Harnessing CLOs: income, risk, and regulations for European insurers

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Introduction

As global financial markets continue to evolve, investors are increasingly looking for new ways to diversify their portfolios and enhance returns. One asset class that has attracted growing attention in recent years is Collateralized Loan Obligations (CLOs), with the CLO market expanding significantly to $1.4 trillion globally.[1]

Traditionally, CLO investments were utilised by select institutional investors, but this landscape is evolving. The growth of the market and further introduction of CLO ETFs has opened the door to broader participation, with ETFs adding the operational simplicity, liquidity and transparency needed for a wider range of market players, while still providing a number of attractive features.

But what exactly are CLOs, why are they drawing attention from investors, and how does the ETF structure enhance their appeal?

What is a CLO?

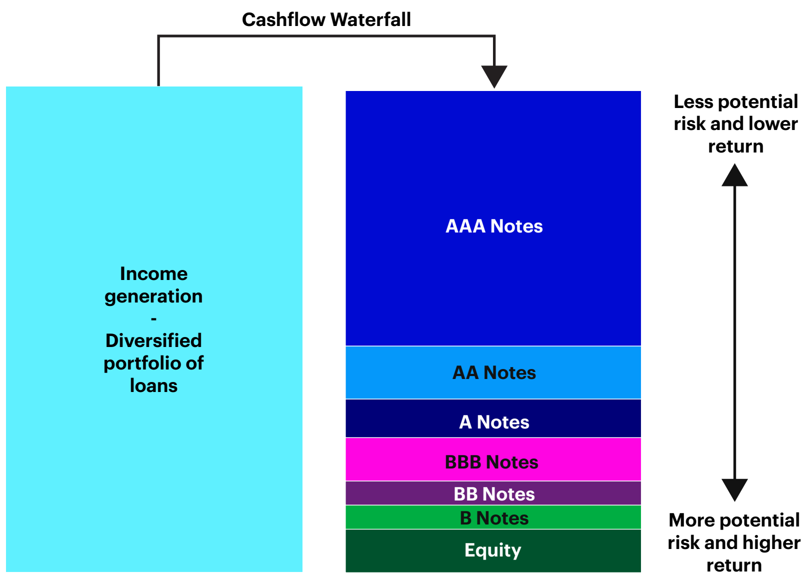
A CLO is a structured finance vehicle that pools together broadly syndicated loans — typically senior secured loans issued by corporate borrowers.

The acquisition of these loan assets is financed through the issuance of multiple layers, or "tranches", of securities. These consist of several classes of debt ranging from senior, highly rated notes to more junior tranches alongside an equity tranche. Each tranche has a defined priority of payment and risk profile.

Cash flows generated by the underlying loan portfolio are distributed by a "waterfall" structure whereby interest and principal payments are first directed to the most senior tranches, while subordinated debt and equity tranches absorb losses before senior investors are affected. This provides substantial credit enhancement to senior and investment grade (IG) tranches while junior and equity tranches are compensated for their additional risk with higher return potential.

Unlike the senior and junior debt tranches, equity tranches do not have a stated spread; instead, coupon income is generated as the arbitrage between income generated by the CLO and costs for the remaining CLO debt tranches, with equity receiving the residual.

Illustrative European CLO structure



Zero
historical credit impairments in AAA tranches

Why AAA / Investment Grade (IG) CLO debt is attractive to insurance portfolios

For insurance providers, who rely on stable, long-term income to support their liabilities, CLO AAA and IG CLOs in general offer several notable advantages:

- **Enhanced yield:** CLOs have historically provided higher income levels than other similarly rated assets due.[2] This premium is the result of numerous factors, including accounting for the structural complexity and liquidity of the CLOs.
- **Limited impairment history:** Coverage/collateral tests, coupled with the cashflow waterfall, have helped enable relatively low levels of historical principal impairments compared to similarly rated corporate bonds, with no impairments in AAAs.[3] If such tests are breached, then the CLO structure:
  - Redirects cashflows to best cushion senior note holders.
  - Puts further restrictions on CLO managers' reinvestment flexibilities.

