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U.S. Insurers' Collateralized Loan Obligation (CLO) Exposure Jumps Almost 23% at Year-End 2020

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Executive Summary

- As of year-end 2020, U.S. insurers' collateralized loan obligation (CLO) exposure increased by about 23% to $192.9 billion in book/adjusted carrying value (BACV) from about $156.9 billion at year-end 2019. Note this exposure includes CLOs collateralized predominantly by broadly syndicated bank loans (BSLs).

- The proportion of AAA rated CLO investments increased slightly from 2019 to 2020; the majority of U.S. insurers' CLO investments were high credit quality at year-end 2020, with approximately 80% rated BBB or higher (not including BBB-), consistent with the year prior.

- CLOs continue to represent a small proportion of total assets, and they were about 2.6% of total cash and invested assets at year-end 2020, representing a slight increase from about 2% as of year-end 2019.

- The majority of U.S. insurer CLO investments were held by large life companies—i.e., those with at least $10 billion in assets under management—many of which have CLO asset manager subsidiaries. The top 10 U.S. insurance groups accounted for 45% of the U.S. insurance industry's total CLO exposure.

U.S. Insurers' CLO Exposure

As of year-end 2020, U.S. insurers had $192.9 billion in BACV exposure to CLOs that were collateralized predominantly by leveraged bank loans and middle market loans, representing a $36 billion increase from $156.9[1] billion at year-end 2019. Similar to the last few years, U.S. insurers' CLO exposure was determined via data reported in the annual statement filings, as well as through additional analysis that was completed with third-party data sources, allowing for a more granular review. Consistent with years prior, the majority, or almost 80% of total CLOs, was held by life companies at year-end 2020, followed by 18.2% with property/casualty (P/C) companies.

Table 1: U.S. Insurer Exposure to CLOs – 2019 and 2020

Industry Type	$BACV YE2020	% of Total	$BACV YE 2019	% of Total
Life	150,503,540,844	78.0%	124,737,089,953	79.5%
P/C	35,193,428,810	18.2%	27,201,231,625	17.3%
Health	5,318,304,678	2.8%	3,756,153,372	2.4%
Fraternal	1,894,695,165	1.0%	1,185,144,309	0.8%
Title	179,359	0.0%	181,044	0.0%
Total	**192,910,148,856**	**100.0%**	**156,879,800,303**	**100.0%**

CLOs have consistently accounted for a relatively small portion of the industry's overall bond investments and were about 2.6% of total cash and invested assets at year-end 2020. As shown in Table 2, large companies, or those with more than $10 billion in assets under management, accounted for almost 80% of the U.S. insurance industry's CLO exposure at year-end 2020.

Table 2: CLO Exposure by Assets Under Management, Year-End 2020 ($BACV)

Industry Type	Less Than $250MM	Between $250MM and $500MM	Between $500MM and $1.0B	Between $1.0B and $2.5B	Between $2.5B and $5.0B	Between $5.0B and $10.0B	Greater Than $10B	Total
Life	320,313,935	464,713,678	1,933,081,558	4,050,786,220	3,142,173,909	6,079,950,471	134,512,521,073	150,503,540,844
P/C	1,202,957,004	1,445,349,127	1,435,611,567	5,314,846,836	5,495,881,355	5,823,776,276	14,475,006,645	35,193,428,810
Health	292,278,593	508,517,056	701,589,113	1,463,253,355	1,185,673,508	504,218,019	662,775,034	5,318,304,678
Fraternal	9,190,227	7,438,898		296,837,112	51,101,891		1,530,127,037	1,894,695,165
Title	179,359							179,359
Total	**1,824,919,118**	**2,426,018,759**	**4,070,282,238**	**11,125,723,523**	**9,874,830,663**	**12,407,944,766**	**151,180,429,789**	**192,910,148,856**
% of Total	1%	1%	2%	6%	5%	6%	78%	100%

Consistent with year-end 2019, the top 10 U.S. insurance groups with CLO exposure accounted for almost half, or 45%, of the U.S. insurance industry's CLO exposure at year-end 2020. At least five of the top 10 have CLO management subsidiaries. As such, these insurers benefit from having internal CLO infrastructure and knowledge. The top 25 insurer groups accounted for 70% of the industry's CLO exposure at year-end 2020.

