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The NAIC Capital Markets Bureau monitors global capital market developments and analyzes their potential impact on the investment portfolios of U.S. insurance companies. Previously published NAIC Capital Markets Special Reports and Primers are available via the Capital Markets Bureau web page and the NAIC archives (for reports published prior to 2016).

Middle Market Collateralized Loan Obligations Primer

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Executive Summary

- Middle market collateralized loan obligations (MM CLOs) are a subsector of the overall CLO market, whereby the underlying collateral includes loans to small and medium-sized companies, many of which have been assigned below investment grade credit estimates by one or more of the credit rating agencies.
- Middle market loans have no secondary market, limited data, and pricing availability and, therefore, lack transparency; they also tend to have tighter covenants than broadly syndicated loans.
- MM CLOs are typically balance sheet transactions originated by asset managers who securitize loans they directly lent to companies; the asset manager often retains the capital structure's equity or first-loss position.
- Because of the credit risk of the underlying collateral, MM CLOs are structured with significant credit enhancement to protect the interests of the investors, and they offer a significant spread for comparable credit risk.
- MM CLOs are becoming a larger proportion of the overall CLO market, especially as the private credit market has been expanding.

A subsector of the broader collateralized loan obligation (CLO) market is middle market (MM) CLOs, where the underlying collateral is predominantly senior secured loans to small and medium-sized companies or those with less than $100 million earnings before interest, taxes, depreciation, and amortization (EBITDA)[i]. Traditionally, MM CLOs are structured as balance sheet transactions, where loans directly made to companies by the asset managers are securitized and moved off the balance sheet as a financing trade to free up the ability to generate new loans. Asset managers often retain the equity tranche of the MM CLOs they originate, or the first-loss position, which aligns their interest with those of the transaction's remaining investors.

MM CLOs are structured similarly to CLOs that are collateralized by broadly syndicated loans (BSLs) in that the cash flow dynamic between the income generated by the underlying pool of loans and payment to investors is, for the most part, substantially the same. The NAIC Capital Markets Bureau published a primer on CLOs, discussing the structure, collateral, and risks inherent in these transactions, among other relative topics. Some market participants have been referring to MM CLOs as "private credit CLOs," as an increasing proportion of middle market funding has come from private credit. However, not all MM CLOs are collateralized by loans derived from private credit. Refer to the NAIC Capital Markets Bureau primer on private credit for more details on this asset type.

Characteristics of the Underlying Collateral

Direct lending to middle-market borrowers is relationship-based. Middle market loans are predominantly first lien to small and medium-sized companies, and in many instances, they are generally originated by the MM CLO manager via direct lending, or in some cases, they may be originated by small groups of private credit lenders. MM CLO collateral may also include larger loans from unrated companies. Loans that serve as collateral in MM CLOs are privately rated or are assigned credit estimates by one or more nationally recognized statistical ratings organizations (NRSROs). According to S&P Global, credit estimates on middle market loans are point-in-time measurements. MM CLO investment pools, for the most part, contain B- rating category credits, and they also tend to have a higher concentration of CCC-rated loans as compared to BSL CLOs. Like other CLOs, MM CLO collateral is subject to diversification requirements, such as industry and issuer concentrations; however, these concentrations tend to be larger than those for BSL CLOs. MM CLO collateral also has other investment limitations, including maximum allocations to second lien exposures, percentage of assets paying interest less frequently than quarterly, and assets rated CCC+ and below, for example.

Because there is limited trading in the secondary market for middle market loans, there are not many pricing services available. As a result, loans that collateralize MM CLOs tend to lack liquidity and transparency. And because of the riskiness of the borrowers, middle market bank loan covenants are usually stronger than traditional bank loans, and many are backed by private equity sponsors.[ii] In addition, the average spread on middle market loans is wider than BSLs by approximately 200 basis points (bps). Credit fundamentals for middle-market borrowers are more favorable when borrowing costs are lower (such as in a low or declining interest rate environment) and when earnings are resilient (such as in a strong economy).

