

What Comes Next for European CLOs?

The European collateralized loan obligation (CLO) market will enter 2027 with robust investor appetite and sustained issuance momentum, but increasingly challenging issuance economics. Borrower fundamentals remain relatively resilient at the headline level, yet performance is increasingly dispersed. Limited new broadly syndicated loan (BSL) supply, tight asset spreads and declining original issue discounts are putting pressure on CLO arbitrage, while European middle market CLOs and hybrid BSL/middle market structures could broaden the collateral opportunity set.

At the same time, the emergence of more differentiated collateral and structures is raising questions around relative value, [price discovery](#) and whether additional spread adequately compensates for greater complexity and credit risk. Managers are also exploring alternative financing solutions, including [rated note feeders](#), while some CLO equity investors appear increasingly willing to accept more modest returns and a slower return of capital. Regulatory changes could expand the universe of potential CLO investors, although upcoming Solvency II reforms may not immediately translate into greater demand from European insurers.

Together, these developments raise a broader question for the European CLO market: How can the market sustain its growth amid tighter arbitrage, evolving collateral and financing structures, and a potentially changing investor base, and what will these changes mean for the pricing and valuation of CLO securities?

These themes featured in Lincoln International's European CLO Breakfast, where participants expressed both common concerns and differing views on the appropriate responses.

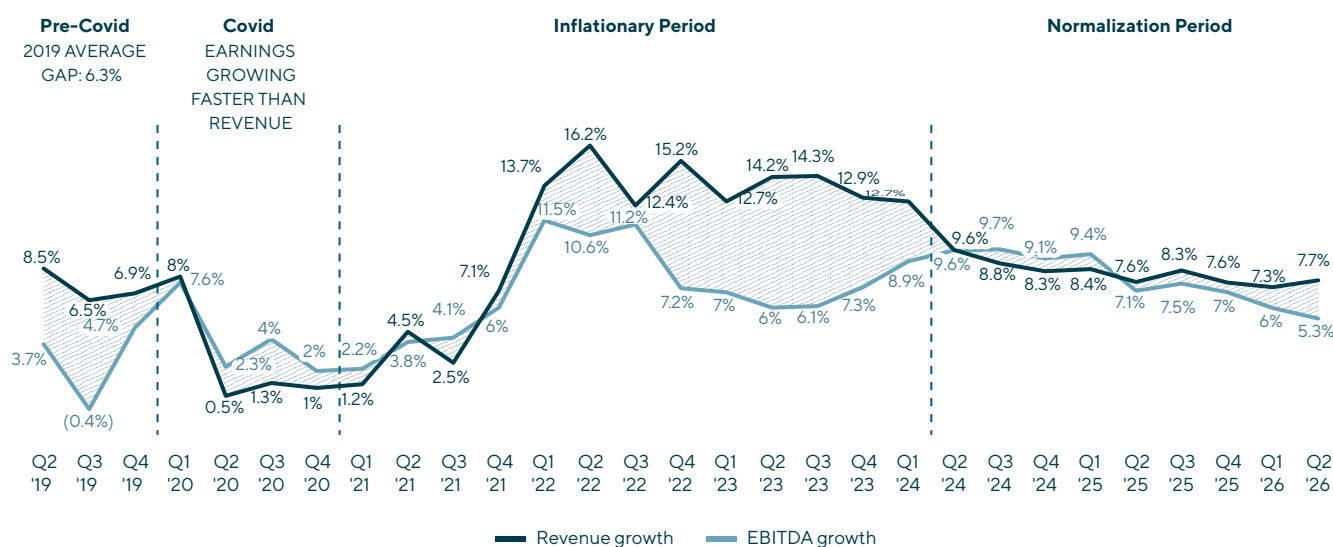
Borrower Fundamentals: Resilience Masks Growing Dispersion

Headline defaults, ratings and loan prices may not tell the full story of the companies supporting CLO collateral. Revenue continues to grow alongside slower EBITDA growth, but the distribution of performance remains wide. Amendments, PIK usage and sponsor support provide additional indicators of borrower health and potential stress that may emerge before a formal default.