[1] Revised slightly downward from the $158 billion previously reported for year-end 2019 by the NAIC Capital Markets Bureau (CMB) due to the availability of a more granular review.

In terms of credit quality, as of year-end 2020, 42% of total U.S. insurers' leveraged loan CLO exposure consisted of AAA-rated tranches (see Chart 1), totaling about $80 billion in BACV. This was slightly higher in percentage terms and BACV terms than 41% of total CLO exposure (see Chart 2), or $65.2 billion BACV, in 2019. This implies that U.S. insurers' CLO exposure to the highest credit quality CLO investments increased slightly year-over-year (YOY). Nevertheless, about 80% of U.S. insurer CLO investments were rated BBB or higher as of year-end 2020, which was consistent with that of year-end 2019 (Note: This excludes CLO investments rated BBB-).

Chart 1: U.S. Insurer CLO Credit Quality as of Year-End 2020

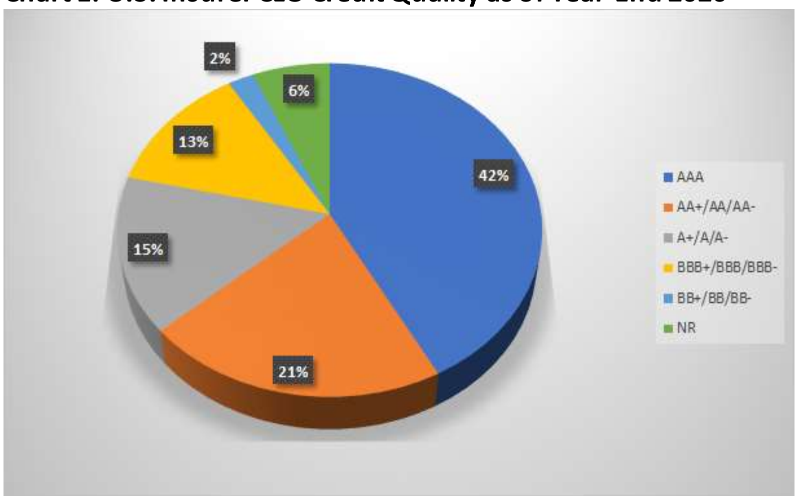
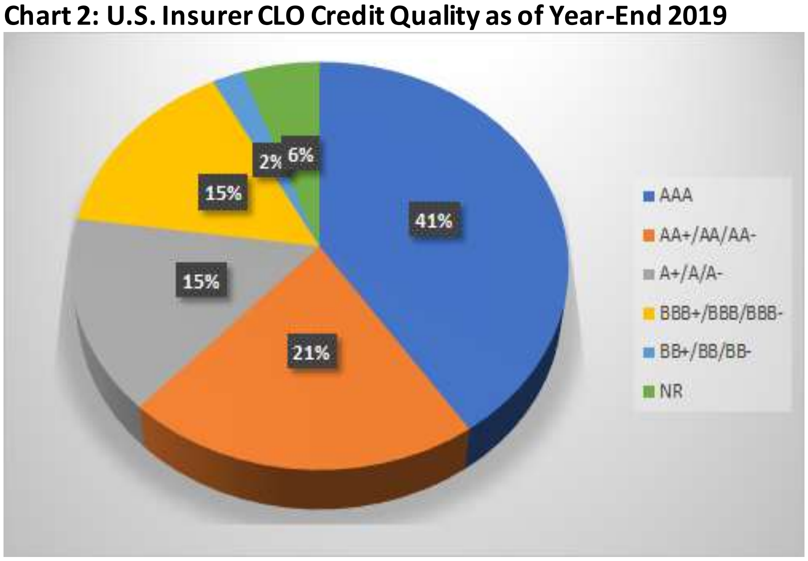


