

# Understanding collateralised loan obligations (CLOs)

A comprehensive primer



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# Introducing CLOs

Collateralized Loan Obligations (CLOs) are financial instruments that consolidate cash-flow-generating assets—primarily senior secured loans made to businesses across various sectors of the economy—and repackage them into tranches with varying risk and return profiles.

This document provides an overview of CLOs, covering their structure, performance, regulatory frameworks, regional comparisons, common misconceptions, and how they operate within an ETF structure.

# CLOs defined

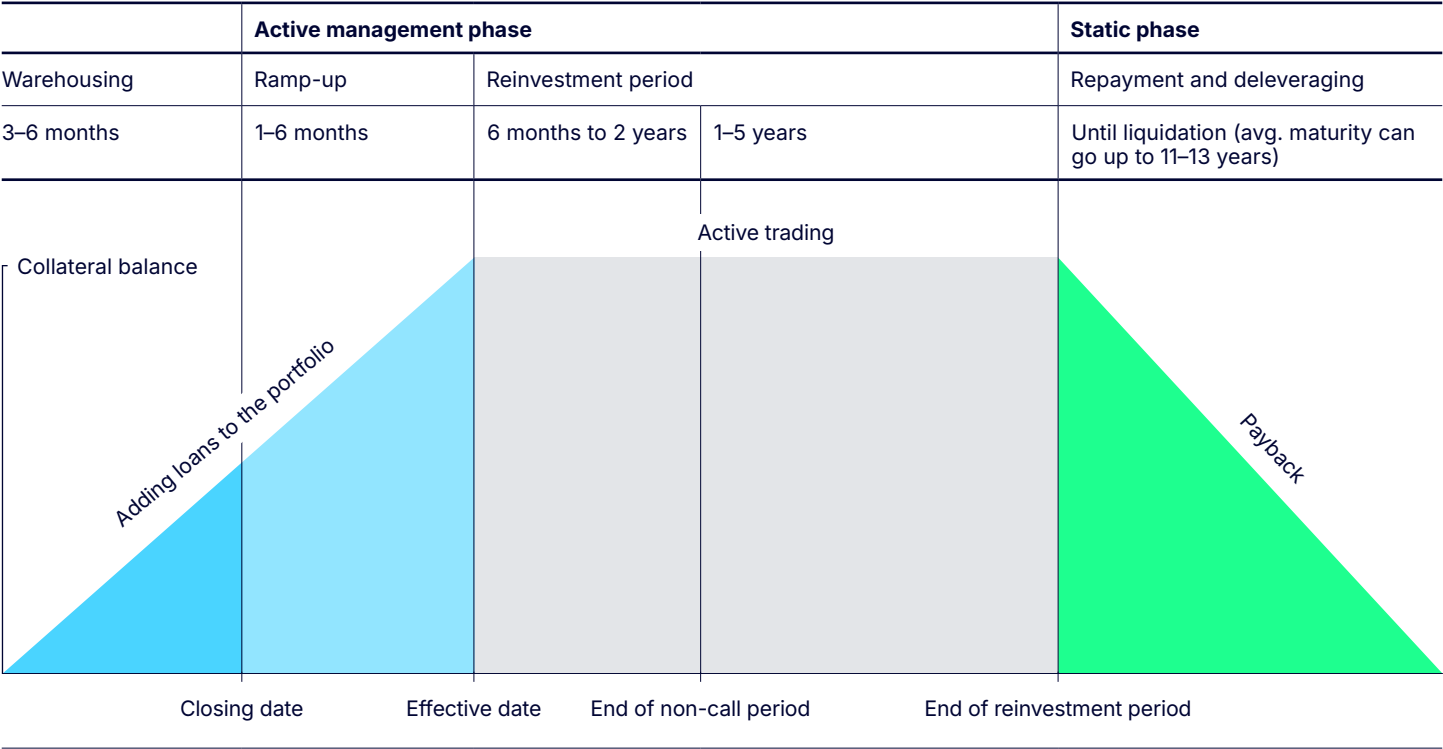
CLOs are structured finance securities backed by a diverse pool of corporate loans, both investment-grade and non-investment grade. CLOs raise capital by issuing bonds and equity, and use the proceeds to invest in a portfolio of corporate loans. Each security within a CLO carries a different level of risk depending on its position—known as a tranche—within the CLO’s capital structure.

The interest generated by the loan portfolio must cover the interest payments due to all rated tranches, with any surplus paid to equity holders.

## CLO key features

- **Tranches:** CLO debt is divided into senior (AAA and AA rated), mezzanine (typically rated A to B), and equity tranches, with escalating levels of yield to reflect higher levels of risk (Figure 2).
- **Cash-flow prioritization:** Senior tranches get paid first. After all rated tranches are paid, any excess interest goes to equity holders. Equity holders receive residual cash flows.
- **Active management:** A collateral manager buys and sell loans within the portfolio of loans.
- **Reinvestment period:** For the first four to five years, the manager can reinvest proceeds from maturing or sold loans. After this period, the proceeds are used to pay down debt in order of seniority (Figure 1).

Figure 1: The lifecycle of a CLO



Source: State Street Investment Management, Blackstone, Pinebridge, as of 31 July 2025.

# The lifecycle of a CLO

The loans that underpin a CLO are of finite length, so the CLO itself has a finite lifespan. The lifecycle of a CLO (Figure 1) usually comprises four phases:

- 1 **Warehousing:** Before issuance, the collateral manager begins assembling the portfolio of loans that will back the CLO.
- 2 **Ramp-up period:** The collateral manager builds the initial loan portfolio to prepare for the CLO’s issuance.
- 3 **Active trading:** After issuance, the manager actively buys and sells loans, reinvesting principal proceeds to optimize the portfolio.
- 4 **Static phase:** During this time, the portfolio is gradually repaid until the CLO vehicle is liquidated.