The discussion highlighted the increasingly K-shaped nature of the recovery: While some borrowers continue to perform well, others face more persistent margin and financing pressures. [Lincoln's broader private-market data](#) illustrate this divergence, with revenue growth outpacing EBITDA growth and signs of stress concentrated in weaker borrowers. While these observations are drawn from private credit markets, they reflect broader themes of borrower performance dispersion and credit differentiation that are also relevant to the broadly syndicated loan market.

Magnitude of LTM Revenue & Adjusted EBITDA Growth

Quarterly, Q2 2019 to Q2 2026



Source: [Lincoln Lens - Private Market Intelligence](#)

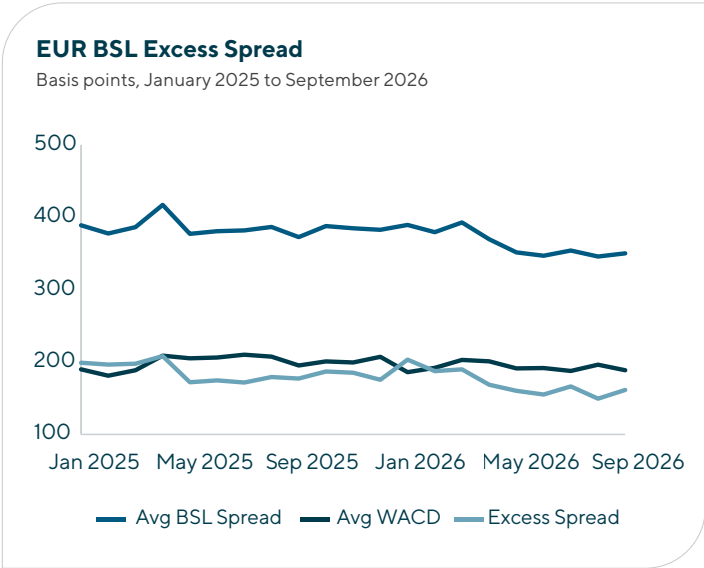
While participants expressed concerns about the broader economic outlook, some managers indicated that they had yet to observe a meaningful increase in realized or anticipated defaults across their portfolios. Some maturity extensions were also described as being driven by factors other than deteriorating credit quality. This distinction matters: Extensions or amendments do not necessarily signal distress, although their underlying rationale warrants scrutiny.

For CLO managers and investors, these developments reinforce the importance of looking beyond headline credit indicators to assess underlying borrower fundamentals, identify emerging risks and differentiate credit quality across portfolios as they are likely to result in greater dispersion in performance and valuation.

CLO Formation: Navigating Tighter Arbitrage

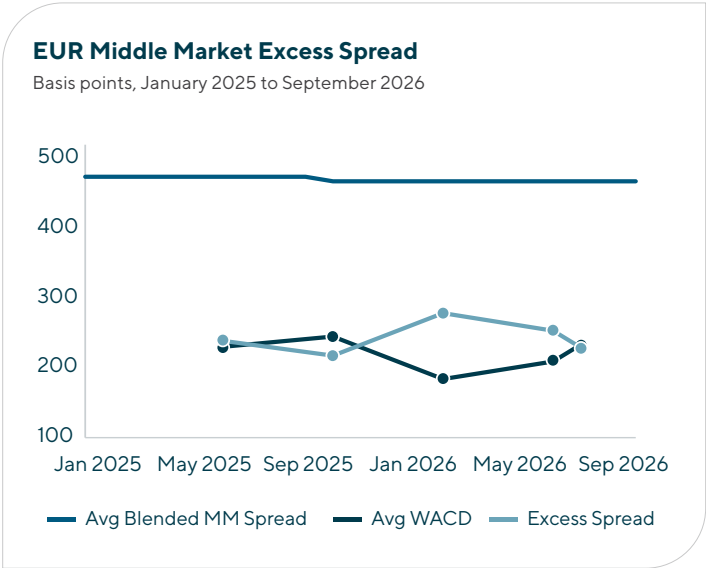
Strong investor demand continues to support European CLO issuance, but the availability of attractively priced collateral remains a key constraint on growth. With new BSL supply struggling to keep pace with CLO formation, competition for underlying loans has contributed to tighter asset spreads and smaller original issue discounts, placing further pressure on CLO arbitrage and equity returns.

