



What is a CLO Waterfall and What Does it Do?

The “waterfall” is one of the more colourful phrases used by the CLO community.

More formally known as the Priorities of Payments, it is the mechanism that controls the flow of interest and principal proceeds received from the assets owned by the CLO to investors subject to certain controls (the Par Value Tests and the Interest Coverage Tests).

A CLO can make a particular payment only if there is enough cash left over after it has made every higher (or more senior) payment in the “waterfall”.

There are two parallel waterfalls: the interest waterfall and the principal waterfall (governing application of interest proceeds and principal proceeds received from the CLO’s assets, respectively).

To make it slightly more complicated, sometimes the waterfalls are connected - for instance, interest proceeds can be diverted to the principal waterfall if coverage tests are breached.

Interest “Waterfall”

There is a clear “pecking” order amongst investors. For example, Class A Noteholders (rated AAA) receive highest priority of payment (after settlement of taxes, expenses and certain fees). This contrasts with Subordinated Noteholders (unrated) who are at the bottom of the waterfall. The return payable to the Noteholders will be commensurate with their position in the waterfall and therefore the credit risk they assume.

In most circumstances, there will be enough money generated from the portfolio to pay all amounts when they fall due.

However, there may be occasions when the funds received from the portfolio are insufficient to pay everyone or certain CLO tests are breached which leads to the diversion of cash from junior to more senior classes of notes.

Investors may become concerned if there is a high level of assets rated CCC+ or lower. Typically, if this level exceeds 7.5% of the portfolio it causes a par value “haircut” and a reduction in the cushion (please see [CLO Insights Series: Understanding Par Value in CLOs](#)).

For example, if the quality of the portfolio deteriorates such that the Class A/B Par Value Test is breached, instead of paying interest to the Class C Noteholders, available interest proceeds would instead be used to

redeem the Class A Notes and (if needed) Class B Notes until the Class A/B Par Value Test is satisfied. Operation of the waterfalls and coverage tests therefore go hand in hand.

Similarly, if there are insufficient interest proceeds available to pay interest due on all classes of notes on a given payment date, the interest waterfall will facilitate the deferral of interest in respect of the more junior classes of notes (normally from Class C down).

The interest waterfall is also particularly relevant to the CLO Manager as it determines the priority of payment for its collateral management fees. While the senior collateral management fee is paid near the top of the waterfall ahead of the Noteholders, the subordinated and incentive fees are paid lower down beneath the rated notes.

This creates balance and aligns the interests of the CLO Manager with investors at different levels of the capital structure. While the CLO Manager will want to invest in a high yielding portfolio with a view to hitting its incentive fee hurdle, the CLO Manager will also want good quality performing assets to ensure it gets paid its subordinated management fee after all payments are made to the rated notes.

Taking a Closer Look

The Conditions of the Notes includes clear rules regarding the timing and quantum of payments to noteholders. The following table provides more details.

Step	Payments	Condition
A	Tax Issuer Profit Amount	None
B	Trustee fees and expenses Administration expenses	Capped (but not after EOD) Capped
C	Expense Reserve Account	Manager Discretion
D	Senior Management Fee	None
E	Senior Hedge Payments	None
F	Payments of interest to A Noteholders	None
G	Payments of interest to B Noteholders	None
H	Payments to redeem A / B Noteholders	If the A/B Coverage Tests are not met and sufficient to satisfy the tests
I	Payments of interest to C Noteholders	None
J	Payment of deferred interest on the C Notes	None
K	Payments to redeem C Notes	If the Class C Coverage Tests are not met and sufficient to satisfy the tests
L	Payments of interest on D Notes	None
M	Payments of deferred interest on the D Notes	None
N	Payments to redeem D Notes	If the Class D Coverage Tests are not met and sufficient to satisfy the tests
O	Payments of interest on E Notes	None
P	Payments of deferred interest on the E Notes	None
Q	Payments to redeem E Notes	If the Class E Coverage Tests are not met and sufficient to satisfy the tests
R	Payments of interest on F Notes	None
S	Payments of deferred interest on the F Notes	None
T	Payments to redeem F Notes	If the Class F Coverage Tests are not met after the expiry of the Reinvestment Period and sufficient to satisfy the tests
U	To redeem the notes	If an Effective Date Rating Event has occurred and is continuing
V	Up to 50% of remaining interest proceeds in payment to the Principal Account for purchase of additional collateral.	If during the Reinvestment Period, the Reinvestment Over Collateralisation Test has not been met
W	Subordinated collateral management fee Payment on due and unpaid collateral management fees Payment of deferred collateral management fees Repayment of Collateral Manager Advances and interest	The manager has discretion to defer payment of this fee to buy additional collateral or transfer to the Principal Account pending reinvestment.
X	Payment of Trustee fees and Administrative Expenses above the Senior Expenses cap. Payment of any Hedge payments (where hedge counterparty is defaulted)	
Y	Payments to the Collateral Enhancement Account	At the managers discretion
Z	Remaining interest is to be paid to subordinated note holders Up to 20% of remaining interest proceeds to the Collateral Manager plus any VAT Any remaining interest is paid to subordinated note holders.	If the Incentive fee threshold has not been reached If the Incentive fee threshold has been met

Principal “Waterfall”

The payment of Principal Amounts follows a similar pattern to the Interest Priority of Payment until after the end of the Reinvestment Period. After that the notes are redeemed according to the Note Payment Sequence (i.e. AAA notes first) with some exceptions related to Unscheduled Principal Proceeds and Sale Proceeds from Credit Improved or Credit Impaired assets (which are permitted to be reinvested by the CLO Manager subject to certain Reinvestment Criteria).

