Collaterized Fund Obligations
(CFOs)

CFOs Overview

What are Collateralised Fund Obligations?

CFOs are structured credit vehicles that securitise expected cash flows from diversified portfolios of private capital assets - primarily limited partnership interests.

Once considered a niche product, they've evolved into a mainstream tool within structured finance.

Market Growth

From 2018 to 2024, KBRA rated $28.5 billion of debt across 67 CFO transactions, with total issuance reaching $37.7 billion. While not indicative of the full market, this highlights growing institutional interest in CFOs - driven by demand for rated exposure to private capital and new liquidity tools for GPs.

CFOs vs. Other Fund Finance Solutions

CFOs - Securitize private fund interests usually in longer-term rated tranches

CLOs - Backed by corporate loans; more predictable cash flows

Rated Feeder Funds - Similar to CFOs but often one step removed from direct asset ownership

NAV Facilities - Tend to be shorter-term with lower advance rates and from a single lender

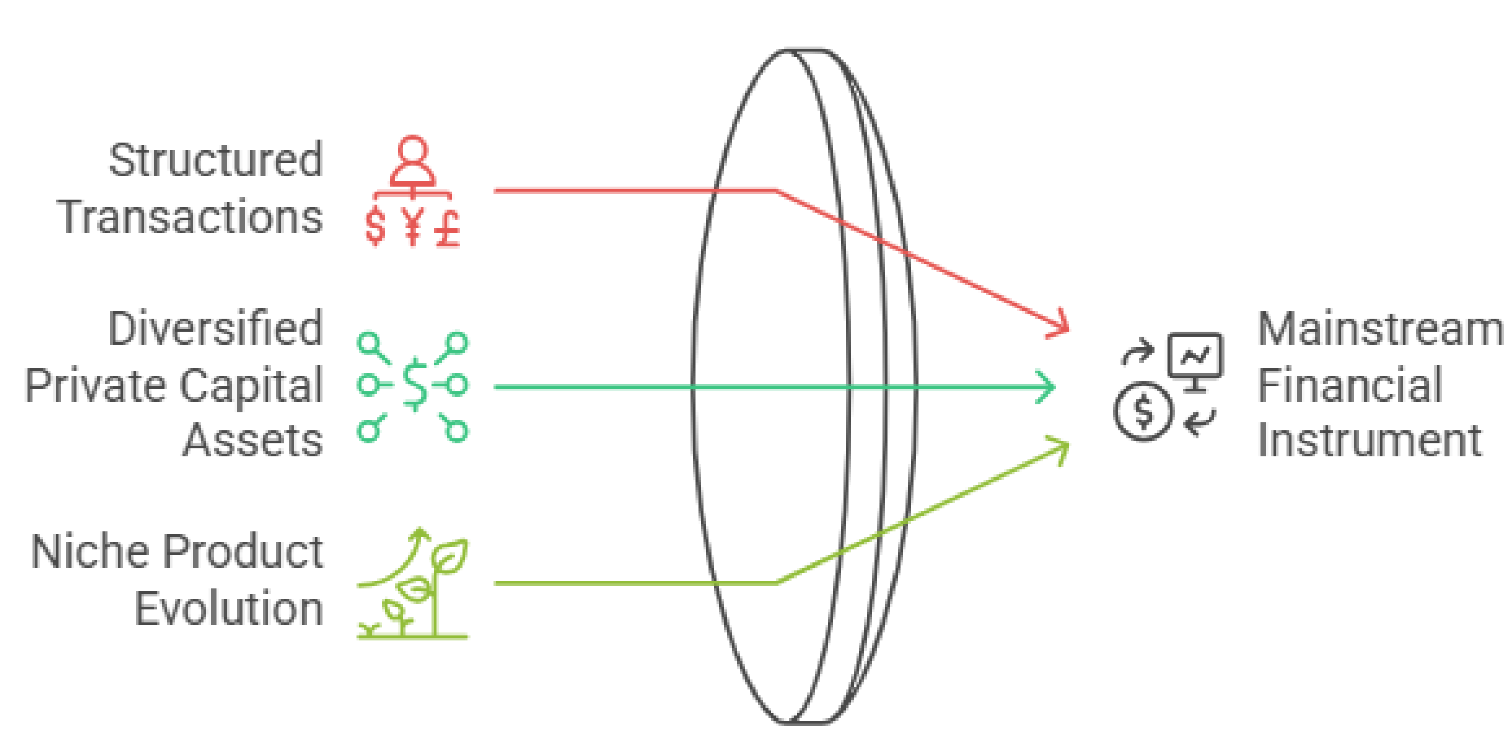
Key Market Drivers

Investor Demand - Regulated institutions seeking capital-efficient exposure to private markets

