NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research

# Capital Markets Special Report

The NAIC's Capital Markets Bureau monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of U.S. insurance companies. Please see the Capital Markets Bureau website at INDEX.

## U.S. Insurance Industry Exposure to Collateralized Loan Obligations Update as of Year-End 2017

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### Executive Summary


- As a non-traditional investment for U.S. insurers, collateralized loan obligations (CLO) represent a small proportion of total assets, at nearly 1% of total cash and invested assets.
- CLOs are structured securities collateralized primarily by leveraged bank loans, which include broadly syndicated bank loans (BSL, the largest segment of the bank loan market) and/or middle market loans.
- U.S. CLO new issuance totaled about $118 billion in 2017, with respect to those collateralized primarily by BSLs, almost reaching the peak of $124 billion in 2014. CLOs collateralized by middle market loans were about $15 billion in 2017, compared to a peak of $22 billion in 2009.
- As of year-end 2017, U.S. insurers reported having about $51 billion in book/adjusted carrying value (BACV) of CLOs. The majority of U.S. insurers' CLO investments were high credit quality, based on NAIC designations.

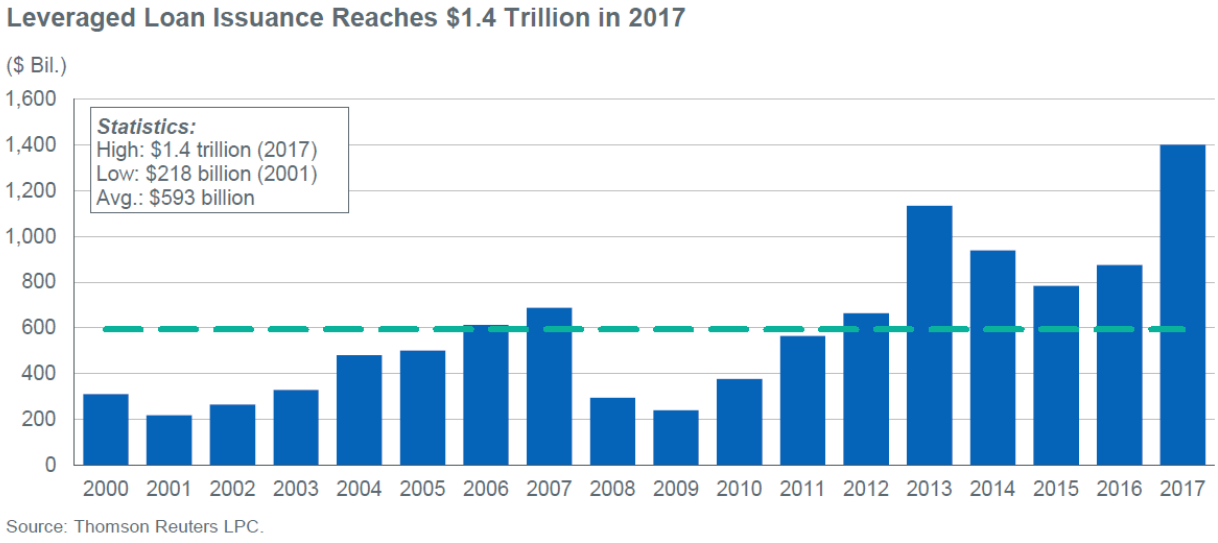

CLOs have historically been a small component of U.S. insurer assets. Nevertheless, U.S. insurer exposure to CLOs has been steadily increasing in recent years. CLOs offer an attractive yield alternative to other more traditional asset types, such as fixed-rate corporate bonds, especially as interest rates are projected to continue rising and CLO debt is floating-rate.

The underlying portfolio of a CLO consists most often, but not exclusively, of leveraged bank loans. Due to a relatively benign credit environment, the trailing 12-month U.S. leveraged loan default rate was 2.3% as of July 2018, according to Fitch Ratings, with year-to-date total defaults at $16.6 billion,

compared with $15.2 billion the previous year.

