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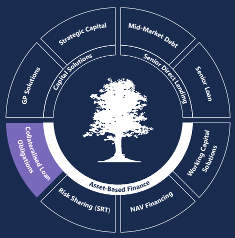


CLO Insights Series

Understanding Par Value in CLOs

September 2025

Introduction

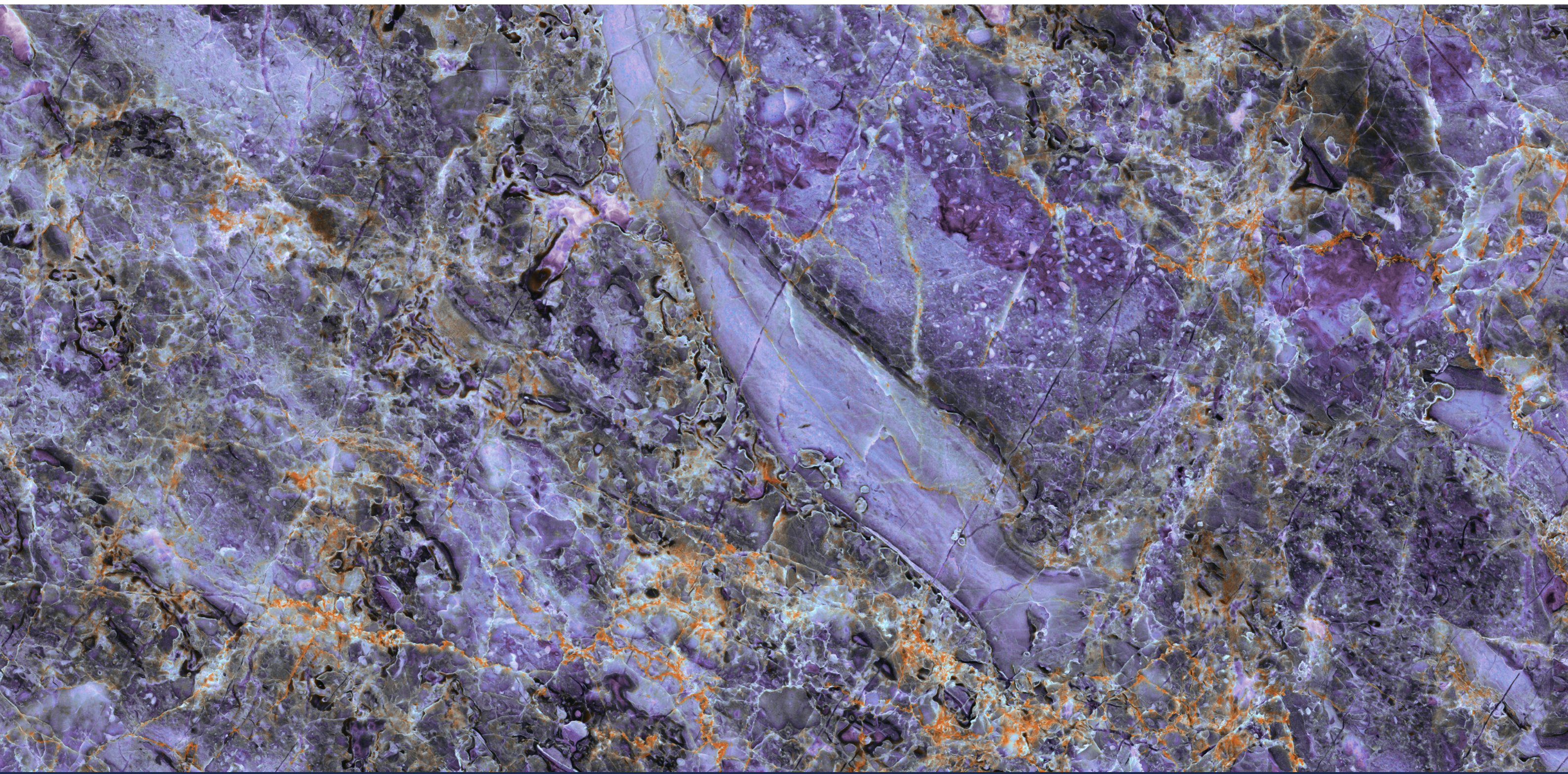
CLOs generally account for assets at par value (i.e. 100% of principal) irrespective of purchase price or market value. This is because the underlying loans are expected to repay in full. There are exceptions to this convention which are discussed below.