GP Liquidity Needs - Alternative capital raising and balance sheet management

Secondary Market - Alternative to traditional portfolio sales

The Rise of Collateralised Fund Obligations



Source:Private Equity Bro

CFO Structural Components

🏢 Core Legal Structure

CFO Issuer (SPV): Bankruptcy-remote entity that issues notes and acquires fund interests

Asset Holdco: Subsidiary holding fund interests to bypass GP consent restrictions

The equity of the Asset Holdco is pledged to secure repayment obligations

💰 Tranched Capital Structure

Senior Tranches: Highest rating, lowest risk/return, first priority in waterfall

Mezzanine Tranches: Moderate rating, balanced risk/return profile

Equity Tranche: Unrated, highest potential return, first-loss position

🛡 Credit Enhancements

Overcollateralization: Collateral value exceeds debt principal

Liquidity Facilities: 10-15% of issuance for ongoing obligations

Reserve Accounts: Cash held back for timely payments

⏱ Funding Management

Delayed Draw Debt: Aligns draws with capital calls

Liquid Asset Investment: Generates returns on unused capital

Together, they reduce cash drag without compromising deployment flexibility

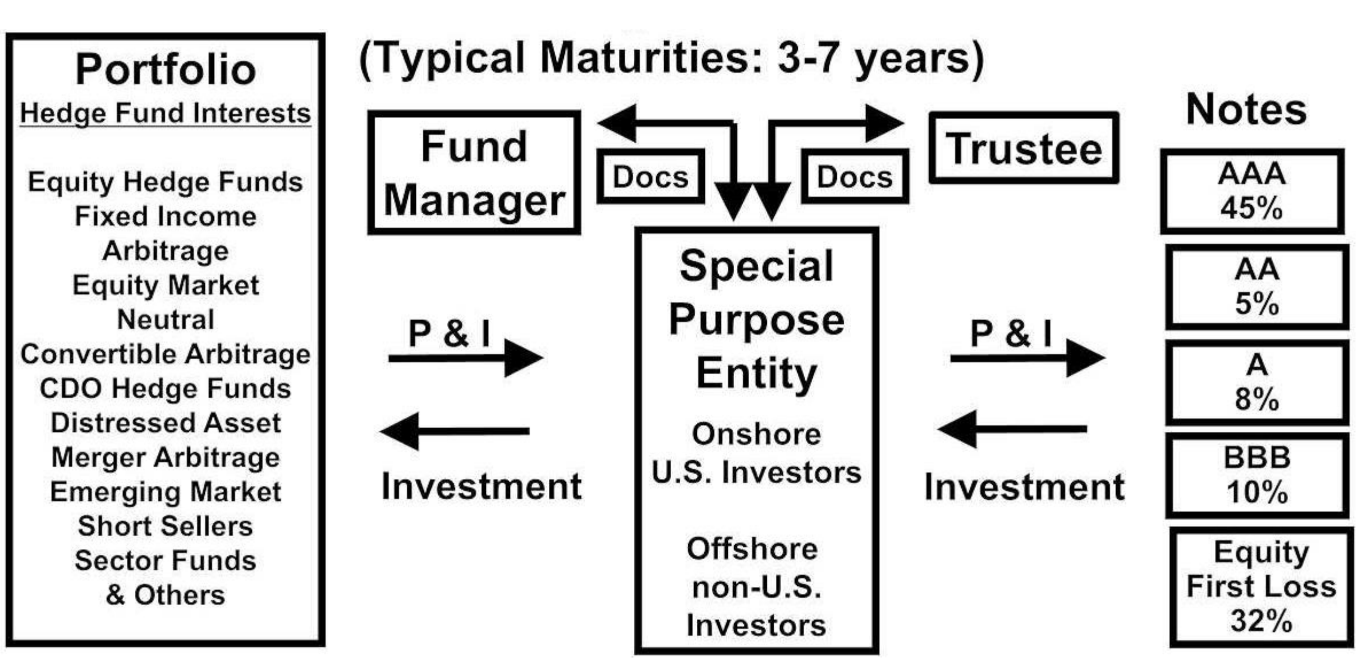
⚠ Investor Considerations

Senior tranches: Capital efficient exposure with protection

Mezzanine: Higher yield with moderate risk

Equity: Highest return potential but first to absorb losses

CFO Structure



Source: Tavakoli Structured Finance

Asset Pool Analysis: The Engine of CFO Performance

Underlying Asset Types

CFOs securitize diverse private capital assets including:

- Limited partnership (LP) interests in PE funds
- Private credit funds with predictable cash flows
- Real estate and infrastructure funds
- Direct co-investments and CLO residuals

Portfolio Composition & Diversification

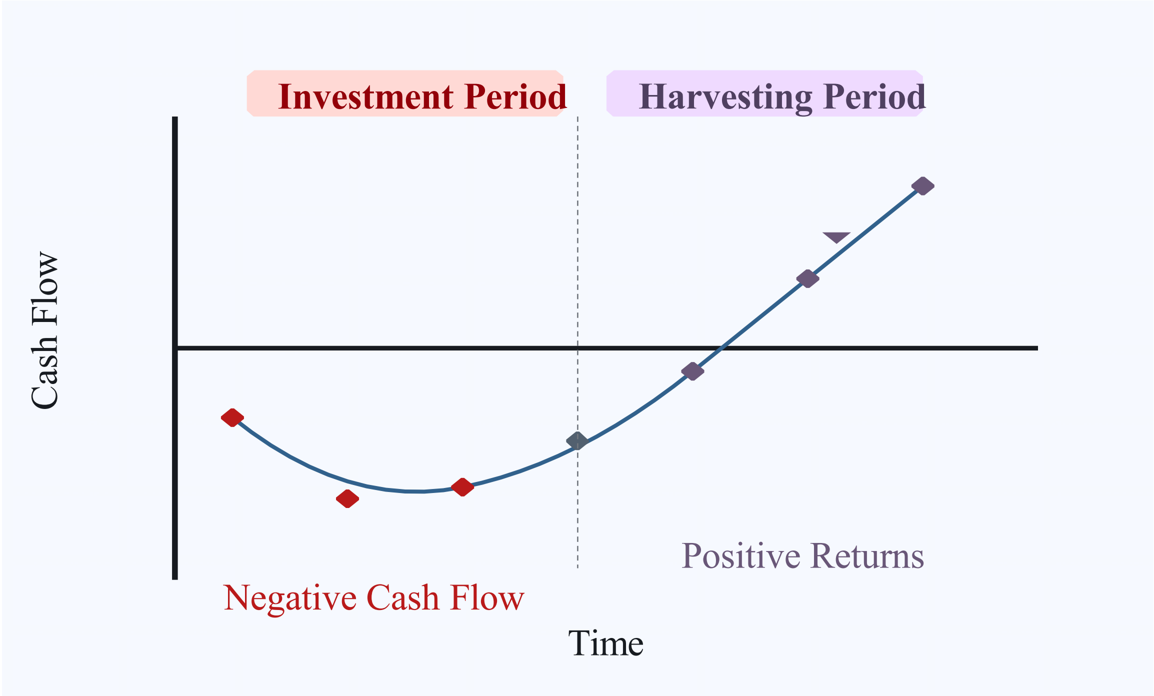
Critical factors for risk assessment:

Fund Strategy Mix: Influences cash flow predictability

Geographic & Sectoral Diversification: Mitigates concentration risk

Concentration Limits: Rating agencies usually impose 25% per GP and 10% per fund limits

Typical Private Equity Fund Cash Flow Profile (J-Curve)



Source: Private Equity Bro

Vintage Dispersion Analysis

Fund age significantly impacts cash flow profile:

Older vintages: Generate more distributions, less capital calls

Newer vintages: Higher capital call requirements, less immediate cash flow

Strategic combination balances cash flow throughout CFO life

Cross-Correlation Metrics

How underlying fund returns move together:

- Private equity shows ~80% correlation with public markets during crises
- Valuation smoothing masks true correlations
- Higher correlations during market stress reduce diversification benefits
- Critical for accurate assessment of portfolio risk

Rating Methodology

Key Rating Agency Approaches

Fitch, KBRA, S&P, and Moody's evaluate CFOs using both quantitative and qualitative factors:

- **Loan-to-Value (LTV) Ratios** - Critical for investment-grade ratings
- **Collateral Quality Tests (CQTs)** - Trigger corrective actions when losses exceed thresholds
- **Liquidity Assessment** - Evaluates ability to meet obligations during stress periods
- **Manager & Sponsor Evaluation** - Track record and alignment of interests

Investment-Grade Thresholds

Rating agencies impose strict limits for achieving investment-grade status:

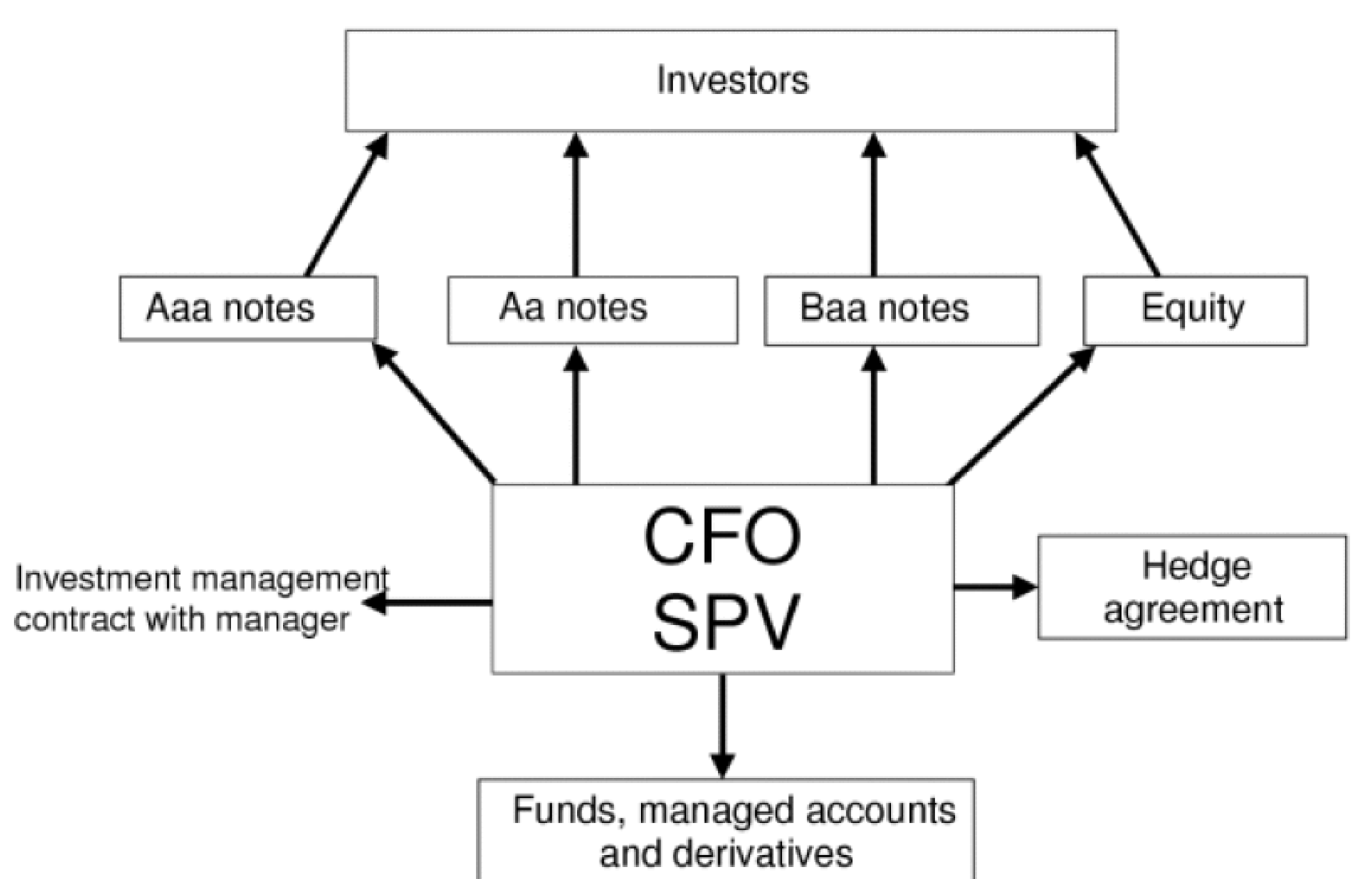
Fitch limits investment-grade ratings to CFOs with LTV up to 50% Transactions exceeding this threshold receive non-investment grade ratings