Structural Features

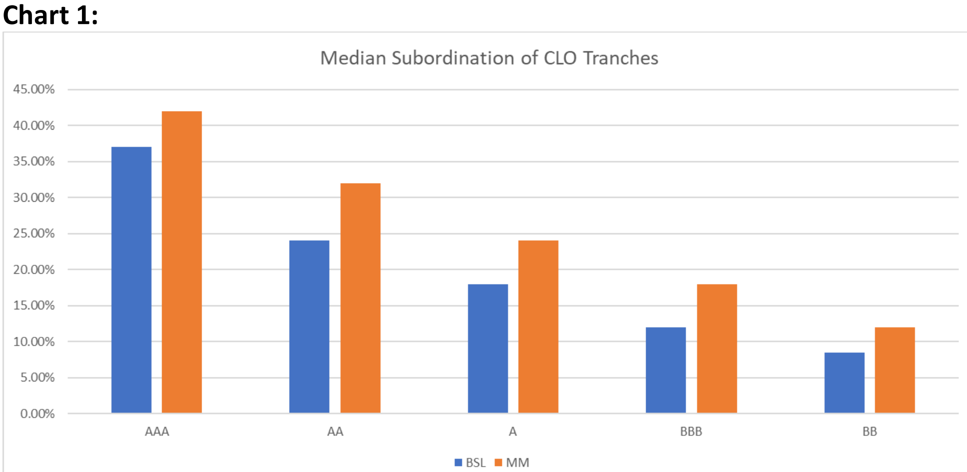
MM CLOs are structured similarly to BSL CLOs and other types of structured securities in that their capital structure includes several layers, or tranches, of debt. The debt tranches range from the highest credit quality at the top (i.e., senior tranche, usually rated AAA by the NRSROs) to speculative/below investment grade (i.e., subordinated tranches) at the bottom, with the bottom-most layer being (unrated) equity or the first-loss position. Similar to BSL CLOs, MM CLO debt is priced at a premium above the three-month

Secured Overnight Financing Rate (SOFR). However, due in part to the credit risk of MM CLO borrowers, the spread over SOFR is more significant than that of BSL CLOs.

Unlike BSL CLOs, the capital structure of MM CLOs may be tailored to meet the needs of a specific investor group; however, they are not all structured in this manner. Because of this feature, MM CLOs have more diverse structures than BSL CLOs. Similar to other structured finance transactions, principal and interest on the MM CLO debt and returns to equity holders are paid in accordance with “waterfall” instructions that are included in legal documents. MM CLO structures also benefit from large over-collateralization (O/C) cushions, or credit enhancement. That is, subordination to the senior-most tranche ranges between 40% and 46% (down to the junior-most tranche), according to S&P Global, with a median of 42%. (Refer to Chart 1.)[iii]

An MM CLO must comply with a predetermined O/C ratio on each payment date to minimize potential losses to investors. The O/C ratio compares the par value of the underlying portfolio of loans to the outstanding debt balance. Triggering an O/C test could occur if there are excessive defaults, delinquencies, sales, or excess CCC-rated loans in the underlying portfolio. When an O/C test “fails,” the structure allows for cash flow diversion to accelerate repayment of the structure’s senior debt tranches first, with any remaining funds passed down to subordinated noteholders. Another form of credit enhancement is excess spread as measured by interest coverage (I/C), whereby interest generated by the underlying pool of loans must be greater than the interest due (i.e., the I/C ratio) to investors on payment dates. The I/C ratio is also subject to triggers to ensure that sufficient funds are available for investors on payment dates.

Chart 1:



Source: S&P Global

These aforementioned structural features are put in place to mitigate concerns about full and timely debt service for the MM CLO investors, given a collateral pool comprising middle market loans tends to lack in transparency and contains predominantly low-speculative grade quality borrowers.

