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Commercial Real Estate Collateralized Loan Obligations Primer

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Executive Summary

- Commercial real estate (CRE) collateralized loan obligations (CLOs) may be considered a “hybrid” of traditional leveraged bank loan CLOs and commercial mortgage-backed securities (CMBS) in that they are structured as CLOs but have CRE loans as collateral.
- CRE CLOs are structured similar to traditional CLOs with several tranches of rated debt issued to investors, along with a first-loss, or equity tranche.
- The collateral securitizing CRE CLOs includes CRE loans that are short-term, on transitional properties, usually with a duration of three to five years, and they are floating rate.
- Like CLOs and other structured finance transactions, risks to investing in CRE CLOs include credit risk, whereby sufficient income on the underlying loans may not be available to make full and timely payments to bond holders, due in part to an unfavorable CRE market.
- An advantage to investing in CRE CLOs is access to the underlying CRE loans that investors may not otherwise have and the relatively short duration of the tranches of debt issued to noteholders, which limits interest rate risk.

Brief Background on CLOs

CLOs in their broad sense are structured finance transactions predominantly collateralized by broadly syndicated bank loans (BSLs), as well as middle market loans. Principal and interest income earned on the underlying pool of assets is used to pay periodic interest (most often, semi-annually or quarterly) and principal when due at maturity (on average, 10 years) to investors. Please refer to the NAIC Capital Markets Bureau's Primer on [CLOs](#) published in 2018 for more detail.



What are CRE CLOs?

CRE CLOs are CLOs that are collateralized by CRE loans that are transitional, or short-term and floating rate. Income earned on the underlying CRE loans—i.e., principal and interest payments—is utilized to make debt service payments to noteholders. Due in part to the strong U.S. economy and investor appetite for higher yields, the CRE CLO market experienced substantial growth in 2019. Some sources cite the first CRE CLOs having been issued around 2012 or 2013. CRE CLOs are structured with reinvestment periods (usually one to three years), during which time the collateral manager, which manages the underlying portfolio of loans, may buy and sell loans in and out of the underlying portfolio. In addition to having a collateral manager to manage the portfolio, CRE CLOs may have a servicer to service the underlying CRE loans.¹

Characteristics of the Underlying CRE Collateral

Collateral for CRE CLOs primarily consists of bridge loans (short-term loans) on CRE properties that are in transition, such as renovations, expansion, or repositioning. They are “transitional” loans on properties that will have more value in the future and are not seeking long-term financing. The transitional loans typically have a duration of three to five years and are floating rate. In addition, they are predominantly whole loans and pari passu participation whole loans secured by first-mortgage liens on CRE assets.²

In contrast, CMBS are structured finance transactions collateralized by stabilized property loans; i.e., those that have achieved an occupancy rate of at least 80%. Chart 1 shows the difference in collateral and structural characteristics between a CRE CLO and CMBS, including statistics from 2020.

¹ Commercial Real Estate CLOs: Features That Make Them an Attractive Asset Class, *Journal of Structured Finance*, Fall 2014.

² What Institutional Investors need to Know About CRE CLOs, *pionline.com*, August 2018.



Chart 1:

Collateral characteristics	CMBS	CRE CLO
Property type	Stabilized	Transitional
Interest rate	Fixed	Floating
Typical term	5–10 years	3 years
2020 stats		
Loans per deal	43	30
Loan size	\$24M	\$24M
Retail + hospitality	23.20%	6.10%
Structure		
Typical use	Stand-alone structure	Balance sheet financing
Loan contributors	May be multiple origination platforms	Typically, the sponsor of the vehicle
Equity holder	Third-party “B-piece” buyer	Typically, the sponsor of the vehicle
Loan management	Third-party servicer	Sponsor/originator
Management	Static pool	Managed or static pool

Source: FS Investments, Morgan Stanley, J.P. Morgan.

Capital Structure of CRE CLOs vs. CMBS

CRE CLOs typically have four to five tranches, or layers, of debt; the subordinated tranches that are rated below investment grade are typically held by the issuer or transaction sponsor. The subordinated tranches are about 20% of the transaction balance, providing a large proportion of credit enhancement to the investment grade-tranche(s). There is also a bottom-most equity layer, or first-loss position, that remains with the agent that originated the underlying portfolio of CRE loans. Structurally, the first-loss position of a CMBS capital structure, also known as the “B piece” tranche, is typically owned by a third-party investor that has not contributed to the asset pool. CMBS tend to be static transactions, in that once loans are identified for the pool, they are not swapped out during a reinvestment period, and the principal on the notes issued to CMBS investors is paid down as the underlying commercial mortgage loans mature (also known as amortization). CRE CLOs on the other hand, may be static or managed transactions, meaning the manager of the underlying CRE pool may remove and acquire loans at its discretion during a specified reinvestment period (as is the case with “traditional” CLOs). Just like CLOs, after the reinvestment period, principal proceeds from CRE loans pay down principal on the notes issued to investors. Also like CLOs, CRE CLOs may have a ramp-up period, during which time CRE loans are acquired for the portfolio prior to closing. In addition, CRE CLOs have overcollateralization and interest



coverage tests and collateral quality tests that must be satisfied as loans are substituted within the portfolio during the reinvestment period.