## Diving into the CLO waterfall

The CLO structure typically involves a special purpose vehicle (SPV) that issues multiple tranches of securities, each with different risk and return characteristics. The cash flows from the underlying loan pool are distributed to the tranches in a waterfall structure, where senior tranches receive payments first, followed by mezzanine and equity tranches. The less senior the tranche, the higher the potential return, as a reward for taking on greater risk.

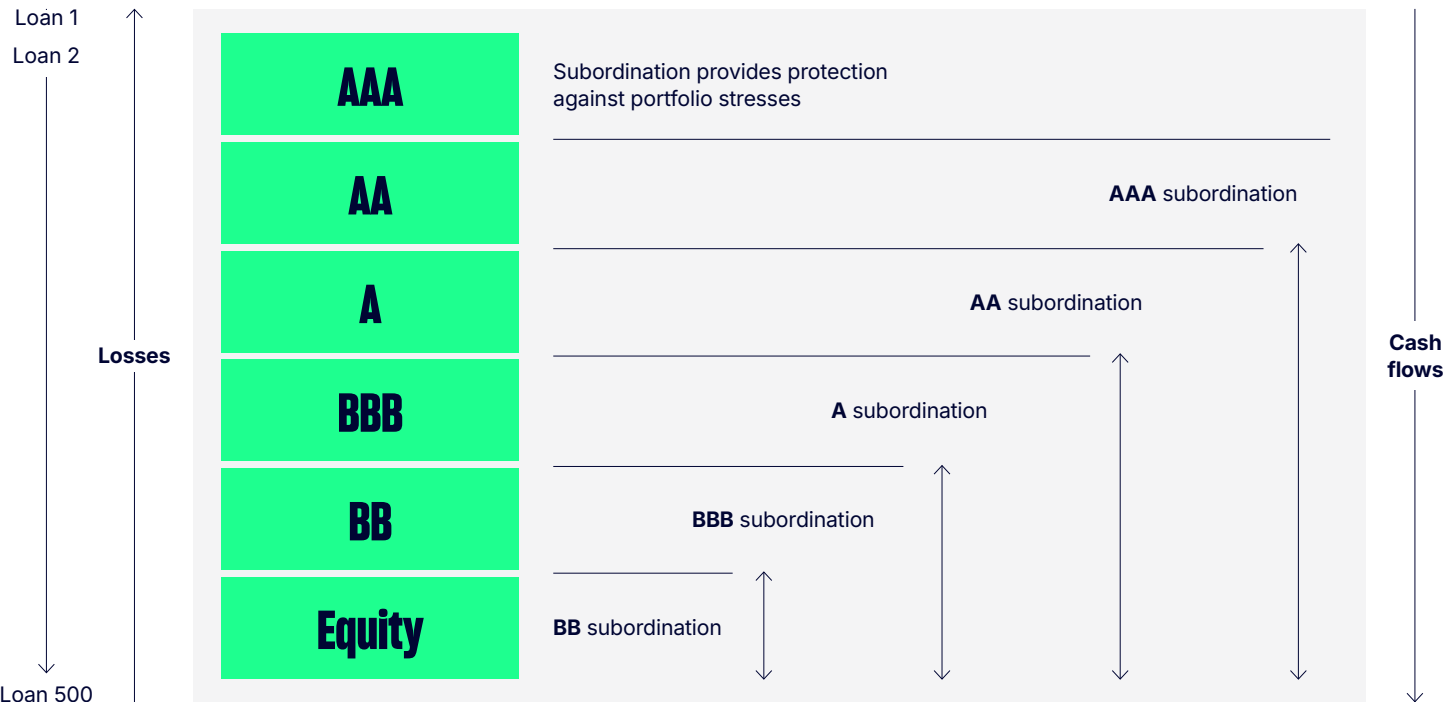
# Tranches

CLOs are divided into tranches, each representing a different level of risk and return. The tranches are categorized as senior, mezzanine, and equity. Senior tranches have the highest credit quality and receive payments first but offer lower yields. Mezzanine tranches have moderate credit quality and yields, while equity tranches have the lowest credit quality and highest yields. The performance of each tranche depends on the cash flows generated by the underlying loan pool and the priority of payments in the waterfall structure.

Below is a short description of the types of debt and a graphic visualization of the losses and cash flows across pools of loans.

**Senior debt:** Senior debt obligations are the less risky or most protected types of obligations. They carry the lowest interest rate. Usually rated AAA or AA, they make up the largest part of the total CLO debt issued in USD or EUR. They are usually not deferrable, i.e., a missed interest rate payment would lead to a default event. In the majority of cases the AAA rated debt is the controlling class, which means that its holders have a higher power of control over changes in the CLO indenture.

Figure 2: CLO tranches



Source: State Street Investment Management, Citi Research, as of 1 August 2025.

**Mezzanine debt:** Mezzanine debt obligations are riskier than senior debt. They are usually rated from single A to single B. They will offer a higher rate in exchange for the higher risk but may still provide protection against collateral default (i.e., they may have a higher recovery rate in case of default).

**Equity:** The equity tranche represents a claim on all excess cash flows once the debt obligations of each rated debt tranche have been honoured. The equity returns benefit from contractual cash flows of the underlying portfolio and are not directly impacted by the market fluctuation of the portfolio. This structure allows the manager to focus on the long-term credit worthiness of the portfolio. These tranches will typically be less liquid than senior debt.

## Structure protection

CLOs are designed to potentially provide protection through diversification and the use of first-lien collateral, which is the most senior and highest priority for repayment.

- Broad diversification: CLOs provide exposure to a range of assets across more than 30 different industry sectors.
- Large number of borrowers: There are generally over 175 borrowers—with each representing less than 2% of the portfolio, on average.
- Comprised primarily of first lien senior secured loans, although there may be small allowances for second lien loans and unsecured debt.