European BSL vs Middle Market Spread and Issuance Price Mechanics



BSL OID **99.50%**

Source: [Lincoln Lens - Private Market Intelligence](#); PitchBook LCD
Note: Data represented above considered Senior and Unitranche Term Loans.



Middle Market OID **98.25%**

Source: [Lincoln Lens - Private Market Intelligence](#); PitchBook LCD
Note: Data represented above considered Senior and Unitranche Term Loans.

This pressure on transaction economics was one of the clearest points of agreement at the breakfast. Participants highlighted that compression in collateral spreads has been more pronounced than the improvement in liability funding costs, prompting managers to explore alternative sources of collateral spread and reconsider how best to generate attractive equity returns.

Those pressures help explain growing attention around European middle market CLOs. A broader collateral universe could potentially provide managers with additional sources of spread and diversification. The more fundamental question, however, is whether European middle market CLOs can develop into a meaningful standalone market alongside traditional BSL CLOs or remain a comparatively specialist segment.

Whether European middle market CLOs can achieve meaningful scale will depend on investor appetite, collateral availability and the economics of building portfolios that meet CLO structural requirements. Hybrid structures may offer one route to addressing some of these constraints, although their long-term viability remains a subject of debate.

The changing arbitrage also appears to be influencing CLO equity investors. Some participants observed greater willingness to accept more measured returns and a slower return of capital than in earlier periods, particularly where investors have confidence in the manager and platform. That patience may support issuance, but does not eliminate the underlying economic constraints.

Hybrid CLOs: A Route to Scale or a Complementary Niche?

If European middle market CLOs are to grow materially, hybrid structures may provide one route to scale by combining the liquidity and depth of the BSL market with the wider spreads and potentially stronger lender protections available in middle market private credit. Recent transactions, including Sona Aclai CLO I, illustrate how managers are exploring opportunities across a broader collateral universe.

However, participants expressed differing views on whether hybrids represent a viable long-term solution. Some see them as a means of improving collateral economics and expanding the investment opportunity set. Others question whether the incremental spread adequately compensates for greater structural complexity, reduced price transparency and potential credit risks that may only become apparent later in a transaction's life. For these investors, the familiarity and liquidity of the traditional BSL market may outweigh the potential economic benefits of hybrid structures.

Combining BSL and private credit collateral also introduces greater complexity in valuation and relative-value analysis. Investors must weigh the additional spread available from private credit against differences in borrower characteristics, documentation, liquidity and structural protections. This becomes particularly important where the proportion of private credit assets can evolve over time, potentially changing the portfolio's risk profile and the effectiveness of existing structural safeguards.

Greater collateral diversity also has implications for CLO tranche relative value. While ratings and headline spreads provide useful reference points, they may not fully capture differences in underlying credit quality, liquidity and structural protections. Bottom-up collateral analysis can therefore help investors assess whether differences in tranche pricing reflect underlying credit and structural risks or are driven primarily by liquidity and broader market technicals.

While collateral composition was a central theme, participants also discussed the role of liability structuring, including dual-currency issuance. The decision to issue notes in multiple currencies is driven primarily by manager preference, investor demand and transaction economics, rather than technological constraints. Recent European middle market CLO transactions have already demonstrated the feasibility of such structures, although the benefits of accessing a broader investor base must be weighed against additional hedging costs and the complexity of managing currency exposures.