Advantage to Investing in CRE CLOs

CRE CLOs are attractive to investors seeking short-term investments, due in part to the short duration of the underlying CRE loans. In addition, the short duration and floating rate nature of the notes issued benefit investors in a rising interest rate environment. CRE CLO managers can replace CRE loans in the underlying pool during the reinvestment period, which could improve portfolio credit quality and performance.

Depending on investment strategy and philosophy, CRE CLOs represent attractive investment options when risk/reward opportunities may be challenging. Most CRE CLO notes within the U.S. insurance industry are held by life companies.

What Are the Risks?

Similar to traditional CLOs collateralized by leveraged bank loans, CRE CLOs have credit risk; i.e., risk that the underlying portfolio of CRE loans will not be able to generate sufficient cash flow to pay investors when principal and/or interest payments are due. This potential payment default can be influenced by a few factors, one of which is the CRE loan market in general. This means it is important for CLO managers to take notice of any issuers and/or property types that are experiencing difficulties or challenges in the current environment as they are making investment decisions. Default in payment on the CRE loans results in less cash from the underlying portfolio and, in turn, less funds available to pay noteholders. For this reason, it is important that CRE CLO portfolios are diversified by issuer and property type.

Given the short-term nature of the underlying CRE loans, prepayment risk is not as significant as with leveraged bank loans that collateralize traditional CLOs in a decreasing interest rate environment. Notwithstanding, as interest rates rise, borrowers may experience challenges making payments on the underlying CRE loans, resulting in delinquencies and/or defaults and, in turn, decreased cash flow to pay investors. Note that the CRE CLO note is typically floating rate as well, so interest owed to the noteholders will also increase as rates rise.

Another factor is the experience of the CRE CLO manager. This is not only relative to credit analysis, portfolio management, and necessary operations and administrative duties, but also having experience with effectively managing CLO structures to the best interest of all investors.

U.S. Insurers and CRE CLOs

Statutory Accounting and Reporting

For reporting and statutory accounting purposes, CRE CLOs typically fall into the category of loan-backed and structured securities (LBASS). LBASS are generally issued by special-purpose corporations or trusts



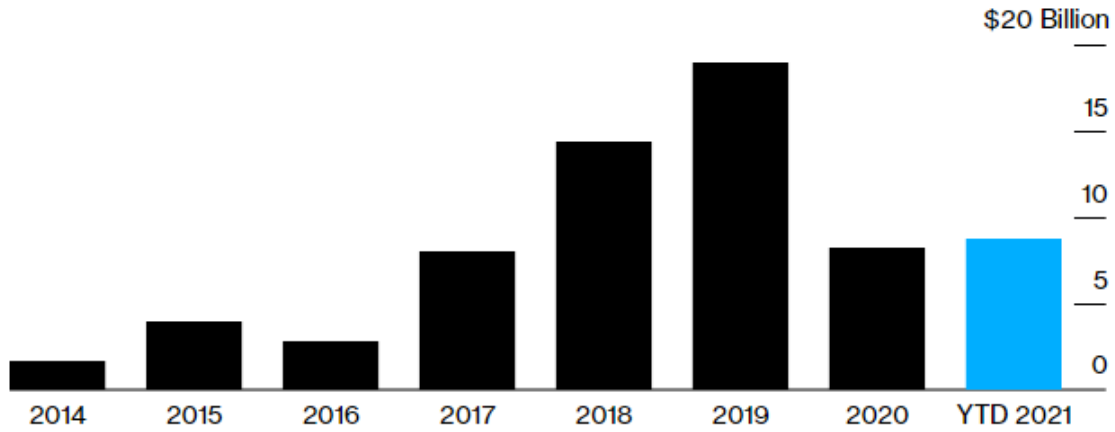
(issuer) established by a sponsoring organization. According to the *Accounting Practices and Procedures Manual* (AP&P Manual), “loan-backed securities are defined as securitized assets not included in structured securities...for which the payment of interest and/or principal is directly proportional to the payments received by the issuer from the underlying assets, including but not limited to pass-through securities, lease-backed securities, and equipment trust certificates.” If a CRE CLO is defined as an LBASS, then it follows the guidance of *Statement of Statutory Accounting Principles (SSAP) No. 43R—Loan-Backed and Structured Securities*. SSAP No. 43R securities are reported on Schedule D, Part 1: Long-Term Bonds, and the measurement method for the investment depends on the reported NAIC designation. For U.S. insurers that maintain an asset valuation reserve (AVR) (life and fraternal companies), CLOs that are LBASS are to be reported at amortized cost, except for those with an NAIC designation of 6, which are to be reported at the lower of amortized cost or fair value. For U.S. insurers that *do not* maintain an AVR (non-life or fraternal companies), CLOs that are defined as LBASS designated that the highest quality and high quality (NAIC designations 1 and 2, respectively), are to be reported at amortized cost. CRE CLOs defined as LBASS with NAIC designations 3 through 6 are to be reported at the lower of amortized cost or fair value.