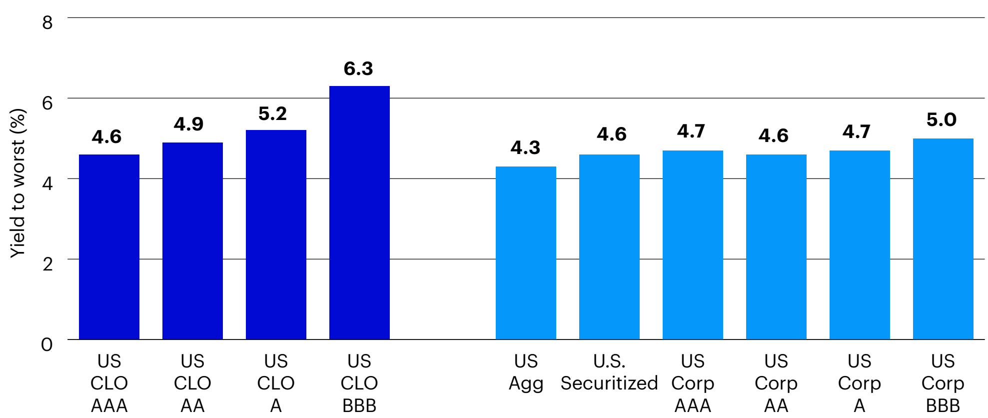
  With cash redirected away from equity distributions to amortize down the senior or AAA investments, the overall structure de-levers and de-risks.
- **Diversification and floating rate benefits:** CLOs are backed by hundreds of loans across various industries and regions, reducing the risk tied to any single borrower. Their floating rate nature also minimizes interest rate sensitivity, enhancing portfolio resilience.[4]

Principal impairment comparison (1993 – 2024)

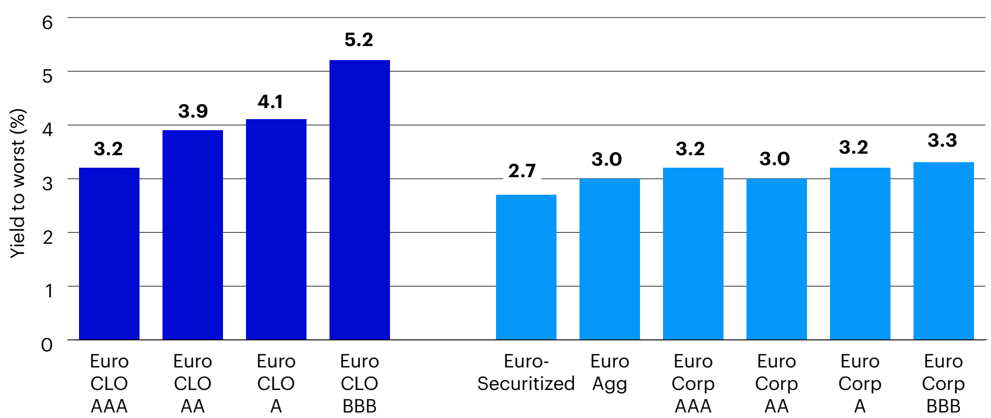
Global CLOs (Original rating)	Tranche count	# of impairments	% of CLOs impaired (%)	Implied loss rate (%)
CLO Aaa	7,943	0	0.0	N/A
CLO Aa	4,203	0	0.0	N/A
CLO A	3,410	1	0.0	N/A
CLO Baa	3,218	26	0.8	0.2
CLO Ba	2,858	54	1.9	1.1
CLO B	1,175	28	2.4	1.5

Source: Moody's Ratings, Structured Finance: Impairment and loss rates of global CLOs: 1993 – 2024 as of June 2025. Past performance does not predict future returns

Yield to worst comparison – December 2025[2]



Source: U.S. CLO investments are represented by the respective J.P. Morgan CLOIE Index. U.S. Aggregate is represented by the Bloomberg U.S. Aggregate Bond Index. U.S. Corporates are represented by the Bloomberg U.S. Corporate Bond Index (by credit rating). U.S. Securitized is represented by the Bloomberg U.S. Securitized (MBS, ABS, and CMBS) Index. An investment cannot be made directly in an index. Past performance is not a guarantee of future results. Data as of 31 December 2025.