Total U.S. leveraged bank loan new issuance in 2017 was over $1 trillion across 1,600 issuers according to Fitch Ratings' leveraged loan research (see Chart 1), 87% of which constituted BSLs, or loans made to corporations and syndicated by banks to investors. Technology accounted for the largest sector of leveraged bank loan issuance, at about 14% of the market (as of May 2018), according to Fitch Ratings. Coincidentally, leveraged bank loans most often included in CLO portfolios are BSLs. Note that while the average rating on a given underlying portfolio of bank loans tends to be predominantly speculative (below investment grade), achieving higher ratings (or investment grade ratings) on the CLO notes is accomplished through credit enhancement and diversification.

**Chart 1:**




CLOs may also be collateralized by middle market (MM) loans, which are a subset of the leveraged loan market consisting of loans generally made to companies with less than or equal to $500 million in gross revenues and less than or equal to $50 million in earnings before interest, tax, depreciation and amortization (EBITDA). The definition of MM loans can vary, as another source defines MM loans as those to companies with EBITDA up to $100 million (which were referred to as "traditional" MM loans). MM CLOs comprise a smaller proportion of the overall CLO market. MM CLO tranches tend to require more subordination to achieve investment grade ratings due to a lower credit quality portfolio of borrowers and a higher historical default rate on the underlying loans. According to Standard & Poor's (S&P) Global Ratings, the average MM lagging one-year default rate is 4.6% higher than that of BSLs due primarily to the lower credit quality of the borrowers.

This special report is an update to the NAIC Capital Markets Bureau special report published in June 2014 titled "U.S. Insurance Industry Exposure to Collateralized Loan Obligations & Market Trends", which included U.S. insurer exposure to CLOs as of year-end 2013.

## Leveraged Bank Loans

A Fitch Ratings leveraged loan primer defines a leveraged bank loan as "a commercial loan to a high-yield company provided by a group of lenders." They are typically senior secured debt, positioned at the top of a company's capital structure. Leveraged bank loans are floating-rate, priced at a spread over a base rate, such as the London Interbank Offered Rate (LIBOR). BSLs are the largest segment of the leveraged loan market, and they are the predominant loan type included in CLO portfolios.

Investor interest in leveraged loans has been fueled in part by expectations of continued interest rate hikes by the Federal Reserve, as increasing interest rates tend to raise investor interest in floating-rate investments, such as leveraged bank loans. CLOs represent the largest investor of leveraged bank loans, accounting for approximately 60% of bank loans syndicated through the first half of 2018, according to Leveraged Commentary & Data (LCD), an S&P Global Market Intelligence offering.

### *Covenant-Lite Bank Loans*

Covenant-Lite (cov-lite) generally refers to leveraged bank loans with no, or "loose", financial maintenance covenants; i.e., the borrowers are either not required to maintain certain financial performance measures throughout the life of the loan, or the covenants are loosely set and are only triggered for a certain portion of the loan. Financial covenants are intended to provide an "early-warning" mechanism of a potentially deteriorating credit situation. Fitch Ratings' research cites that the re-emergence of cov-lite loans in late 2012 (since the financial crisis) is due to the evolution of the investor base. According to Fitch Ratings, cov-lite loans have comprised the majority of newly-issued leveraged loans, and they have become the norm in the institutional leveraged market. About 33% of all outstanding cov-lite loans at year-end 2017 were issued throughout that year. In addition, in 2017, cov-lite loan issuance reached a peak of $742 billion (double the amount in 2016), the majority of which (17%) were in the technology industry. About 72% of outstanding institutional leveraged loans were cov-lite as of year-end 2017, according to Fitch Ratings research.