LBASS meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets*, and they are admitted assets to the extent that they conform to the requirements of SSAP No. 43R. CRE CLOs have typically been a relatively small subset of the U.S. insurance industry’s overall CLO exposure, which has predominantly been to CLOs securitized by BSLs. Also similar to insurers’ BSL CLO investments, CRE CLO investments have been high credit quality.

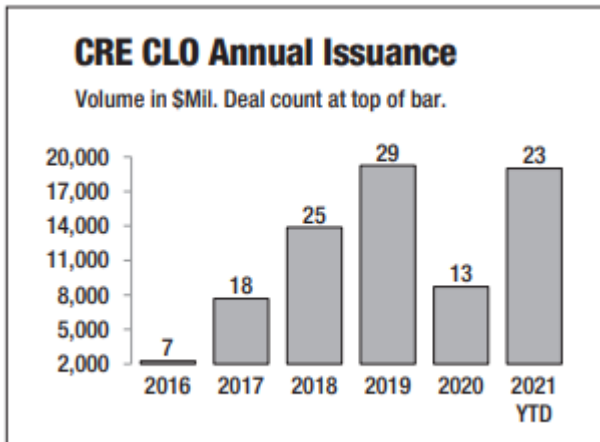


Appendix:

CRE CLO Issuance (YTD = April 2021)



Source: Trepp, Bloomberg.



Source: Commercial Mortgage Alert, May 28, 2021.



Key Terminology

Amortization Period

Once the reinvestment period has ended, the CRE CLO manager pays down the notes (tranches or CLO liabilities) following the priority of payments included in the legal documents, using loan prepayments or proceeds from the sale of underlying assets.

AVR

Capital required to be set aside to cover a company against unexpected losses. The AVR serves as a backup for equity and credit losses.

CLO Manager

Responsible for credit analysis, portfolio management, operations, and administration of the CLO. The CLO manager selects the underlying assets for the CLO portfolio and has a fiduciary responsibility to the noteholders and equity holders. Sometimes a CLO manager may be an investor in the CLO.

Closing Date

Date the underlying portfolio is fully ramped, and coverage and quality tests begin to take effect.

CLO

Structured finance security collateralized predominantly by BSLs.

CMBS

Structured finance security collateralized by stabilized commercial mortgage loans.

CRE

CRE refers to any income-producing real estate that is used for business purposes (e.g., offices, retail, hotels, and apartments).

CRE CLO

Structured finance security collateralized predominantly by transitional CRE loans.

CRE Loan

A CRE loan is a mortgage secured by a lien on commercial property as opposed to residential property.



Credit Enhancement

Also referred to as “overcollateralization,” it is the ratio of the aggregate principal value of pooled assets to the outstanding debt (tranches) that make up the capital structure.

Credit Risk

Possibility that a payment obligation will be missed, resulting in a loss; possibility of loss if a borrower defaults on making a loan payment.

Interest Coverage Ratio

Ratio of total interest income generated by the underlying pool of assets to the total interest due on the debt (tranches) outstanding.

Leveraged Bank Loans

Loans by a group of lenders to companies that are typically rated below investment grade. The loans are *typically secured with a lien on the company’s assets and are generally senior to the company’s other debt.*

Overcollateralization Test

Tests at each tranche level, whereby the principal value of the underlying portfolio must be greater than the principal value of the outstanding tranches.

Prepayment Risk

The risk that a borrower will repay a loan before its maturity, depriving the lender of future interest payments.

Ramp-Up Period

Following the closing date, the months following during which the CRE CLO manager purchases the remaining collateral for the portfolio.

Reinvestment Period

Period of time during which the CRE CLO manager can remove and acquire new CRE loans for the portfolio.

Stabilized Loans

CRE loans to a completed property that has had an occupancy rate of at least 80% for one full calendar quarter; any completed property that has achieved an occupancy rate of 80% or more, at any time in the past.



Special Purpose Vehicle (SPV)

Trusts whose operations are limited to the acquisition and financing of specific assets into the pool that collateralizes the structured securities (in this case, CRE CLOs); an SPV is the actual issuer of the CRE CLO notes.

Tranche

Class of debt within a securitization's capital structure.

Transaction Sponsor

Issuer of the transaction, often the collateral manager or originator.

Transitional Loans

CRE loans to properties that are short-term or bridge loans on CRE properties, whose value is yet to be maximized; loans on properties in a transitional phase such as expansion, renovation, or repositioning.