Principal subordination:

- The AAA tranche has approximately 40% subordination—i.e., if losses on the underlying portfolio do not exceed that amount, AAA investors will receive their principal in full.

Senior note interest:

- Once senior expenses (such as taxes, trustee, and admin fees) are paid, interest payments flow first to the most senior tranche.
- The overcollateralisation (OC) and interest coverage (IC) tests must be satisfied if interest is to flow down the structure. If these tests fail, any remaining interest is used to amortize the notes sequentially.

## The CLO cash-flow waterfall structure

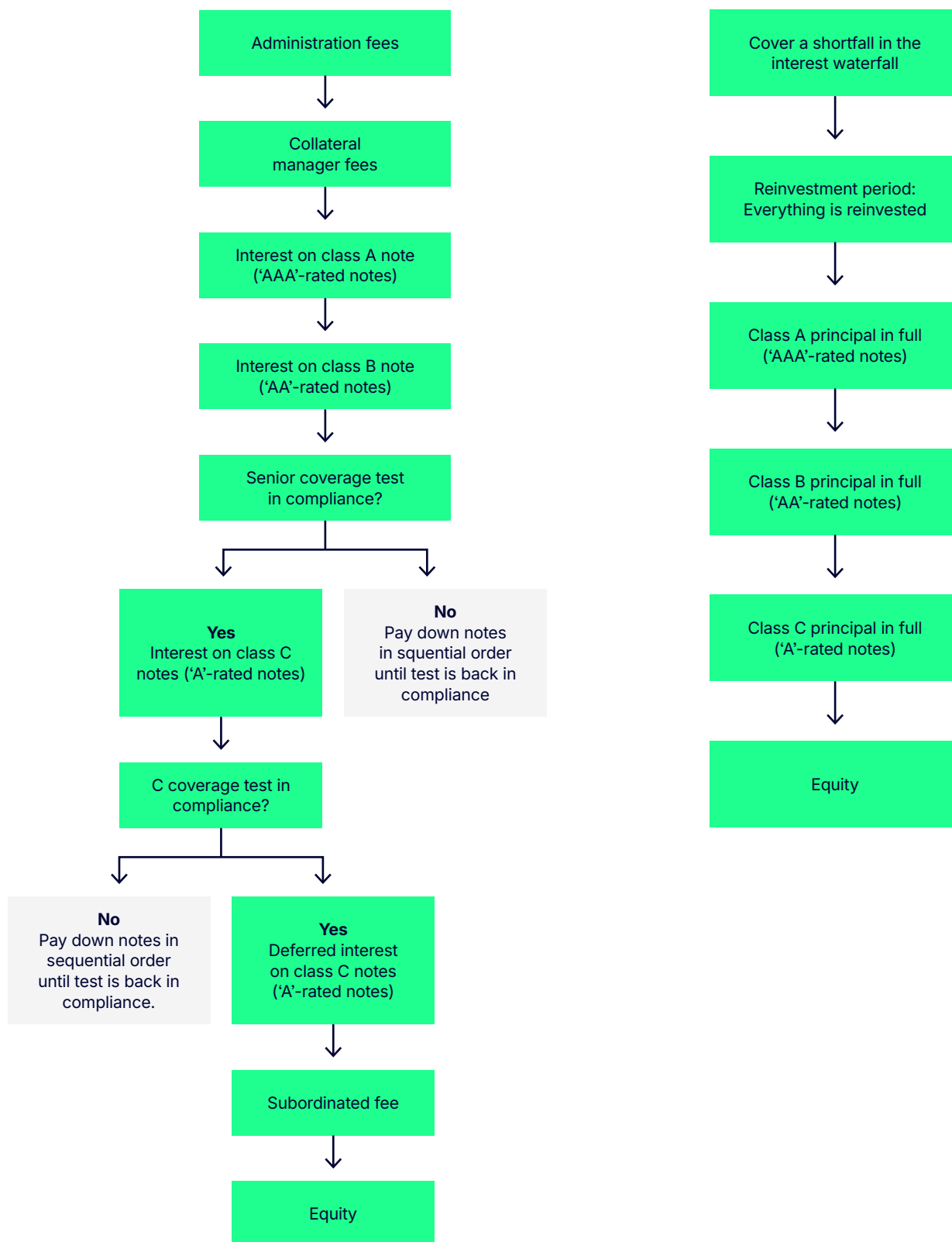
The cash flows generated by a CLO portfolio are used to make payments to the different classes of debt based on their seniority, as described in Figure 2.

For principal and interest to flow down the structure (starting from the top), each debt obligation must be paid in full. The senior debt obligation must receive its full principal and interest due before proceeds left can flow down the waterfall.

### Figure 3: The CLO waterfall

The interest waterfall uses interest received from the assets to pay interest on the notes (usually sequentially). Any excess interest is then paid to the equity tranche. If a coverage test fails, interest proceeds are diverted to pay down note principal.

The principal waterfall uses principal and potential recoveries from the assets to either invest in new assets (during the reinvestment period) or pay down note principal (during the post-reinvestment period).



Source: Blackstone BXCI, S&P, CLO Primer, Blackstone—September 2018.

# CLO market history and growth

CLOs originated in the late 1980s alongside other securitized products.