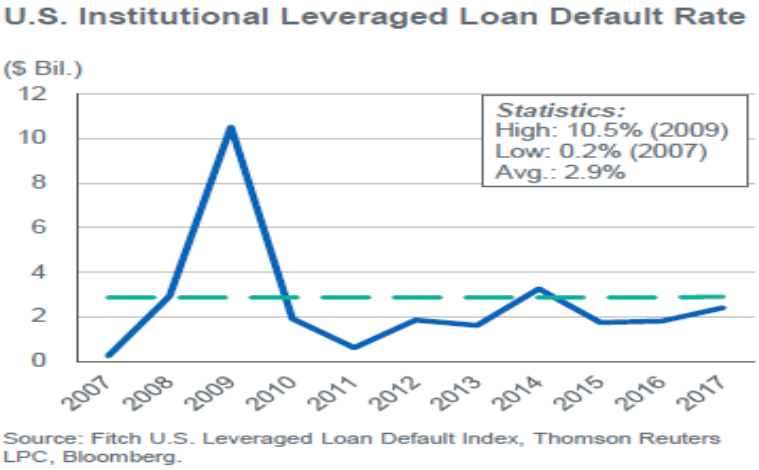
### *Second Lien Loans*

Second lien loans are "second-in-line" to first lien loans for any post-bankruptcy recoveries. Second lien loans are typically highly-leveraged (compared to first-lien loans, which receive priority in terms of payment in the event of a company's liquidation), and they are low in credit quality; i.e., low B or CCC ratings from the nationally recognized statistical rating organizations (NRSRO)). According to Fitch Ratings research, second lien loan spread premiums over first lien loans averaged 3.64% between 2003 and 2017. Second lien loan issuance was about $32 billion in 2017, close to the $39.2 billion peak in 2007. The largest two sectors issuing second lien loans in 2017 were technology and financial services, at about 32% of total issuance in aggregate. CLO portfolios may contain a limited amount of second lien loans as specified in the transaction's investment guidelines.

## Leveraged Bank Loan Default Rate

In terms of defaults, for the ten years ending in 2017, the annual leveraged bank loan default rate was below 3% in all but two years according to Fitch Ratings research; it reached 3.2% in 2014 due to a large energy company's bankruptcy, and it peaked at 10.5% in 2009 (see Chart 2). The leveraged bank loan default rate was 2.4% in 2017. Overall, the energy and metals/mining industries accounted for more than 30% of total defaults between 2015 and 2017, and most defaults in the ten years were in cyclical sectors, according to Fitch Ratings, as they experienced significant loss to cash flows partly as a result of the financial crisis.

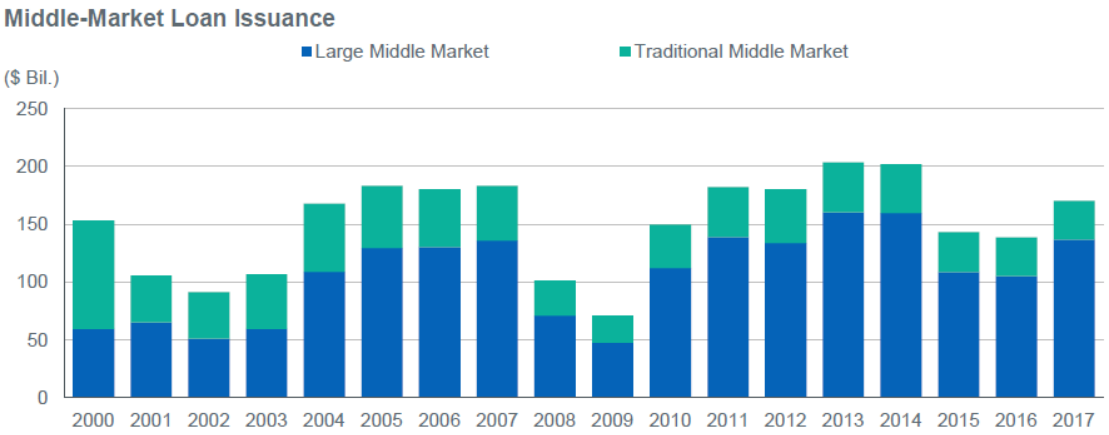
**Chart 2:**




## Middle Market Loans

Fitch Ratings research idenifies CLOs, business development companies (BDCs), alternative asset managers, credit oppportunity funds and regional banks as lenders of MM loans. In 2017, MM loan new issuance was about $175 billion, according to Fitch Ratings research (see Chart 3). Many of the companies that issue MM loans are privately held.