Risks and Mitigants

Because of the lower credit quality of loans that collateralize MM CLOs, the borrower's credit fundamentals and loan structure protections are key to whether sufficient funds will be generated to pay investors principal and interest payments when due. Middle market borrowers may have financial maintenance covenants; that is, recurring tests of specific financial metrics that monitor the health of the borrower's credit risk, or the ability to pay-in-kind (PIK)—a flexibility not available in the BSL markets—whereby instead of paying interest due, the borrower defers interest, adding it to the outstanding principal balance on the loan at an accrual rate. Borrowers utilize this option when they want or need to preserve cash. The reason borrowers utilize the PIK option can identify whether there is cause for concern about their ability to pay in the long term. Without the PIK option and/or financial maintenance covenants, a default in payment on the underlying loans could result in less or insufficient cash to pay investors. Strong financial maintenance covenants can provide direct lenders with negotiating power to maximize loan recovery values if and when a maintenance covenant is breached.

MM CLOs provide investors with exposure to smaller medium-sized companies not otherwise available in the public markets, yet they are more challenging to monitor due to the limited data availability and lack of a secondary trading. For this reason, MM CLOs are structured with a larger proportion of credit enhancement than BSL CLOs (i.e., the cushion under each tranche). In addition, loans made to middle market borrowers via direct lending tend to have tighter covenants, offering additional protection. Since MM CLO managers are often the originator of the loans in the underlying collateral pool, and they typically have "skin in the game" as the equity investor, they are not incented to manage for self-serving interests.

Advantages to Investing in MM CLOs

Depending on investment strategy and philosophy, MM CLOs represent an attractive investment option, especially during times when risk/reward opportunities may be challenging, such as during a low-interest rate environment or when interest rates are declining. Because of the higher-yielding underlying loans, even after subtracting any manager portfolio management fees and expenses, the net yield on MM CLO debt is still attractive. In addition, middle market loans offer structural features (i.e., PIK and financial maintenance covenants) to maintain financial flexibility, which are not available in the public markets.

Most U.S. insurance companies are yield-sensitive and, therefore, have been attracted more so to investing in the coupon offered by AAA-rated notes (the senior-most in an MM market CLO capital structure and, therefore, the highest credit quality). Also, most MM CLO investments within the U.S. insurance industry are historically held by life companies. MM CLOs are becoming a larger portion of U.S. insurers' overall CLO investments, and in general, the investor base for MM CLOs has been expanding. This is due in part to the growth of private credit, resulting in the growth of MM CLOs in the market.

Statutory Accounting Treatment

According to the principles-based bond definition in the NAIC *Accounting Practices and Procedures Manual* (AP&P Manual), effective Jan. 1, 2025, all debt securities must be assessed as to whether they qualify for bond reporting as defined and detailed in *Statement of Statutory Accounting Principles (SSAP) No. 26—Bonds*. For asset-backed securities (ABS), bonds are issued by an entity where the primary source of repayment is derived from the cash flows associated with the underlying defined collateral. To qualify as an ABS for bond reporting, a capital structure is supported by substantive credit enhancement, which can be achieved through overcollateralization/subordination or other form of guarantee or recourse.

For reporting and statutory accounting purposes, MM CLOs typically fall into the category of ABS, and if the MM CLO qualifies for bond reporting and the requirement for substantive credit enhancement, it follows the guidance in *SSAP No. 43—Asset-Backed Securities.* These investments are admitted assets to the extent they conform to the requirements of SSAP No. 43. If the MM CLO does not qualify as an ABS for bond reporting (i.e., if it does not have a form of substantive credit enhancement), it would be reported on Schedule BA: Other Invested Assets.