Conclusion

The “waterfall” is an intrinsic feature of the structure of a CLO.

It tells the CLO Manager exactly what it needs to do, and the Investors know exactly what to expect, in respect of interest and principal proceeds received from the assets owned by the CLO.

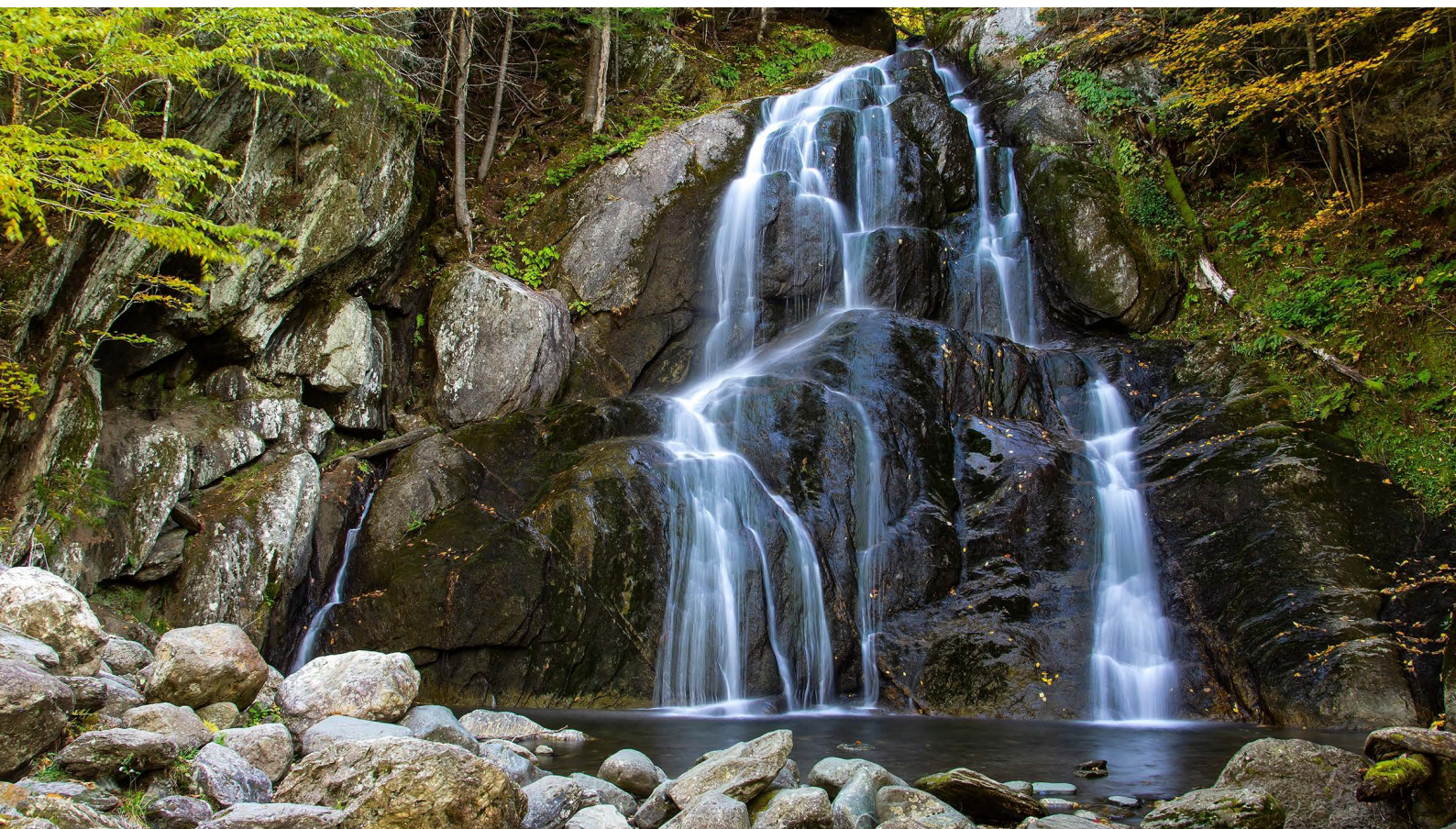
Subordinating most of the CLO Managers’ fees behind the payments to the rated noteholders incentivises the manager to manage the CLO Portfolio to ensure that rated noteholders are paid on time and in full.

The “waterfall” also provides the method to “cure” certain test breaches. This is a key component of the structuring process when determining the rating classifications of the notes.

It means that higher ranking notes benefit from cash flows that would otherwise have been paid to lower ranking notes. This represents an extra layer of protection against portfolio losses as higher ranking notes are cushioned by the diversion of the interest cash flows from the portfolio that would otherwise been paid to lower ranked notes and to the CLO Manager.

Finally, the incentive management fee rewards out-performance compared to the CLO Base Case meaning that Subordinated Noteholders should expect to receive their expected return before the CLO Manager gets paid its “performance bonus.”

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