**Chart 3:**




Note: Large Middle Market defined as deal sizes $100 million–$500 million. Traditional Middle Market defined as deal sizes less than $100 million.
Source: Thomson Reuters LPC.

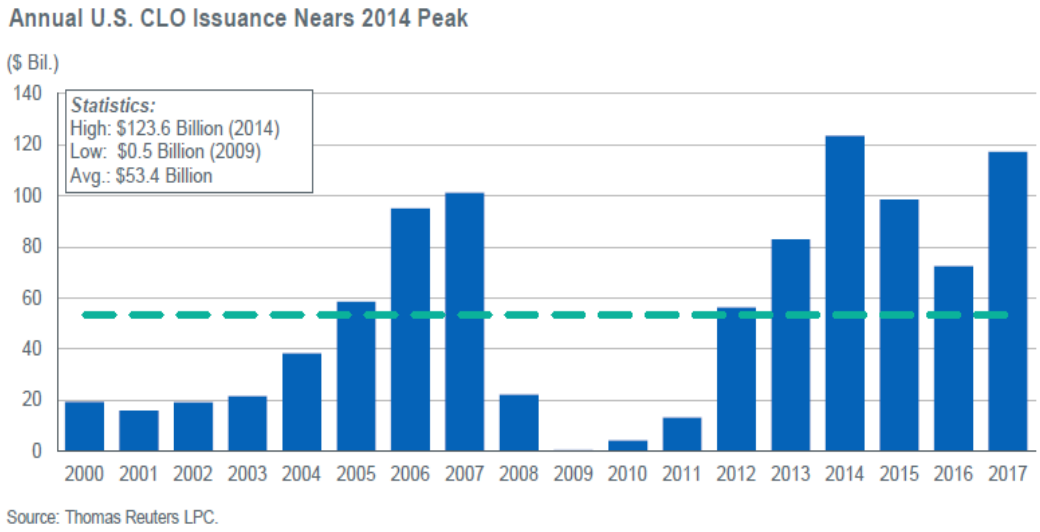
## CLO Market Trends

### *BSL CLOs*

As of year-end 2017, BSL CLO issuance was about $118 billion; it reached a record $124 billion in 2014 according to LCD (see Chart 4). Note that this new-issuance activity does not include any CLO refinancings—i.e., "refis", existing CLOs that were restructured to lower the yield on their outstanding debt, taking advantage of a low-spread environment—or resets (where existing CLOs are, effectively, restructured to extend their reinvestment periods[1]). A wave of refis/resets occurred in 2017—according to Fitch Ratings, over $29 billion in CLO debt was refinanced or reset, with $19 billion accounting for resets alone. The decrease in new-issuance from 2014 to 2015 was attributed not only to the exclusion of refinancing/reset CLO activity in the totals, but it was also impacted by issuers being wary of the possibility that CLO managers would be subject to the risk retention rules implemented by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) whereby CLO managers would have to retain 5% of the CLO capital structure. Due, in part, to this rule not being implemented for BSL CLOs (effective February 2018, see Regulatory Update below), according to Thomson Reuters data, new-issue CLO activity year-to date through the end of July 2018 was $78 billion; volume was not only 29% ahead of last year's levels, but also 5% ahead of record-setting 2014 new issuance.

[1] The Reinvestment Period is the time during which the CLO manager may purchase additional bank loans for the underlying portfolio using maturity and prepaid bank loan proceeds.