Chart 2: U.S. Insurer CLO Credit Quality as of Year-End 2019



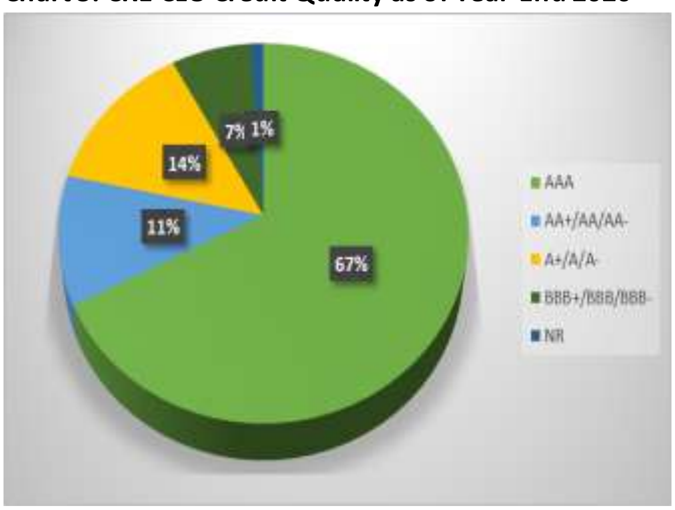
U.S. insurer exposure to CLOs has been increasing over the years, evidenced by the YOY data reported in the NAIC annual statement filings. Risk is dependent, in part, on the credit quality of the CLO collateral, which for the most part is mitigated by the high percentage of AAA-rated tranches held. In addition, risk is also dependent on the concentration of exposure within each insurer's investment portfolio, particularly as a percentage of a company's total capital and surplus.

Commercial Real Estate (CRE) CLO Investments

In addition to the leveraged loan CLO investments, at year-end 2020, U.S. insurers held approximately $5.2 billion in commercial real estate (CRE) CLOs, 78% of which were held by life companies, followed by 19% with P/C companies. In comparison, at year-end 2019, U.S. insurers held $3.7 billion in CRE CLOs. The YOY growth was in part due to the attractiveness of the relatively shorter duration of CRE CLO debt tranches, which limits interest rate risk.

While similar in structure to other CLO types, the underlying collateral in CRE CLOs includes shorter-term loans on transitional real estate properties. As such, they tend to have more credit risk than leveraged loan CLOs and therefore more credit enhancement. About 67% of CRE CLOs held by U.S. insurers at year-end 2020 were rated AAA, the highest credit quality, followed by 11% in the double A ratings category (see Chart 3) mitigating credit risk concerns.

Chart 3: CRE CLO Credit Quality as of Year-End 2020



CLO Market Trends

U.S. insurer exposure to CLOs has reached its highest level in recent years. CLOs are mainly floating rate, and they have offered an attractive yield alternative to other more traditional asset types, such as investment grade corporate bonds. Spreads on new-issue AAA-rated CLOs, which are the most commonly held rated tranches by U.S. insurers, were about 136 basis points (bps) over three-month London Interbank Offered Rate (LIBOR) as of 4Q 2020 (see Chart 4) compared to 134 bps a year prior. However, spreads on AAA-rated CLOs have narrowed since year-end 2020 and were 116 bps as of 2Q

2021. Spreads tend to decrease with a presumed decrease in risk and may also move based on other factors such as supply and demand. With the increase in inflation, along with a move away from the Federal Reserve's "easy money," CLO debt has become even more attractive to investors, as there is a current demand by investors for floating-rate debt, and yields will increase with rising rates anticipated in the future.