Appendix:

BSL And MM CLOs | Comparing Middle-Market CLOs To BSL CLOs

	Broadly syndicated loan CLOs (BSL CLOs)	Middle-market loan CLOs (MM CLOs)
Outstanding Amount (Q4 2023)	About $875 billion	About $125 billion
Size of median CLO (par $)	About $500 million	About $475 million
Collateral attributes	Senior secured loans to larger companies: • EBITDA greater than $100 million; and, • Loan facility sizes greater than $500 million.	Senior secured loans to smaller companies: • Loan facility sizes of $50 million to $300 million • Issuer EBITDA sizes of: • < $20 million (lower middle market) • $20 to $50 million (core middle market) • $50 to $100 million (upper middle market)
Source of CLO collateral	BSL CLO managers purchase the loans for their CLOs in the open market to create a portfolio	Some MM CLO managers (or their affiliates) are direct lenders and issue some/most of the loans in their CLOs
Typical issuer motivation	BSL CLO managers typically use BSL CLOs to build assets under management and generate fee income	Most MM CLO managers use CLOs to fund their direct lending and maintain diverse funding sources
CLO manager relationship with borrower	Investor	Direct lender or Investor
Risk retention	U.S. BSL CLOs are generally not subject to risk retention since the manager acquires the loans in the open market	MM CLOs are generally subject to risk retention since the manager is the issuer of some/all the loans in the CLO
Loan covenants	Covenant-lite loans are the norm (80% plus of BSL loan market) along with looser provisions	A large majority of loans in MM CLOs have maintenance covenants. Generally, the smaller the loan, the more likely it is to have covenants/restrictive provisions.
CLO equity holder	Historically most BSL CLO managers have placed CLO equity with third-party investors (although this was less true in 2023)	Most MM CLO managers hold their CLO equity, although some now have third-party equity in their CLOs.
Junior-most 'AAA' subordination	Typically ranges from 34% to 39% (median is 36%)	Typically ranges from 40% to 46% (median is 42.5%)
Source of ratings/implied ratings	S&P Global Ratings has ratings on more than 95% of BSL loan issuers	Credit estimates typically cover > 60% of the issuers in MM CLOs
Typical spreads of loans within portfolio	SOFR+350 to SOFR+400	SOFR+550 to SOFR+600
Maturity of loans	Loans in BSL CLOs have an average of maturity of 4.4 years	Loans in MM CLOs have an average of maturity of 3.5 years
Number of obligors in CLO pool	Varies, but average is 310 obligors	Varies, but average is 108 obligors
Number of industries in CLO pool	Typical BSL CLO has loans from ≈ 24 industry sectors	Typical MM CLO 15 to 20 industries

Source: S&P Global Ratings.

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
New issue (U.S. bil. $)													
BSL CLOs	50.11	78.12	117.78	93.76	64.01	103.58	112.88	103.65	82.21	164.97	116.99	88.71	164.20
MM CLOs	4.15	4.31	6.32	5.15	8.28	14.49	15.97	14.82	11.33	22.53	11.98	27.10	37.75
Total new issue	**54.26**	**82.43**	**124.10**	**98.91**	**72.30**	**118.07**	**128.86**	**118.47**	**93.54**	**187.49**	**128.97**	**115.82**	**201.95**
MM CLO (%)	7.60	5.20	5.10	5.20	11.50	12.30	12.40	12.50	12.10	12.00	9.30	23.40	18.69
Reset/refi (U.S. bil. $)													
BSL CLOs	0.00	0.00	0.00	0.00	39.73	161.53	151.97	41.33	30.39	237.61	17.35	21.55	287.56
MM CLOs	0.00	0.00	0.00	0.00	0.00	5.48	3.92	2.46	1.09	13.70	7.42	3.05	19.38
Total resets/refis	**0.00**	**0.00**	**0.00**	**0.00**	**39.73**	**167.01**	**155.89**	**43.79**	**31.48**	**251.31**	**24.77**	**24.60**	**306.94**

BSL—Broadly-syndicated loan. MM—Middle-market. Source: S&P Global Ratings and Pitchbook LCD.

Questions and comments are always welcome. Please contact the Capital Markets Bureau at CapitalMarkets@naic.org.

[i] S&P Global*, Scenario Analysis: Middle-Market CLO Ratings Withstand Stress Scenarios With Modest Downgrades (2024 Update)*, December 2024.

[ii] Barings, *Structured Credit – Private CLOs: 101*, February 2024.

[iii] S&P Global, *1Q2025 Private Credit And Middle-Market CLO Quarterly: Waiting For The Sun,* January 2025.