CLO investors pay particular attention to par value as CLO performance is largely driven by this number. One of the key tests which CLOs are subject to is the overcollateralisation (OC) or Par Value Test. There are different OC tests with their own pass levels for each class of notes. The OC test passes if the relevant OC ratio for each class of notes is above its original pre-determined level. The "OC ratio" is the par value of the CLO's collateral divided by the outstanding amount of that particular class of notes (expressed as a percentage) and all the classes of notes senior to it in the capital structure. The Par Value Tests therefore measure the value of the collateral cover underpinning the CLO notes.

A distinct but related test is the Interest Coverage Test. As with the Par Value Tests, there is an Interest Coverage Test at different levels in the capital structure. The numerator is the interest proceeds available in the waterfall and the denominator is the interest payment due on the next debt tranche. Interest Coverage Tests therefore measure the capacity of the CLO to pay coupons to the noteholders.

This article looks at the importance of par value as a way of protecting investors, comparing CLOs and assessing the skills of the CLO Manager.

Firstly, we consider some of the dynamics of the CLO note structure.



Structural Importance

CLO funding is provided by investors who subscribe to various classes of notes depending on their investment preferences. The highest category of notes is rated AAA followed by an AA tranche and further classes of notes with the lowest ranking notes being unrated. The returns investors receive vary depending on their position in the capital structure and consequently their exposure to the credit risk of the assets underlying the CLO.

Investors in the CLO notes are fundamentally interested in the quality of the portfolio as it determines how much protection they have. The highest rated noteholders have first claim on the assets in the portfolio. They benefit from the credit enhancement derived from the lower rated noteholders having subordinated claims.

The level of protection that each class of notes receives is reflected by the Par Value Tests and the Interest Cover Tests. These tests are at the heart of the CLO structure.

Over-Collateralisation Test / Par Value Ratio

Class of notes	Indicative Par Value Ratio	Approx. Opening Level	Initial Test Cushion
A/B	129%	138%	9%
C	120%	127%	7%
D	110%	116%	6%
E	106%	111%	5%
F	103%	107%	4%

Interest Cover

Class of notes	Indicative Interest Cover	Approx. Opening Level	Initial Test Cushion
A/B	120%	197%	77%
C	110%	176%	66%
D	105%	155%	50%

For illustrative purposes only.

As the tables above show the A (rated AAA) and B (rated AA) notes benefit from the highest level of asset cover and interest cover cushion. In a typical €400m CLO, the total of the AAA and AA notes is €290m which means they have €110m surplus asset cover. Additionally, the opening cushion equates to ca. €36m to cover potential losses before the AB Par Value Test is at risk. Lower classes of notes have sequentially lower levels of protection – but receive higher returns for their investment.

There are a number of consequences if any of the tests are breached. This will be the topic of a subsequent paper.

Par Build and Par Erosion

Secondly, we look at what can happen to par value as it is important to realise that it is not a static figure.

As mentioned above, CLO assets are generally accounted for in terms of their par value. However, this par value is subject to certain deductions or "haircuts", for instance, when an asset is in default.

Conversely, the CLO manager is also able to increase the par value of the portfolio. This benefits investors since it provides more cushion to each class of note holder to withstand losses. It also increases the asset base upon which interest income is generated. Furthermore, it benefits investors in the subordinated notes who receive any excess cashflows after the CLO debt tranches are repaid.

There are a number of ways that the par value of the portfolio can be increased or decreased. This is known as par build or par erosion.

Par Build

There are several ways a CLO manager can increase par:

- Buying assets below par which can be booked at par.
- Trading assets to generate gains.
- Switching between loan tranches and bond tranches of the same obligor.
- Buying discounted assets (i.e. below 80%) which subsequently increase in price satisfying the terms of the CLO documentation enabling them to be booked at par.
- Diversion of cash flows in the waterfall to purchase additional assets.

Par Erosion

Par value can be reduced by:

- Selling assets below par (which are not replaced by cheaper assets).
- CCC rated assets above the CCC limit (typically 7.5% of the portfolio) which are recorded at the lowest rating agency recovery rate.
- Defaulted assets which are at valued at the lowest rating agency recovery rate, or if such defaulted assets have been in default for 3 years are valued at zero.
- Assets bought below 80% will be recorded at purchase price.
- Holding long dated loans (due after the CLO maturity date) which are treated at 70% of par.

Conclusion

Par value is one way of monitoring the performance of a CLO portfolio. It also helps to gauge the skills of the CLO manager. A CLO manager who successfully builds par does so for the benefit of all classes of note holders. A CLO manager who erodes par, risks reducing the protections available to note holders in inverse order of seniority.

Produced in association with Weil, Gotshal & Manges (London) LLP.

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