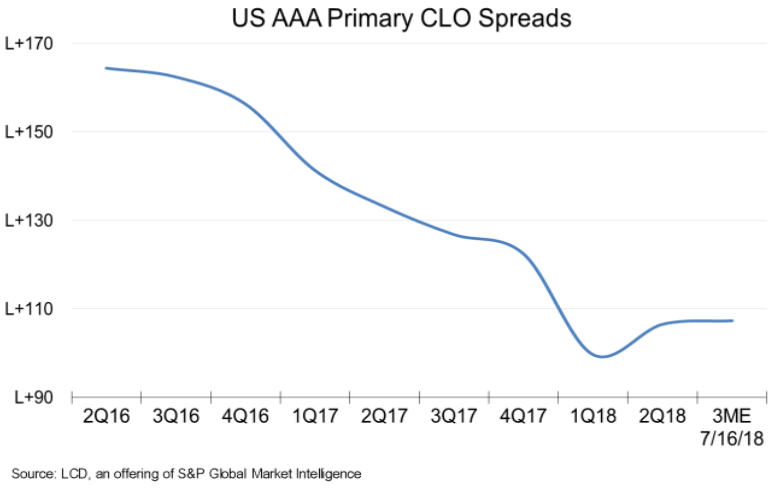
**Chart 4:**




As of July 30, 2018, total U.S. CLO assets under management by CLO managers totaled $547 billion according to Thomson Reuter's data, with 87% consisting of 2014 to 2016 loan vintages. The top five sectors held in CLOs are technology, healthcare, financial services, business services, general manufacturing and telecommunications.

The spread—or the yield over LIBOR paid to investors of CLO tranches—has been declining since the second quarter of 2016, particularly on the AAA/Aaa-rated senior-most notes, as shown in Chart 5. The increased demand for CLOs has resulted in a significant amount of cash entering the market, in turn, causing downward pressure on pricing. The AAA/Aaa spread dipped to 93 basis points (bps) in March 2018 but then increased to about 107 bps in July, according to LCD. The AAA/Aaa-rated tranche typically represents about 60% of a CLO's total capital structure.

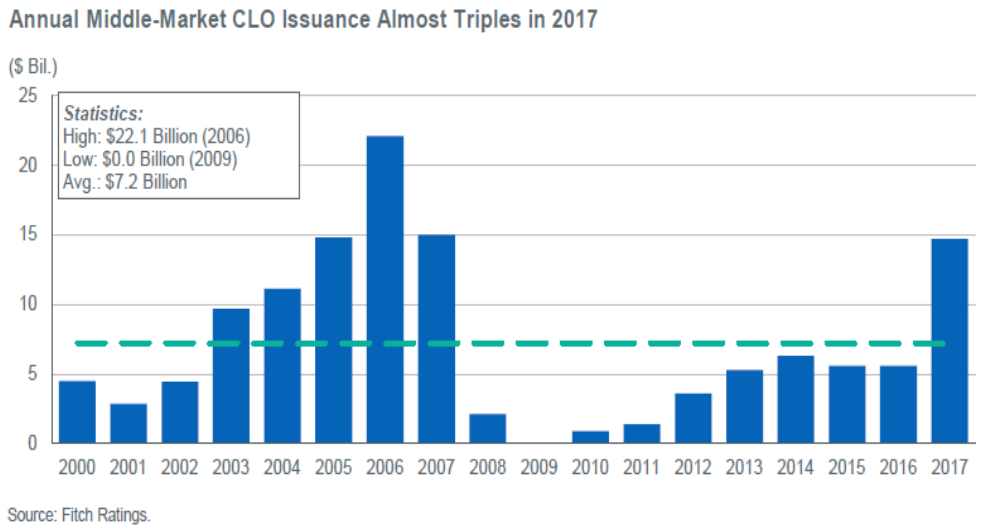
**Chart 5:**



### *Middle Market CLOs*

According to Fitch Ratings research, issuance of MM CLOs tripled in 2017, due, in part, to the continued low interest rate environment and attractive higher yields offered by these transactions compared to BSL CLOs. MM CLO issuance was about $15 billion in 2017, almost triple the amount issued in 2016 as shown in Chart 6. In comparison, MM CLO issuance reached a peak of $22 billion in 2009. The substantial year-over-year increase from 2016 to 2017 was due, in part, to a wave of refis and resets (similar trend as BSL CLOs). According to S&P Global Ratings research published in April 2017, "MM CLOs offer higher levels of subordination (about 10% more of subordination for the 'AAA' rated CLO notes), shorter asset maturities, and higher asset spreads, making them resilient to fairly high levels of economic stress."