The CLO market has evolved through three major vintages, each shaped by regulatory changes and lessons from financial crises:

## CLO 1.0 Mid-1990s to 2008

**Structure:** included both leveraged loans and high-yield bonds

**Reinvestment period:** typically six years or more

**Risk management:** less stringent credit support and covenant protections

**Drivers:** innovation in securitization; demand for high-yield structured products

**Downfall:** the 2008 Global Financial Crisis exposed weaknesses in risk modelling and credit protections

## CLO 1.0 evolution 2010–2013

**Structure:** excluded high yield bonds; focused solely on senior secured loans

**Reinvestment period:** shortened to four to five years

**Credit enhancements:** increased subordination, tighter collateral quality tests, and stricter overcollateralization (OC) and interest coverage (IC) tests

**Regulatory influence:** response to the financial crisis and new regulations like Dodd-Frank

**Restore confidence:** improve transparency, reduce risk, and restore investor confidence

## CLO 2.0 2014–present

**Structure:** initially adhered to CLO 2.0's conservative framework, but subsequent amendments to the Volcker Rule in 2020 allowed for limited high-yield bond exposure (typically 5–10%)

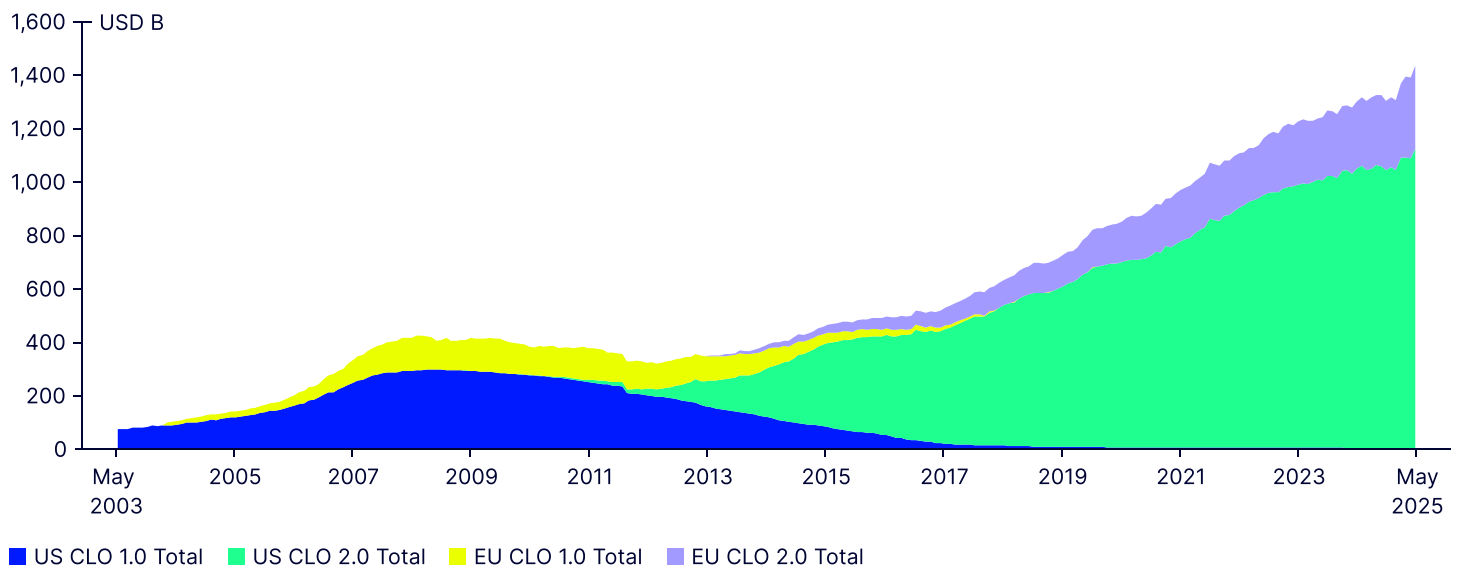
**Compliance:** adheres to risk retention rules and other post-crisis regulations

**Innovation:** more sophisticated modelling, sustainability considerations, and dynamic portfolio management

**Market share:** CLO 2.0 vintages now dominate the market, with CLO 1.0s now very rare



**Figure 4: The CLO market is growing**



Source: State Street Investment Management, Bank of America Merrill Lynch, as of 30 June 2025.

## Participants in the CLO Market

The CLO market involves various participants, including loan originators, CLO managers, investors, rating agencies, and service providers.

- Loan originators, such as banks and financial institutions, originate the loans that are pooled into CLOs.
- CLO managers are responsible for selecting and managing the loan portfolio.
- Investors, including institutional investors and hedge funds, buy the CLO tranches.
- Rating agencies assess the credit quality of the tranches, while service providers offer administrative and operational support.