Chart 4:

US CLO average coupon across the stack and weighted average cost of capital (bps)

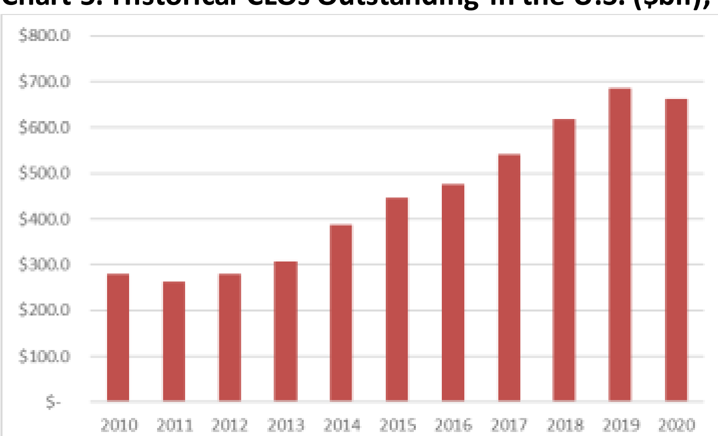
Time frame	AAA	AA	A	BBB	BB	WACC
4Q19 (L+)	134	196	277	406	734	203
1Q20 (L+)	124	174	234	349	675	182
2Q20 (L+)	193	266	338	463	690	241
3Q20 (L+)	160	213	279	417	757	217
4Q20 (L+)	136	181	250	392	737	193
1Q21 (L+)	116	155	199	313	647	163
2Q21 (L+)	116	171	208	318	654	167
Change from 1Q21	0	15	10	4	7	4
Change from a year ago	-77	-95	-130	-145	-36	-74

Data through June 30, 2021.

Source: LCD, an offering of S&P Global Market Intelligence

According to the Securities Industry and Financial Markets Association (SIFMA), there was about $662.3 billion in outstanding CLOs at year-end 2020 (see Chart 5), representing a 3% decrease from $686 billion as of year-end 2019. As of the end of May 2021, U.S. CLOs outstanding grew to more than $700 billion, according to Bank of America Corporation.

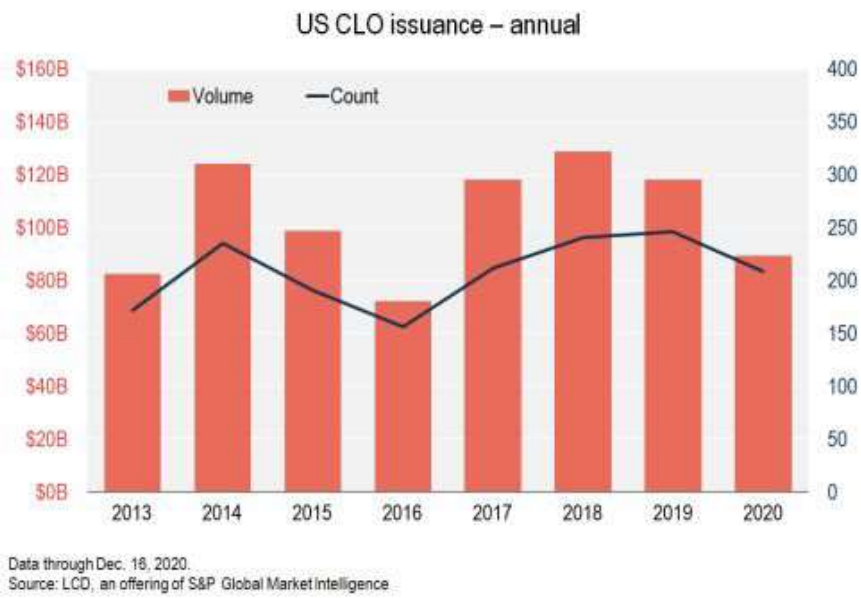
Chart 5: Historical CLOs Outstanding in the U.S. ($bil), 2010–2020



Source: SIFMA

Due in part to the COVID-19 pandemic, new issuance of CLOs in 2020 was the second lowest since 2016, according to S&P Global. Equity investors were scarce at the beginning of COVID-19 pandemic due in part to unattractive excess spread, but this trend has since reversed evidenced by the increase in CLO issuance. That is, new CLO issuance is partly dependent on availability and willingness of equity investor participation. At year-end 2020, new CLO issuance totaled approximately $90 billion (see Chart 6) in 2020.[2] Through 1H 2021, new CLO issuance totaled $82.4 billion in 169 transactions according to S&P Global.[3] When CLO refinancings and resets are considered, total CLO activity for 1H 2021 totaled $219 billion. New CLO issuance in 2021 so far is strong, and it is expected to exceed that of 2020 based on the current rate. Quite possibly, it could exceed the record new CLO issuance level set in 2018 of about $130 billion.