**Chart 6:**




## CLO Managers

CLO managers are responsible for investment management decisions for a CLO's underlying portfolio. As such, they must have the appropriate infrastructure in place to properly manage the transactions. This not only includes having seasoned portfolio managers and credit analysts as part of the team, but it also includes having experienced operations professionals and appropriate data management systems in place. With the increase in demand for CLOs in recent years came new CLO managers into the market, taking advantage of favorable economic conditions. Currently, the 30 largest CLO managers represent 60% of total current CLO issuance, remaining relatively concentrated according to Fitch Ratings data. In 2017, nine new CLO managers entered the market compared to four in 2016. Chart 7 shows a count of U.S. CLO managers dating back to the second quarter of 2015. For the second quarter of 2018, there were 52 U.S. CLO managers according to S&P Global Ratings.

**Chart 7:**


## U.S. Insurer Exposure

As of year-end 2017, U.S. insurers had approximately $51.5 billion in BACV exposure to CLOs as reported in the annual statement filings.[2] The majority, or 81%, was held by life companies. In comparison, at year-end 2016 U.S. insurers reported $50.9 billion in CLO investments (see Table 1), with life companies accounting for 82% of total exposure. Total CLO exposure held by U.S. insurers does not differentiate between BSL CLOs and MM CLOs.

**Table 1**: **U.S. Insurer Exposure to CLOs as of Year-End 2017 and Year-End 2016**

| | 2017 | | 2016 | |
|---|---|---|---|---|
| **Industry Type** | **BACV ($bil)** | **% of Total** | **BACV ($bil)** | **% of Total** |
| Life | 41,651.23 | 81% | 41,790.53 | 82% |
| P/C | 8,812.77 | 17% | 8,499.55 | 17% |
| Health | 1,114.83 | 2% | 678.59 | 1% |
| Fraternal | 4.26 | 0% | 8.23 | 0% |
| **Total** | **51,583.09** | **100%** | **50,976.90** | **100%** |

Over at least the last nine years, U.S. insurer exposure to CLOs has more than doubled, from about $23.8 billion at year-end 2009. Life companies have consistently accounted for the majority exposure, and CLOs have consistently accounted for a small portion of the industry's overall bond investments.

[2] The $51.5 billion CLO exposure at year-end 2017 excludes approximately $10 billion in BACV that was misreported by U.S. insurers. In addition, the NAIC Structured Securities Group (SSG) identified another $35 billion in BACV that should have been reported as CLOs at year-end 2017 (to total approximately $97 billion in CLO exposure) but instead was reported as other types of bonds or securities. Similarly, SSG showed that CLO exposure for U.S. insurers to be about $95 billion at year-end 2016.

At year-end 2017 and year-end 2016, the majority of CLOs held by U.S. insurers, that is, 98% and 99%, respectively, carried NAIC 1 and NAIC 2 designations for both time periods. However, there was a small shift in the percentage of CLOs with NAIC 1 designations, as they decreased from 89% of total CLOs in 2016 to 84% in 2017; the percentage of CLOs with NAIC 2 designations increased from 8% to 13% over the same time period. The percentage of CLOs with NAIC 3 through 6 designations was unchanged from 2016 to 2017, as shown in Tables 2 and 3.

**Table: 2: NAIC Designations as of Year-End 2017***

| NAIC Designation | BACV ($bil) | % of Total |
|---|---|---|
| 1 | 43,078.90 | 84% |
| 2 | 6,732.07 | 13% |
| 3 | 1,244.35 | 2% |
| 4 | 40.92 | 0% |
| 5 | 108.53 | 0% |
| 6 | 350.33 | 1% |
| **Total** | **51,555.09** | **100%** |

*Total BACV differs from that included in Table 1 because it does not include bonds whose NAIC designation was reported by U.S. insurers as not available (N/A).