Euro CLO investments are represented by the respective J.P. Morgan CLOIE Index. Euro Aggregate is represented by the Bloomberg Euro Aggregate Bond Index. Euro Corporates are represented by the Bloomberg Euro Corporate Bond Index (by credit rating). Euro Securitized is represented by the Bloomberg Euro Aggregate Securitized Index. An investment cannot be made directly in an index. Past performance is not a guarantee of future results. All Euro indices are hedged to the euro. Data as of 31 December 2025.

Enhanced yield with Lower volatility

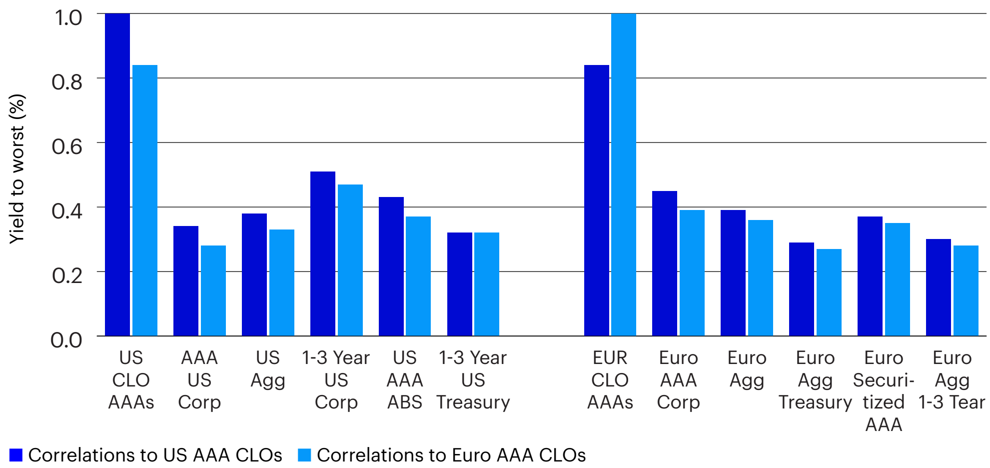
AAA CLOs have enhanced yield and lower volatility over IG asset classes

< 0.5

correlation to broad fixed income markets

Beyond all other tranches, CLO AAAs have seen the largest increase in demand, and we believe they present an especially compelling opportunity. AAA CLO tranches may offer a compelling blend of attractive yields[2] and no historical credit impairments.[3] Over the last five years, AAA tranches have delivered yield enhancements significantly above similarly rated corporate bonds,[2] with volatility two to three times lower than broader investment grade markets.[4] Importantly, CLO AAAs have maintained a record of zero principal losses, rapid recovery during market drawdowns,[4] and lower relative correlation to other IG asset classes, making them a preferred choice for capital preservation and incremental income for longer term investors. All these features stem from their structural advantages, (high level of subordination, overcollateralisation, and interest coverage), their floating rate and diversified income stream, and overall resilient cash-flow mechanics present in the underlying senior loan market.

US/Euro AAA CLO 5 year correlations – June 2025[2]



The case for active management in CLO AAAs and the opportunity in ETFs

As an alternative to either direct investment or a separately managed account (SMA), a CLO ETF can offer insurance investors cost-efficient and diversified access to the market. These ETFs provide easy access to a diversified pool of CLOs, with daily liquidity and full portfolio transparency — a convenient alternative to the purchase of individual CLO tranches, which requires both substantial security-level due diligence and operational capacity.

Invesco's AAA CLO ETFs are managed by the Private Credit team and benefit from the platform's extensive experience in managing both US and European CLO Notes across the rating structure, and the underlying broadly syndicated loans. While focused on AAA tranches, having an experienced specialised active manager can help:

- **Select the right CLO managers and deals:** Not all AAA CLO tranches are created equal, and issuer due diligence is critical. Managers have different levels of experience, expertise, and resources, as well as different management styles. Each of these factors will influence overall CLO performance.
- **Manage risk effectively:** As with other fixed income assets, CLOs can be sensitive to changes in credit markets, interest rates, and macroeconomic conditions. Active managers can adjust positioning in response to evolving risks.
- **Optimise liquidity and execution:** In less liquid markets, trading efficiency matters. Active managers can navigate bid-offer spreads and manage portfolio turnover to minimize costs.
- **Capture relative value:** Exploit pricing/spread opportunities to enhance returns, by focusing on WAL (weighted average life) and observing the relative value between new issue markets, longer maturity CLOs, and shorter maturity CLOs.
- **Diversify correctly:** As with fixed income investing in general, spreading investments across a number of managers is not the only factor to consider in the CLO market. A focus on WAL management, which can impact spread duration, and vintage diversification are key, with each vintage having its own specific challenges.