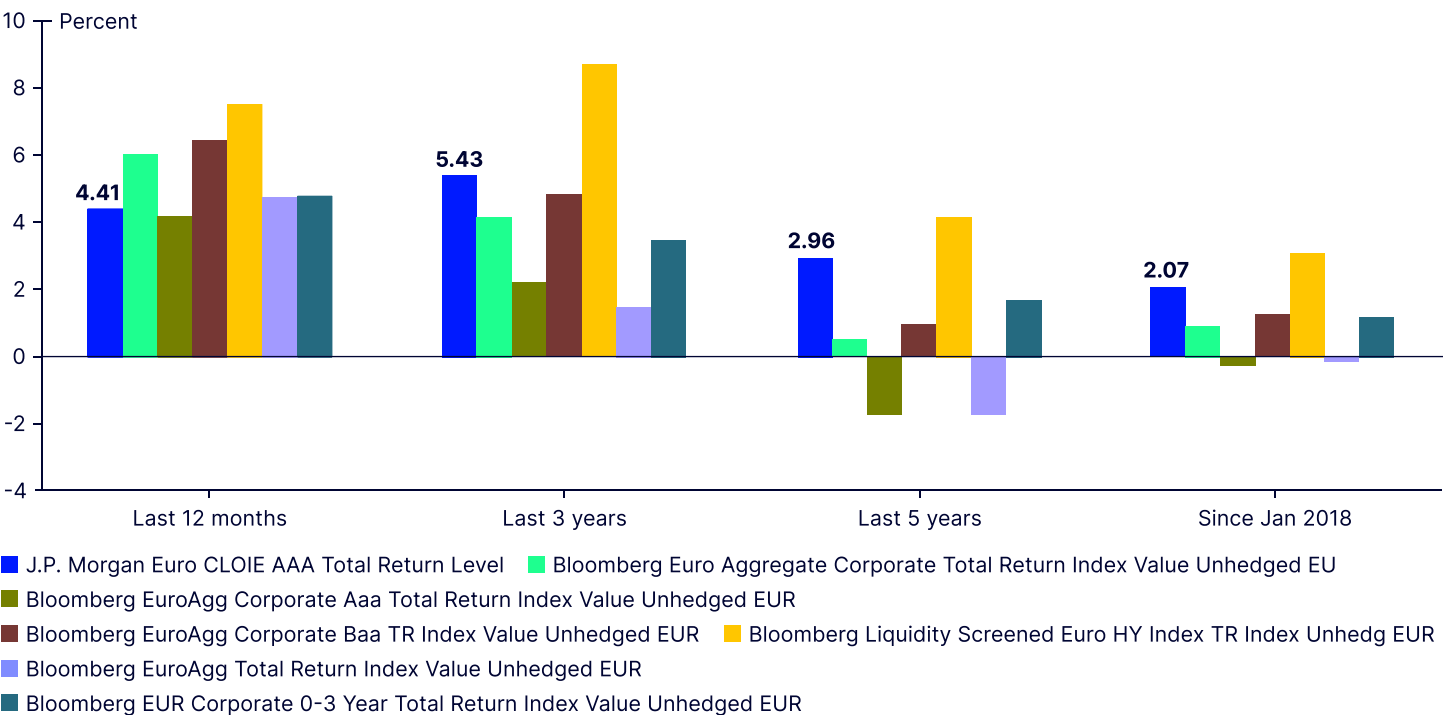
In the AAA CLO space, investors in Europe are typically split between banks and asset managers, comprising around 50% and 40% of buyers, respectively. Insurance companies, hedge funds, and other investors hold the rest. In the AA space, asset managers make up 70% of buyers. Asset managers still hold around 45% of mezzanine loans. Hedge funds hold a similar amount.

# Historical performance

CLOs have historically provided attractive risk-adjusted returns, particularly in the senior tranches. Factors such as loan default rates, recovery rates, and interest rate movements influence performance. The CLO market has experienced significant growth in recent years, with record issuance levels alongside strong

investor demand. The COVID-19 pandemic initially caused disruptions in the market, but it rebounded, with CLOs demonstrating resilience and continued investor interest. A similar rebound occurred after the April tariff announcements.

Figure 5: CLO returns vs. selected bond indexes



Source: JP Morgan, Bloomberg Finance, L.P., as of 30June 2025. Index Performance based on net total return in EUR. **Past performance is not a reliable indicator of future performance.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain, and loss and the reinvestment of dividends and other income as applicable.

# How to invest in CLOs

Investors have different avenues to CLOs. The approach can vary depending on whether exposure is part of a credit fixed income portfolio or broader portfolio asset allocation.

## Direct investment in CLOs

- CLO equity or debt securities can be purchased in the primary (new issues) or secondary (existing issues) market.
- The investor selects the CLO manager and the level of capital structure desired, based on risk and return objectives, the vintage, and whether to invest in primary issues (new CLOs) or secondary issues (for ease of access, liquidity, or potential relative value).
- Equity investors in primary CLOs are often able to negotiate favourable fees and terms with arrangers and managers. However, this can require a substantial investment and longer-term horizon.

## Risk retention strategies

- Investors can gain exposure by investing in CLO equity or warehouse positions, often alongside the manager.
- Investors can underwrite a single manager credit process and its management style.
- This approach is typically a buy-and-hold strategy.

## CLO investment strategies

- The portfolio manager selects and times investment in a diversified basket of CLO securities.
- Portfolios are generally marked-to-market and actively traded.
- The portfolio may include various vintages, managers, primary/secondary and debt/equity exposures depending on the investment objectives of the strategy.