Chart 6:



For more background on CLOs, please see the NAIC CMB primer published in August 2018.

CRE CLOs

A growing segment of the CLO market has been in CRE CLOs. As discussed on the NAIC CMB CRE CLO primer published in July 2021, the underlying collateral typically comprises "transitional" loans, or those that are on CRE properties that are short-term, bridge loans, or properties whose value is yet to be maximized; i.e., they are loans on properties in a transitional phase such as expansion, renovation, or repositioning. New issuance of CRE CLOs in 2020 totaled $8.7 billion, compared to $19 billion in 2019. Through the first half of 2021, new issuance totaled about $20.3 billion across 24 transactions[4] compared to $5.6 billion in eight transactions for the same time period in 2020. The surge in issuance so

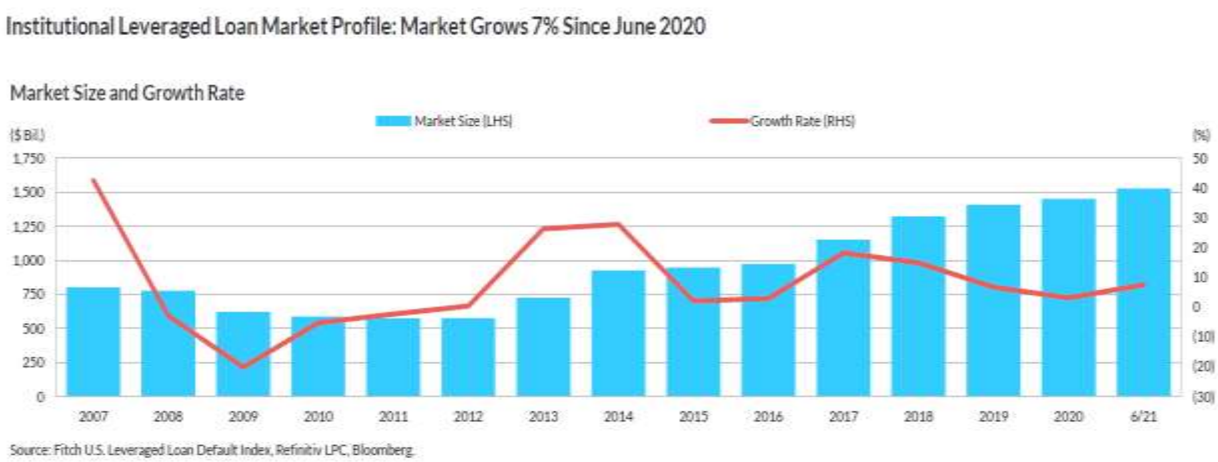
[2] S&P Global, *2021 Outlook: U.S. CLO Market Likely to See Growth in New Issues, Plus Refi/Resets*, December 2020.
[3] S&P Global, *LCD's Leveraged Finance Q2 Analysis – From COVID Recovery to Market Overdrive*, July 2021.
[4] Green Street, *Commercial Mortgage Alert*, July 23, 2021.

far this year is due in part to many properties experiencing a “cash-squeeze” that are now in need of financing. U.S. insurers were active participants in the market with exposure to CRE CLOs increasing 40% YOY from 2019 to 2020.

Leveraged Bank Loan Trends

The primary underlying collateral for CLO portfolios consists most often, but not exclusively, of leveraged bank loans, BSLs in particular, which are loans made to large corporations and syndicated by banks. The size of the U.S. institutional bank loan market was just over $1.5 trillion as of 2Q 2021 (see Chart 7) according to FitchRatings,[5] having grown 7% since June 2020.