LTV-based triggers typically require deleveraging if NAV declines CQTs trigger when losses exceed ~15% of underlying collateral

⚠ Critical Challenges

Investors should be aware of key limitations in rating methodologies:

- **Historical Data Reliance** - Models built on data from different macroeconomic conditions
- **Understated Volatility** - True economic volatility (~30%) significantly higher than reported (~10%)
- **Masked Drawdown Risk** - Expected maximum drawdowns appear much lower than reality
- **Valuation Smoothing** - Creates an "illusion" of stability



Source: IFLR

Regulatory Framework

US Regulatory Landscape

Dodd-Frank Act - Increased transparency and oversight, shifting due diligence burden to banks

SEC Private Funds Rules (2023) - New disclosure requirements with Securitized Asset Fund Exception for CFOs

Volcker Rule - Prohibits banks from investing in "covered funds" (hedge/PE funds), with exceptions for loan securitisations

EU/UK Regulatory Framework

AIFMD - Focuses on leverage assessment for alternative investment fund managers

EU/UK Securitisation Regulations - Post-Brexit divergence creating dual compliance burdens

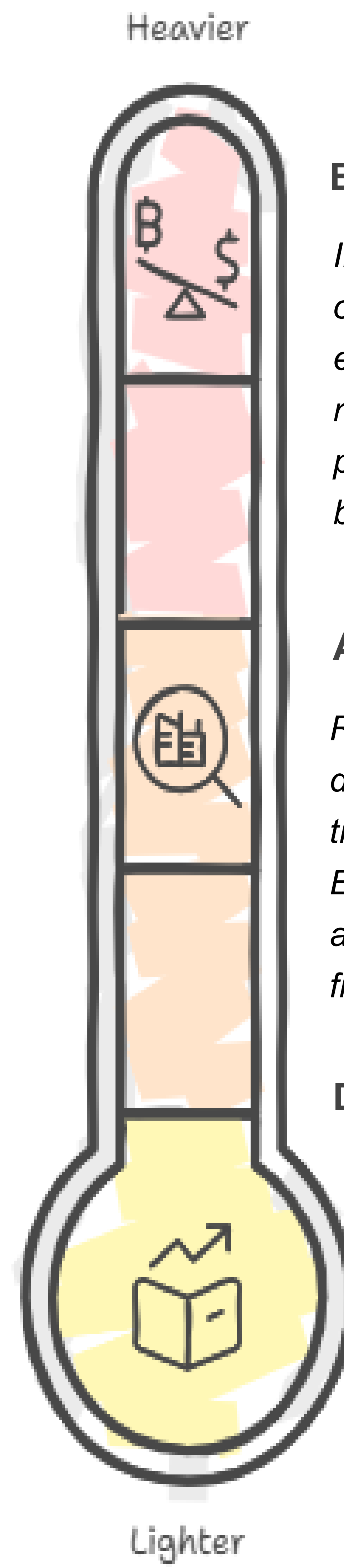
Risk Retention Rules - Both frameworks mandate material economic interest retention by originators/sponsors

Basel III & IV Capital Treatment

Increased capital intensity for securitized exposures, especially under Basel IV's output floor and revised credit risk frameworks

Stricter due diligence requirements: Banks must demonstrate sufficient understanding of securitized assets or face ineligibility for preferential treatment

Reduced bank participation in CFOs and other structured fund exposures due to punitive treatment and low look-through eligibility



Basel III & IV

Imposes high capital charges on securitized exposures, especially under Basel IV reforms, making structured products less attractive for banks.