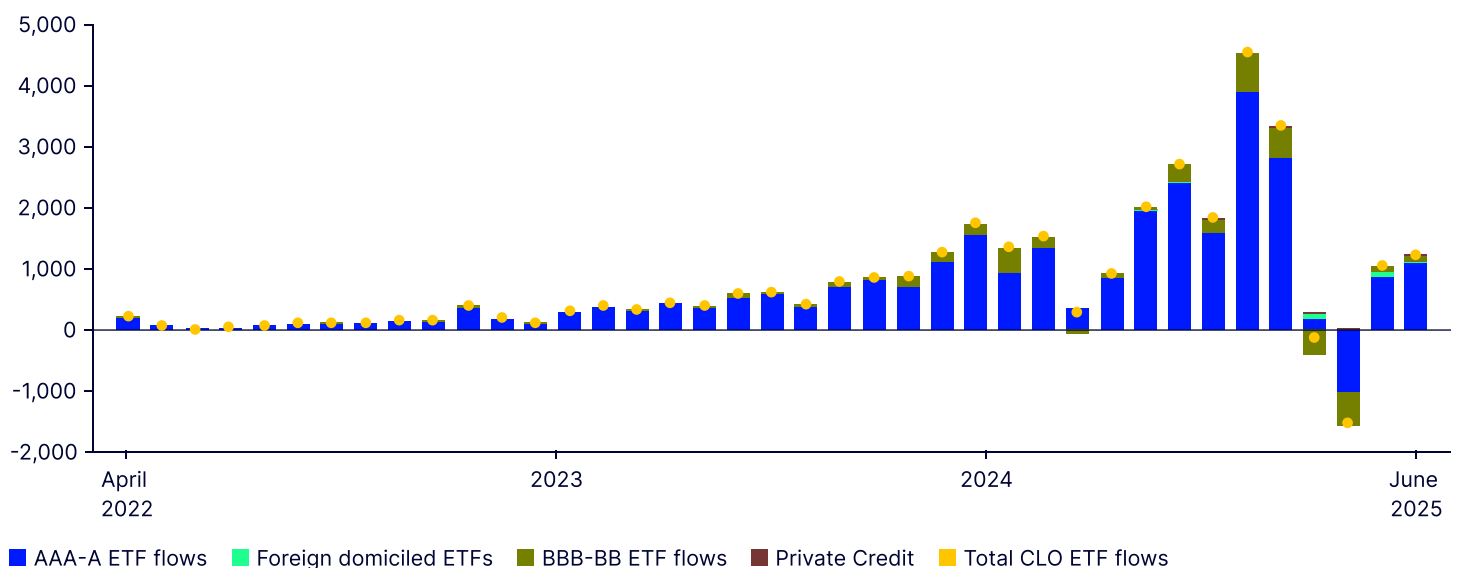
# CLO ETFs take off

Exchange-Traded Funds (ETFs) have emerged as a popular vehicle for accessing CLOs. CLO ETFs offer investors diversified exposure to the CLO market, with the benefits of liquidity, transparency, and cost-efficiency. These ETFs typically invest in a portfolio of CLO tranches, providing a convenient way for investors to access the asset class without directly investing in individual CLOs.

The first CLO ETF launched in 2021 in the US. In 2024 the market took off, with CLO ETF inflows soaring to \$16 billion as the number of ETFs increased, offering a wider range of quality exposure including mezzanine tranches. That same year, two private credit CLO ETFs also launched.

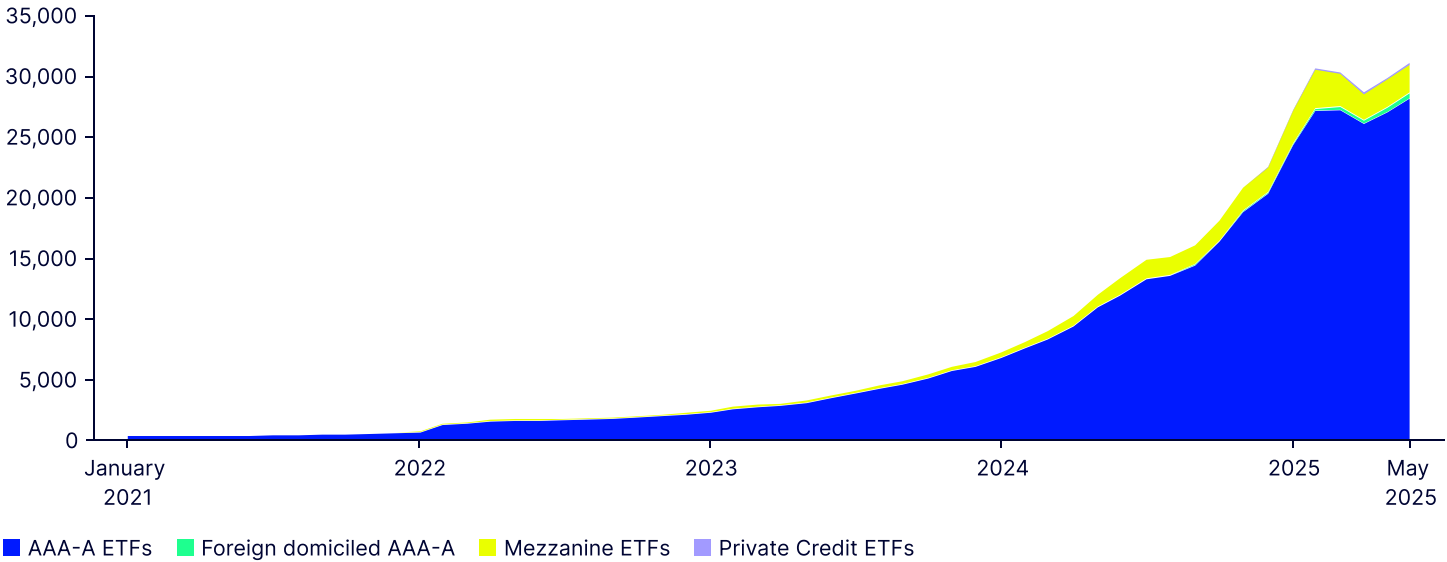
The trend of new CLO ETF launches extended to Europe in 2025, with the unveiling of several EUR and USD CLO ETFs within a UCITS framework. AUM is less than \$1 billion as of 30 June 2025, but the product innovation pathway has started.

**Figure 6: 2022–2025 CLO ETF flows USD M**



Source: State Street Investment Management, Bank of America Merrill Lynch, as of 27 June 2025.

Figure 7: US and non-US domiciled ETF AUM—in US\$ M



Source: State Street Investment Management, Bank of America Merrill Lynch, as of 30 June 2025.

# Regional comparisons (US vs. Europe)

## Issuance

The CLO markets in the United States and Europe have distinct characteristics. The US market is larger and more mature, with a higher volume of issuance and a broader investor base. In contrast, the European CLO market is smaller but growing, with increasing interest from institutional investors. These differences also impact the structure and operation of CLOs in each region. As discussed in the following segment, European CLOs are subject to stricter risk retention requirements compared to their US counterparts.

## Recent issuance

After a weak patch in 2022, issuance recovered at the tail end of 2023 and accelerated in 2024. As of mid-2025, the CLO market has continued this strong momentum, with both USD- and EUR-denominated issuance showing robust growth.