While these key points of active management are true in SMAs and direct investments, the ETF structure can provide additional features that may benefit specific investors:

- **Cost efficiency:** ETFs benefit from economies of scale and typically offer lower fees.
- **Liquidity:** The secondary market allows investors to trade ETF shares without directly transacting in the underlying securities.
- **Transparency and flexibility:** ETFs provide real-time pricing and can be used for both strategic and tactical allocation.

These benefits are particularly valuable in less liquid markets like CLOs. While the CLO market is large, its private credit nature means individual securities may not trade frequently. ETFs mitigate this challenge by offering exposure via a liquid secondary market, where investors can buy or sell shares without triggering transactions in the underlying CLO notes.

This mechanism allows market makers to manage inventory and risk efficiently, often resulting in tighter bid-offer spreads than the underlying securities themselves. For many investors, this means they can swiftly adjust exposures to the CLO asset class, especially during periods of market dislocation, without needing granular issuer-level knowledge. Not only could they adjust their allocation almost immediately after the decision-making process, but they would gain diversified exposure to that asset class in a single trade.

Regulatory considerations for European insurance providers

Alongside a compelling investment proposition, recent and forthcoming developments in insurance regulatory frameworks are reinforcing the attractiveness of this opportunity for European and UK insurers.

Solvency II

Solvency II has long applied a rigorous, risk-based approach to capital adequacy, historically assigning higher capital charges to structured products such as CLOs than to corporate bonds, reflecting their complexity and perceived risk profile.

Recent and proposed reforms under Solvency II are beginning to recalibrate this treatment. Revisions to the Standard Formula are expected to materially reduce capital charges for senior CLO tranches — particularly AAA-rated notes — with reductions of up to 70% – 80%, broadly aligning their capital treatment with that of BBB-rated corporate bonds. This recalibration enhances capital efficiency and is expected to support increased CLO allocations among EU insurers, who have historically maintained limited exposure relative to US peers. While senior tranches benefit most from these changes, mezzanine and junior tranches remain comparatively capital intensive, underscoring the importance of careful portfolio construction.

In parallel, Solvency UK reforms to the Matching Adjustment (MA) framework implemented in 2024/25 are improving the regulatory treatment of high quality structured assets. Recent changes allow certain CLO tranches with stable, predictable cash flows to qualify for MA portfolios through the introduction of Highly Predictable (HP) asset buckets, subject to a capped MA benefit. While the Standard Formula under Solvency UK remains comparatively conservative for structured credit, insurers using approved internal models can apply a more granular, risk-sensitive approach, often resulting in materially lower capital requirements. Together, these developments enhance insurers' ability to capture yield premia from senior CLO exposures within existing risk management frameworks.

AAA CLO ETFs are also expected to benefit from Solvency II reforms where insurers are able to apply look-through treatment to the underlying exposures, effectively inheriting the improved capital treatment of senior CLO tranches, while offering enhanced diversification, daily liquidity and operational simplicity relative to direct note holdings; even where look-through is constrained, recent reforms still support more favourable capital outcomes than historically applied.

Capital charges per year of duration (%)

Rating	Proposed non-STS senior	Current non-STS senior	Reduction
AAA	2.7	12.5	-78
AA	3.3	13.4	-75
A	4.4	16.6	-73
BBB	7.5	19.7	-62
BB	14.3	82.0	-83
B	23.5	100.0	-77

Source: European Insurance and Occupational Pensions Authority (EIOPA) October 2025.