Chart 7:

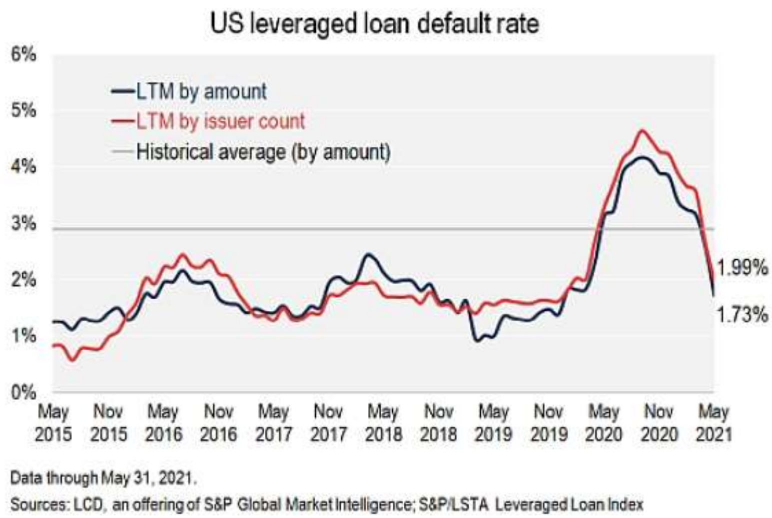


The performance of leveraged loans affects the ability of the CLO structure to pay timely debt service payments to noteholders and returns to equity holders. In 2Q 2021, leveraged loans rated B- accounted for 43% of new issuance according to S&P Global. Most leveraged bank loans issued in 2Q 2021 were in the B-/B/B+ category, totaling about 70% of leveraged loan issuance. Despite the relatively low credit quality of the leveraged loans, which is typical for this asset type, there are other characteristics that contribute to leveraged bank loan performance, such as covenants—i.e., restrictions on what the borrower relative to loan terms—and size of the loan; i.e., liquidity. More background on leveraged bank loans can be found in the NAIC CMB’s primer on Leveraged Bank Loans published in November 2018.

Due in part to a benign credit environment, the U.S. leveraged loan default rate was 1.73% (based on dollar amount of defaults) as of May 2021, down from a cyclical high of 4.17% in September 2020; it was the lowest leveraged loan default rate since the end of 2019, according to S&P Global (see Chart 8).[6]

[5] FitchRatings, *Fitch U.S. Leveraged Finance Market Insight Report*, July 2021.
[6] S&P Global, *Leveraged Loan Default Rate Tumbles to 1.73%, Lowest Level Since December 2019*, June 2021.

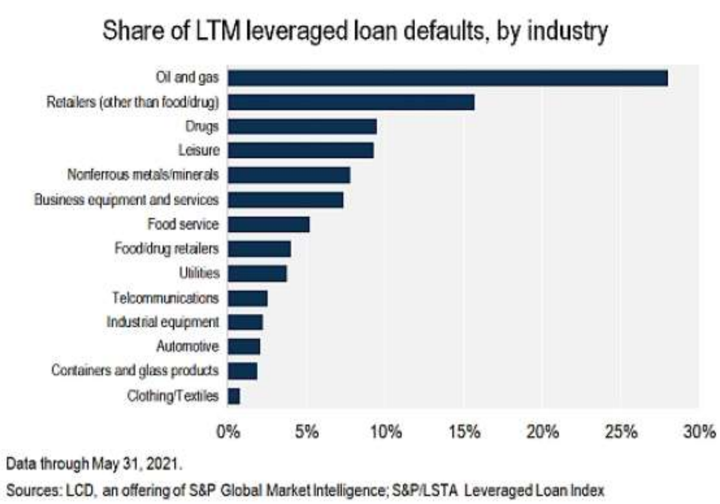
Chart 8:



Source: S&P Global.

The economic impact of the COVID-19 pandemic, as well as oil price volatility, negatively affected particular sectors of the financial markets in 2020. The trailing 12-month (TTM) U.S. leveraged loan default rate was highest for the oil and gas sector (28% of total defaulted loans as of May 2021, see Chart 9), followed by retail at 16%. To mitigate sector concentration risk, CLO collateral is diversified by issuer and industry concentrations.

Chart 9:



The NAIC CMB will continue to monitor trends with CLOs and leveraged bank loans and report as appropriate.