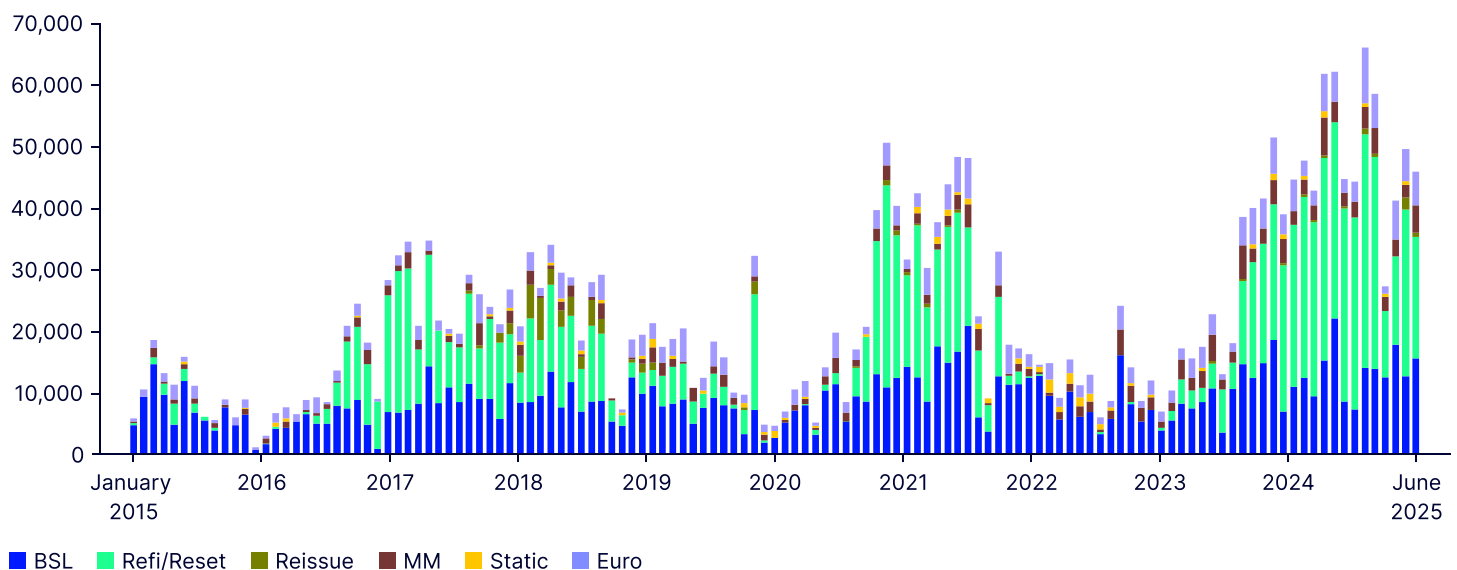
Markets divide into broadly syndicated loan (BSL) CLOs—backed by loans to larger, rated companies—and middle market (MM) CLOs—backed by loans to smaller, often unrated companies—typically originated through direct lending.

In the US the total issuance for H1 2025 was around \$220 billion in the BSL CLO market. Of that, \$83 billion was new issue deals and a further \$137 billion in refinancings and resets.<sup>1</sup> In the Middle Market (MM) CLOs segment, circa \$44 billion was printed, with \$18 billion in new issuance, and \$26 billion in refinancings.<sup>2</sup> This puts the US market on track to surpass 2024's record of \$202 billion in new issuance and \$223 billion in refinance.<sup>3</sup>

In the EUR CLO Market the new issuance level for H1 2025 was around €30 billion in refinancings. Resets accounted for around €21 billion.<sup>4</sup>

Investor demand remains strong, with CLO equity distributions reaching multi-year highs: about 16% in the US and about 19% in Europe in 2024.<sup>5</sup> Technical support from high levels of principal repayments with around over \$175 billion in the US and €25 billion in Europe in H1 2025 met demand while spreads remained attractive for investors.<sup>6</sup> Meanwhile, geopolitical and tariff uncertainties continue to be monitored but have had limited impact on issuance volumes so far.

**Figure 8: CLO issuance (USD M)**



Source: State Street Investment Management, Bank of America Merrill Lynch, as of June 27, 2025.

# Regulatory frameworks

CLOs are subject to regulatory frameworks that vary by region. In the US, they are regulated under the Dodd-Frank Act, which sets out risk retention requirements and transparency rules. In Europe, CLOs are subject to regulations such as the European Market Infrastructure

Regulation (EMIR) and the Securitization Regulation. These regulations aim to enhance the stability and transparency of the CLO market, protect investors, and mitigate systemic risks.

Regulatory Aspect	United States (US)	EMEA (EU & UK)
Regulatory bodies	SEC, CFTC, Federal Reserve	ESMA, EBA, FCA (UK)
Disclosure requirements	Enhanced under Private Fund Adviser Rules: quarterly statements, audited financials	ESMA templates under EU Securitisation Regulation
MNPI compliance	High scrutiny; enforcement actions for misuse and weak policies	Less emphasis, but subject to general market abuse regulations
Custody rule changes	Proposed revisions affecting non-traditional assets	No equivalent changes currently proposed
Beneficial ownership reporting	Required under Corporate Transparency Act	Varies by jurisdiction; less centralized
Originator requirements	Less restrictive; focus on manager conduct	“Sole purpose” test to prevent regulatory arbitrage
Cross-border complexity	Mostly domestic focus; international issuance subject to additional rules	Post-Brexit divergence between UK and EU adds complexity
Market impact	Strong issuance, high equity returns (~16%)	Record issuance, higher equity returns (~19%)
Future outlook	Continued SEC oversight and rule refinements	Potential reforms to Securitisation Regulation for private credit flexibility

Sources: State Street Investment Management, Bank of America Merrill Lynch, ICLG, Deutsche Bank, as of June 2025.

# Misconceptions

There are several misconceptions about CLOs that can lead to misunderstandings about their risk and return profiles.

