VAT	means Value-Added Tax

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About the LuxCMA – Luxembourg Capital Markets Association

Created on 1 March 2019, the LuxCMA is a not-for-profit association (a.s.b.l.), registered at the RCSL (F12205), whose registered office is 6 rue Jean Monnet, L-2180 Luxembourg. The LuxCMA today represents memberships detailed on LuxCMA's website (www.luxcma.com), which is composed by banks, law firms and services providers, amongst others.

Working Group – Best Practice

The aim of this working group is to find practical solutions (or answers) to practical problems. Capital market participants are often confronted with varying practices among the numerous practitioners active in Luxembourg, including when it comes to compliance, accounting, presentation of the financial statements, clearing, reporting, or general legal questions, and the purpose of the group will be to identify any recurring problems or inconsistencies in such practices and to analyse whether it is possible to work out practical recommendations and good market standards which address such issues.

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