AIFMD

Requires detailed due diligence, risk retention, and transparency compliance for EU investors in securitized assets – with added complexity from STS classifications.

Dodd-Frank

Mandates issuers to retain risk and meet strict disclosure standards under Reg AB II – increasing compliance costs, especially in public ABS markets.

Source:Private Equity Bro

Key Risks & Investor Base

Key Risks

Higher interest rates create multi-layered impacts:

Increased funding costs for CFO floating-rate liabilities NAV markdowns of underlying private assets
Reduced debt service coverage for portfolio companies Challenges to models built on "cheap leverage" assumptions

Liquidity-Stress Scenarios

Key vulnerabilities to monitor:

NAV Markdowns: Valuation lags and smoothing mask true volatility
Capital Call Defaults: Risk of investors failing to fund commitments
Redemption Pressures: New dimension from "retailisation" of private markets

Investor Base

Predominantly institutional insurance companies, sovereign wealth funds, and pension funds Seeking capital-efficient exposure to private markets

Sponsor Concentration

Majority are GP-led, serving as strategic tools for:
Capital structure optimization, Leverage enhancement, Investor base diversification

⚠ Investor Implications

Increased leverage within private capital ecosystem may:
- Amplify returns in favorable markets
- Exacerbate risks in downturns
- Create new systemic interconnections

How to manage risks in private asset markets?

Increase Liquidity

Ensures sufficient cash flow to meet obligations and prevent liquidity crises.

Diversify Buyer Pool

Reduces reliance on a few buyers, mitigating demand shocks.

Reduce Leverage

Minimizes the impact of downturn losses and reduces regulatory scrutiny.

Enhance Oversight

Improves transparency and prevents valuation missteps.

Source:Private Equity Bro

References

Mayer Brown – https://www.mayerbrown.com/en/insights/publications/2023/08/collateralized-fund-obligations-a-growing-cdo-clo-and-fund-finance-liquidity-solution

Global Legal Insights (Definition) – https://www.globallegalinsights.com/practice-areas/fund-finance-laws-and-regulations/23-collateralised-fund-obligations

KBRA – https://www.kbra.com/documents/report/116307/kbra-private-credit-cfo-growth-and-performance-snapshot-february-2024

Carlyle – https://www.carlyle.com/media-room/news-release-archive/2024-10-29/alpinvest-closes-largest-publicly-rated-collateralized-fund-obligation

Global Legal Insights (Liquidity) – https://www.globallegalinsights.com/practice-areas/fund-finance-laws-and-regulations/23-collateralised-fund-obligations#liquidity-facility

Global Legal Insights (Delayed Draw) – https://www.globallegalinsights.com/practice-areas/fund-finance-laws-and-regulations/23-collateralised-fund-obligations#delayed-draw

Fitch Ratings (Criteria) – https://www.fitchratings.com/research/structured-finance/global-criteria-for-rating-collateralized-fund-obligations-09-08-2021

Fitch Ratings (MCA Fund III) – https://www.fitchratings.com/research/structured-finance/new-issue-report-mca-fund-iii-holding-llc-28-10-2020

CFA Institute – https://blogs.cfainstitute.org/investor/2020/12/03/myths-of-private-equity-performance-part-iii-correlation-and-volatility/

PIMCO – https://www.pimco.com/en-us/insights/blog/the-value-of-smoothing

BIS – https://www.bis.org/bcbs/publ/d303.htm#due

Dentons – https://www.dentons.com/en/insights/alerts/2023/august/25/sec-adopts-final-rules-for-private-fund-advisers

Cadwalader – https://www.cadwalader.com/resources/clients-friends-memos/risk-retention-in-eu-and-uk-securitisations-a-post-brexit-primer

Found this helpful?

Share this with your team or tag a colleague who would find this useful.

www.PrivateEquityBro.com