A common one is that CLOs are similar to Collateralized Debt Obligations (CDOs), which played a significant role in the 2008 financial crisis. However, CLOs are backed by corporate loans, not subprime mortgages, and have different structural features that enhance their resilience. Another misconception is that CLOs are inherently high-risk investments when, in reality, senior tranches of CLOs have historically exhibited low default rates and strong credit performance.

CLO concentration limits and collateral quality tests highlight how CLOs differ significantly from CDOs.

Common CLO concentration limits regulate the types of loans CLO managers may place in the portfolio. Specific covenants are placed into the deal documents such as:

---

% Second lien or unsecured

---

% Domiciled outside of US

---

% Single obligor

---

% Single industry

---

% Caa collateral obligations

---

% Cov-lite loans

---

% Interest paid less frequently than quarterly

---

% Moody's rating derived from an S&P rating

---

% Fixed rate

---

% Bonds

---

% Current pay

---

% Delayed Draw Term Loans / revolvers

---

% DIP

---

% Participation interests

---

In addition to the concentration limits, collateral quality tests place further restrictions on CLO managers when these tests are breached, for example:

---

Minimum weighted average spread test

---

Weighted average life test

---

Maximum rating factor test

---

Diversity test

---

Minimum weighted average recovery rate test

---

Minimum weighted average coupon test

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# Expectations for CLO market growth

The CLO market has grown in recent years. In 2024, there were record issuance levels, with over \$202 billion<sup>7</sup> issued. This trend is expected to continue through 2025, with forecasts projecting issuance to exceed \$200 billion.<sup>7</sup>

Tightening spreads, strong demand from a diverse investor base, and expectations of favourable regulatory changes are driving these expectations.

The European CLO market is also gaining momentum, with increased investor engagement and collaboration on product development. CLO ETFs are becoming increasingly more popular, offering investors a convenient way to access the asset class. Overall, the CLO market is poised for continued growth and innovation in the coming years.

## Glossary

**Base rate:** base rates, such as Secured Overnight Financing Rate (SOFR), fluctuate over time and attempt to quantify the implied market willingness to lend. SOFR is calculated using data from actual market transactions and is published daily by the New York Federal Reserve.

**Broadly syndicated loans:** Large corporate loans originated by banks and syndicated to a wide group of institutional investors. CLOs backed by BSLs tend to be larger in size, more standardized, and offer greater transparency and liquidity.

**Collateralised bond obligation (CBO):** CBOs share many of the same attributes as CLOs, except that their collateral largely consists of bonds rather than loans.

**Leveraged buyout (LBO):** LBOs are the primary strategy employed by private equity investors in which they purchase a business by contributing a portion of the value themselves (referred to as the equity check) and finance the remainder with debt that is typically collateralized by the assets of the target company. A large portion of the leveraged loan market

**Mark to market:** the revaluing of assets according to the value currently available in secondary markets. If an investor owns a loan with a par value of 100 that is currently trading in the secondary market at 95, the investor can choose to value their portfolio based on the par value of the loan (non-mark to market) or based on the market price (mark to market).

**Mezzanine debt:** Mezzanine debt, like the eponymous architectural structure, occupies the space between two “levels” in the capital structure of a company, lying between senior debt and equity in its priority.

**Middle market loans:** Loans extended to smaller or mid-sized companies, often privately held, with limited syndication and lower liquidity. These loans are typically held by fewer lenders and may involve more bespoke terms.

**Non-call period:** a window of time, normally specified in deal documentation during which the equity tranche is not allowed to call the deal.

**Senior debt:** Senior debt is at the “top” of a company capital structure, meaning that it has the highest priority for repayment in the event of default. Its seniority also means that it has lower risk than more junior debt in the capital structure.

**Special purpose vehicle (SPV):** A special purpose vehicle is a bankruptcy-remote legal entity, often structured as a subsidiary of the management company. The bankruptcy-remote status means that if the parent company (usually the CLO manager) were to collapse, the CLO itself would be free from liability. Conversely, if the CLO were to collapse, investors would also have limited recourse against the manager

## Endnotes

- 1 Source: State Street Investment Management, Bank of America Merrill Lynch, as of 30 June 2025.
- 2 Source: State Street Investment Management, Bank of America Merrill Lynch, as of 30 June 2025.
- 3 Source: State Street Investment Management, Bank of America Merrill Lynch, as of 30 June 2025.
- 4 Source: State Street Investment Management, Bank of America Merrill Lynch, as of 30 June 2025.
- 5 Source: State Street Investment Management, Bank of America Merrill Lynch, as of 30 June 2025.
- 6 Source: State Street Investment Management, Bank of America Merrill Lynch, as of 30 June 2025.
- 7 Source: Bank of America Global Research, CLO Weekly, as of July 2025.

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At State Street Investment Management, we have been helping to deliver better outcomes to institutions, financial intermediaries, and investors for nearly half a century. Starting with our early innovations in indexing and ETFs, our rigorous approach continues to be driven by market-tested expertise and a relentless commitment to those we serve. With over \$5 trillion in assets managed\*, clients in over 60 countries, and a global network of strategic partners, we use our scale to create a comprehensive and cost-effective suite of investment solutions that help investors get wherever they want to go.

\* This figure is presented as of June 30, 2025 and includes ETF AUM of \$1,689.83 billion USD of which approximately \$116.05 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Investment Management are affiliated. Please note all AUM is unaudited.

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CLO debt securities carry certain structural risks including potential subordination to the other tranches of debt in the same capital structure, volatility of underlying collateral values, and potential for principal loss of the underlying assets in excess of the equity valuation. CLOs issue classes or "tranches" of securities that vary in risk and yield. Losses caused by defaults on underlying assets are borne first by the holders of subordinate tranches.

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