EU securitisation regulation

The EU Securitisation Regulation (EU 2017/2402) introduces transparency, due diligence, and risk retention requirements for securitised investments. Key points for insurers include:

- **Risk retention:** CLO sponsors must retain at least 5% of the economic interest, aligning their incentives with those of investors.
- **Transparency and disclosure:** The regulation mandates regular, detailed reporting, supporting robust investor oversight and risk management.
- **Simple, Transparent, and Standardised (STS) Criteria**

Failure to meet these regulatory standards can result in higher capital charges and increased regulatory scrutiny, making comprehensive due diligence and ongoing monitoring essential.

Improved
risk adjusted return potential

Conclusion

For European insurers, investment grade CLO tranches — especially AAA-rated — offer a practical way to increase yield, manage risk, and diversify portfolios. While the regulatory environment requires careful navigation, the benefits of these investments, when managed prudently, can be substantial. By focusing on robust due diligence, manager selection, and compliance with Solvency II and the EU Securitisation Regulation, insurers can confidently integrate CLO AAAs into their investment strategies and achieve strong, resilient income streams.

Sources

1. BofA Global Research, Intex through November 30, 2025.
2. Source: Yield represented by Yield to Worst (YTW). US CLO AAA Notes represented by J.P. Morgan Euro CLOIE AAA Index, AAA US Corporates by Bloomberg U.S. Aaa Corporate Index, AAA US ABS by Bloomberg US Agg. ABS AAA Index, Bloomberg US Aggregate Bond Index by US Agg, 1-3 Yr Treasuries by U.S. Treasury: 1-3 Year Index and 1-3 year U.S. Corp by component of the US Agg index. Euro CLO AAA Notes represented by represented by J.P. Morgan Euro CLOIE Index. Euro Agg 1-3yr by Euro-Aggregate: 1-3 Year Index. Euro Securitized AAA by Bloomberg Euro-Aggregate: Securitized - AAA Index. Euro Agg by Bloomberg Euro-Aggregate Index. Euro Corp IG by Bloomberg Euro-Aggregate: Corporate Index. Euro Corp AAA by Bloomberg Euro-Aggregate Corporate Aaa Index and Euro Agg Treasury 1-5 Yr by Euro-Aggregate: Treasury Index 1-5 Year. All Euro indices are hedged to Euro. An investment cannot be made directly in an index. Past performance does not predict future returns.
3. Source: Moody's Ratings, Structured Finance: Impairment and loss rates of global CLOs: 1993 – 2024 as of June 2025. Past performance does not predict future returns.
4. Source J.P. Morgan CLOIE, JP Morgan Research as of December 31, 2025.
5. Bloomberg, J.P. Morgan CLO Research & Global Index Research as of June 30, 2025. CLO investments represented by respective US/Euro JP. Morgan CLOIE Indices, US/EUR IG Corporate, Senior Loan and HY by US/Euro JP Morgan Leveraged Loan, High Yield Indices and Investment Grade Corporate Indices. An investment cannot be made in an Index. All Euro indices are hedged to Euro.

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The value of investments, and any income from them, will fluctuate. This may partly be the result of changes in exchange rates. Investors may not get back the full amount invested.

The creditworthiness of the debt the Fund is exposed to may weaken and result in fluctuations in the value of the Fund. There is no guarantee the issuers of debt will repay the interest and capital on the redemption date. The risk is higher when the Fund is exposed to high yield debt securities.

Changes in interest rates will result in fluctuations in the value of the Fund.

It may be difficult for the Fund to buy or sell certain instruments in stressed market conditions. Consequently, the price obtained when selling such instruments may be lower than under normal market conditions. Highly rated tranches of CLO Debt Securities may be downgraded, and in stressed market environments even highly rated tranches of CLO Debt Securities may experience losses due to defaults in the underlying loan collateral, the disappearance of the subordinated/equity tranches, market anticipation of defaults, as well as negative market sentiment with respect to CLO securities as an asset class. The Fund intends to only invest in CLOs managed by CLO managers demonstrating higher levels of ESG consideration. This may cause the Fund to forego certain investment opportunities. The Fund may perform differently to other funds investing in CLO Debt Securities, including underperforming other funds that do not screen CLO managers based on ESG criteria.

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