Rated Note Feeders: Broadening the Financing Toolkit

Against a backdrop of tighter CLO arbitrage and evolving financing economics, managers are also exploring alternative financing solutions, including rated note feeders. These structures typically issue rated debt alongside subordinated or residual interests backed by underlying fund investments, offering another potential channel for financing private credit portfolios and accessing a broader investor base. While rated note feeders and middle market CLOs can provide exposure to similar underlying private credit assets, they differ in how those exposures are held, financed and distributed to investors, as well as in their secondary-market liquidity. Both markets remain relatively illiquid compared with traditional BSL CLOs, although liquidity can vary significantly across individual transactions and securities.

Recent European activity has also highlighted differences in investor appetite across jurisdictions. In at least one recent European rated note feeder transaction, European investors showed interest in the equity or residual exposure, while the rated debt attracted interest from U.S. investors, particularly insurers. Differences in insurer capital treatment and investment appetite across jurisdictions remain a challenge for building a broader European debt buyer base.

Whether rated feeders develop into a meaningful funding vehicle will depend on investor demand, financing economics, structural transparency and the ability to accommodate differing regulatory requirements.

Solvency II: Will Regulatory Reform Broaden the Investor Base?

Collateral and structural evolution are only one side of the market's development. The buyer base may also be entering a period of change. The 2027 Solvency II reforms may improve the capital economics of securitization exposures for European insurers, potentially reducing one barrier to

greater participation. A lower regulatory charge, however, does not automatically translate into increased demand.

The potential opportunity is nevertheless significant. European insurers hold approximately €6.4 trillion in investments, while historical EIOPA data indicate relatively limited securitization exposure, with approximately €12.5 billion reported among insurers applying the standard formula. By comparison, CLOs represent a more established component of U.S. insurers' investment portfolios. Applying U.S. insurer CLO allocation levels to European insurers' invested assets and bond holdings would imply approximately €150-200 billion of CLO exposure. While illustrative and not directly comparable with existing European securitization holdings, the calculation highlights the scale of the difference in market penetration rather than representing a forecast of future demand.

€6.4 trillion

Invested by European
insurers

€12.5 billion

Securitization exposure
reported by standard formula
insurers (EIOPA)

€150-200 billion

Implied CLO exposure at U.S.
insurer allocation levels
(illustrative)

Nonetheless, participants remained cautious about whether regulatory reform would meaningfully change allocation behavior. Managers highlighted longstanding difficulties in attracting European insurers to CLOs, despite their potential spread advantages. This skepticism echoes EIOPA's findings that lower capital requirements alone are unlikely to stimulate investment, with risk-adjusted returns, asset-liability matching, liquidity and complexity remaining important considerations.

While the reforms represent a meaningful step forward, including a reduction in the capital factor for senior AAA non-STS securitizations from 12.5% to 2.7%, their impact will ultimately depend on whether CLOs can offer a sufficiently compelling investment case relative to other fixed-income alternatives. Whether this translates into a broader and more diversified European investor base remains to be seen.

Looking Ahead with Lincoln: What Changes in 2027?

The breakfast revealed broad agreement that tight arbitrage is influencing European CLO formation, but less consensus on how the market will adapt, while alternative financing vehicles such as rated note feeders are also attracting attention. However, the ability of these structures to achieve meaningful scale will ultimately depend on investor demand and whether the incremental returns adequately compensate for additional complexity and risk. Greater differentiation in underlying collateral, collateral performance, and structure makes valuation, secondary liquidity, and relative-value judgments more difficult. Against this backdrop, some investors may continue to favor the liquidity, transparency and established credit processes of traditional BSL CLOs.

Underlying borrower performance remains differentiated rather than uniformly weak, and some equity investors are adapting to more measured return expectations. Meanwhile, changes to Solvency II may improve the investment case for insurers without necessarily overcoming longstanding allocation barriers.

The next phase of European CLO development may therefore depend less on any single new structure than on managers' ability to balance incremental yield against credit risk, complexity, price discovery and the preferences of an evolving investor base.

Ready to discuss the opportunities ahead for you?

Connect with a senior professional at connect@lincolninternational.com