**Table 3: NAIC Designations as of Year-End 2016**

| NAIC Designation | BACV ($bil) | % of Total |
|---|---|---|
| 1 | 45,212.20 | 89% |
| 2 | 4,238.72 | 8% |
| 3 | 1,074.88 | 2% |
| 4 | 67.26 | 0% |
| 5 | 1.98 | 0% |
| 6 | 381.86 | 1% |
| **Total** | **50,976.90** | **100%** |

## Statutory Accounting

As discussed in more depth in the NAIC Capital Markets Bureau Primer on CLOs published on Aug. 21 for reporting and statutory accounting purposes, CLOs typically fall into the category of loan-backed and structured securities (LBASS). If a CLO is defined as an LBASS, then it follows the guidance of *Statement of Statutory Accounting Principles No. 43R—Loan-Backed and Structured Securities.* SSAP No. 43R securities are reported on Schedule D, Part 1, and the measurement method for the investment depends on the reported NAIC designation. For U.S. insurers that maintain an Asset Valuation Reserve (AVR), a reserve to offset potential credit-related investment losses, CLOs that are LBASS "…shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value." For U.S. insurers that *do not* maintain an AVR, CLOs that are defined as LBASS are "…designated the highest-quality and high-quality (NAIC designations 1 and 2, respectively), shall be reported at amortized cost." And CLOs that are defined as LBASS with NAIC designations 3 through 6 "…shall be reported at the lower of amortized cost or fair value."

## Regulatory Update

The Dodd-Frank Act risk-retention rules went into effect on Dec. 24, 2016 for asset-backed securities, commercial mortgage-backed securities, residential mortgaged-backed securities and similar securitizations. The rules are designed to prevent lenders from making risky loans, packaging them into bonds, and leaving investors with all of the losses if/when payment defaults begin to occur. The "skin in the game" rules are intended to align interests between issuers and their investors. The rules came about after subprime mortgage bonds triggered significant losses for banks and investors during the 2008 financial crisis.

Effective February 2018, a court ruling exempted BSL CLOs from having to comply with Dodd-Frank Act risk-retention rules—whereby the CLO manager would have been required to retain at least 5% interest in the total capital structure—because the CLO manager is not the originator of the loans they invest in. The ruling is expected to benefit smaller CLO managers that would otherwise have been challenged to comply with the requirement (as they may not have the ability to easily raise the large sums of capital needed to comply), and perhaps, they may have been prohibited from issuing new CLO transactions. Note, however, that MM CLOs are still subject to the risk retention rules. Many MM managers use CLOs as a funding portfolio (and historically have held equity in their transactions).

## Conclusion

Even though CLOs are a small portion of U.S. insurer total cash and invested assets, they represent an alternative investment option to traditional assets such as corporate bonds. As of year-end 2017, U.S. insurers reported having invested about $51 billion in CLOs—based on the reported collateral type code in Schedule D, Part 1. As interest rates are projected to continue to rise, institutional investors are becoming more attracted to floating-rate investments such as leveraged bank loans, including indirectly through CLOs. As such, market data shows that issuance has increased markedly, not only for BSL CLOs, but also for MM CLOs.

The NAIC Capital Markets Bureau will continue to monitor trends with CLOs and leveraged bank loans and report as deemed appropriate.

### *Useful Links:*

**NAIC Capital Markets Primer—Collateralized Loan Obligations,** July 2018

### *Previously Published NAIC Capital Markets Bureau Special Reports on CLOs*:

**U.S. Insurance Industry Exposure to Collateralized Loan Obligations & Market Trends**, June 2014

**U.S. Insurance Industry CDO/CLO Update**, June 2012

**Insurance Company CDO Exposure,** February 2011