



## CLO Insights Series

# Traded vs. Settled

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## Introduction

The Collateral Manager is primarily focused on the traded balance in a CLO, because it is the basis upon which most metrics are measured. However, this should not be to the exclusion of the settled balance because the settled balance is what determines the available cash flow.

## What is the Traded Balance?

The traded balance is calculated by summing the principal balances of all settled positions owned by the CLO and then adding unsettled purchases and deducting unsettled sales.

This traded balance is the basis on which Portfolio Profile Tests, the Collateral Quality Tests and the Coverage Tests (in practice there may be some value adjustments for these purposes – see [CLO Insights Understanding Par Value in CLOs](#)).

So far so good. It all sounds quite straightforward but let's dig into this a bit deeper because there are potential issues relating to timing of settlements that could impact distributions.

## The CLO Portfolio – Recap

A CLO portfolio typically consists of 110 + positions in syndicated loans. These loans are tradeable between counterparties (subject to certain conditions - see CLO Insights A Day in the Life of a Loan Trader – a forthcoming CLO Insight).

## Settled vs. Unsettled Trades

Settled trades are all those positions where the purchase or sale price has been exchanged and interest and/or principal payments are being received into the CLO at regular intervals (during defined collection periods).

This happens automatically as borrower payments are paid via agent banks. The Collateral Manager reconciles the cash against expectations and queries any discrepancies.

In contrast unsettled trades are where there is a binding commitment on the CLO to buy or sell the relevant loan and so risk has been legally transferred, but payment of the purchase or sale price has not yet taken place. Unsettled trades could be up to 5% of the portfolio.

Typically, unsettled trades accrue interest from 10 business days after the trade date. However, settlement of both principal and interest may not take place for a number of weeks or months.

The crux of the issue is that whilst most of the CLO metrics (including Par Value Tests and Collateral Quality Tests such as WAS or WARF tests) are based on traded balances, payments to CLO investors are only possible from available cash being received by the CLO.

This issue comes into sharp focus each quarter when interest is due to be paid on the CLO notes. Timing of settlements therefore needs to be carefully monitored. The Collateral Manager needs to be in firm control of settlements to make sure there is sufficient cash flow for the CLO to meet its payment obligations to the investors.

Let's unpack this a bit more.

The amount to be paid or received for a loan varies according to the time between trade date and settlement date. The buyer wants to be paid for taking on the credit risk irrespective of the actual date of settlement. To cater for this, certain adjustments are made to the interest calculation.

The interest is split into the spread (or margin) on the loan and the base rate. Delayed compensation refers to the spread on the loan whereas cost of carry refers to the base rate. Delayed compensation is paid to the party on risk, whereas cost of carry is paid to the party holding the loan. The exact calculations are set out in a pricing letter once the settlement date is agreed. The calculation is made more complex if there has been a repayment between trade date and settlement date or if there have been other changes (e.g. fees paid, margin ratchet, interest periods).

Let's next consider the differences between trades executed in the secondary market compared to the primary market.

## Secondary Market

The secondary market comprises of a large number of loans to existing borrowers. These loans typically trade in lot sizes of €2m (although other amounts can be agreed). When buying a loan the Collateral Manager will pay the offer price. When selling a loan the Collateral Manager will receive the bid price. The difference between these two prices is called the bid/offer spread and is typically between 50-150bps depending on the liquidity of the loan and market conditions. Sometimes the gap can be wider if the borrower is underperforming or the market is unsettled.

Managing the timing of settlements is a core skill required of the Collateral Manager. This is because CLOs are funded vehicles with an obligation to pay interest on the notes that it has issued.

If a commitment has been made to acquire or dispose of an asset in the secondary market the market convention is for it to settle within 10 business days. However, there is usually some flexibility around settlement times. The pricing letter ensures the economics of the trade are passed through to the rightful party as described above.

This mechanism works most of the time but there could be circumstances where there is a problem with a settlement and this can have a knock-on effect in terms of the cash collected by a CLO.

For example, a delay in the CLO receiving cash from the sale of an existing loan because the purchaser does not have available cash could mean a delay in the CLO being able to pay for the purchase of a new loan. Similarly, there could be a delay in the settlement of a purchase by the CLO because the vendor does not yet have the loan (or sufficient principal thereof) yet settled on its books. In both of these circumstances it could disrupt the timing of interest proceeds being received in the CLO. If this is a material amount it could in turn affect available cash to pay the coupons on the notes.

It's therefore necessary to exercise good discipline over settlement times.

## Primary Market

There are extra considerations when thinking about primary trades.

### Principal

Unlike a secondary trade, timing of settlement on primary trades is outside of the control of the Collateral Manager. The Arranging Bank will expect to be paid in full at closing and will have little sympathy if the Collateral Manager has not got funds to pay because of an upstream issue. In the instances of primary LSTA documented trades, 'ticking fees' (see Interest below) could be forfeited if there are delays in funding a settlement. Collateral Managers often hold tactical positions in bonds to manage these issues. This is because bonds must settle within two business days.

### Interest

There is no "delayed comp" on primary trades. In fact, there is an initial period (up to 30-90 days) where no income is paid at all. Typically, a small ticking fee (e.g. half the spread) applies thereafter. Being on risk but not getting paid is clearly not optimal, especially if it causes a shortfall in the interest proceeds account of the CLO.

For these reasons primary trades work better in warehouses than CLOs.

## Conclusion

A crucial, but under-appreciated aspect of managing a CLO is the importance of operational control.

Of course, the portfolio manager, the analysts pool and loan traders are important people. However equally important are the "invisible" people in the back-office team at the Collateral Manager without which portfolio management would be much more challenging.

# Contact Us

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