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 US insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the **index**

U.S. Insurance Industry Exposure to Collateralized Loan Obligations & Market Trends

In June 2012, the NAIC Capital Markets Bureau published a report on collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs) exposure as of year-end 2011 in a special report titled, "**U.S. Insurance Industry CDO/CLO Update**." This special report focuses more specifically on the U.S. insurance industry's CLO exposure along with an update on market trends within this asset type.

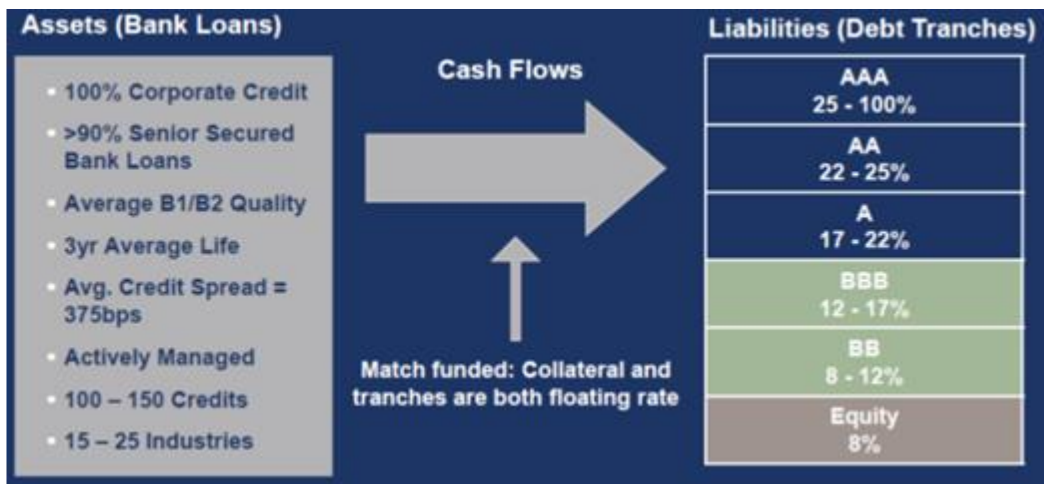
CLOs serve as a source of diversification for insurers more so than a core investment focus. However, there is evidence that insurers have increased their exposure to CLOs in recent years. Given the persistent low-interest rate environment, CLOs offer an attractive yield alternative to other more traditional asset types, such as corporate bonds.

In addition, the underlying bank loan assets — most often, but not exclusively, leveraged bank loans — have performed well, with low default rates and relatively stable credit conditions over the past few years. Notwithstanding, during the financial crisis, credit deterioration of bank loan portfolios did contribute to rating downgrades on some CLO tranches; however, as conditions improved and because of structural features, the ratings on many tranches were subsequently upgraded. According to Fitch Ratings, the trailing 12-month U.S. leveraged loan default rate was 1.6% at year-end 2013 and decreased further to 1.4% as of March 2014. Total leveraged loan new issuance in 2013 was $605 billion (according to Standard & Poor's Capital IQ Leveraged Commentary & Data) with the majority of new issuers in the B rating, or speculative, category. Note that while the average rating on a given underlying portfolio of bank loans tends to be predominantly speculative or below investment grade, achieving higher ratings on the CLO notes is accomplished through credit enhancement or subordination.

Positive Attributes of CLOs as Investments

According to Babson Capital Management research, no AAA or AA-rated CLO tranches have incurred losses at the senior level in the last two recessions. Subordination — or credit enhancement — below these tranches has typically ranged from 15% to 35% of the capital structure. In addition, CLOs have benefitted from certain structural features, such as covenants that redirect cash flows from subordinate to more senior tranches when the underlying portfolio credit quality deteriorates. By paying down senior debt, the percentage of the total capital structure supporting the remaining senior debt increases.

CLOs offer investors an opportunity to invest in a diverse portfolio of (mostly) below investment grade senior secured bank loans. CLO tranches offer a higher spread for comparable credit risk. Typically, the yield on CLO tranches is floating, with a spread over the three-month London Interbank Offered Rate (LIBOR), and is "match-funded" (i.e., a natural hedge) to the underlying pool of floating rate bank loans. Because CLO yields are floating rate, they increase as interest rates increase, which is an attractive feature for investors with concerns about the potential for rising rates.



Source: Babson Capital Management

Changing CLO Investor Base: Impact of the Volcker Rule

CLO investors have traditionally included banks, insurance companies, asset managers and other institutional investors, with banks comprising about 70% of all CLO investors. However, due to uncertainty regarding the impact of the so-called Volcker Rule on banks' CLO holdings, there has been an increase in marketing by brokers to insurance companies and asset managers. In addition, private equity firms and hedge funds have also been increasing their CLO market share since 2010.

As part of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Section 619 (commonly referred to as the "Volcker Rule") was, according to the Board of Governors of the Federal Reserve System, established to:

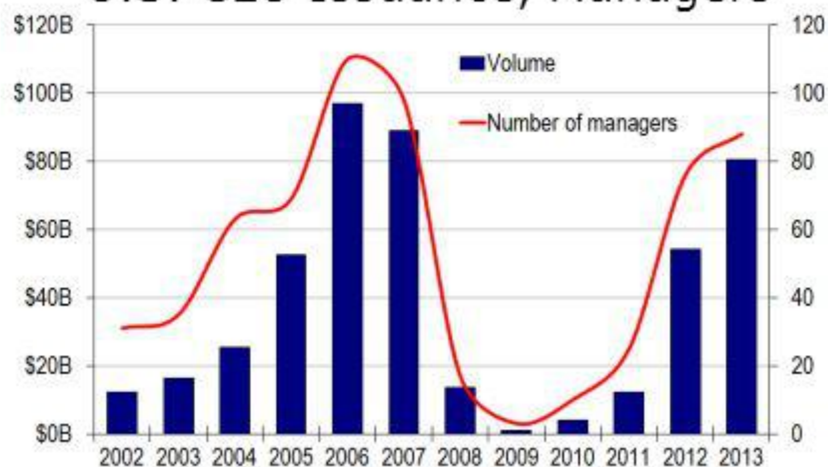
"…prohibit insured depository institutions and companies affiliated with insured depository institutions ("banking entities") from engaging in short-term proprietary trading of certain securities, derivatives, commodity futures and options on these instruments, for their own account. The final rules also impose limits on banking entities' investments in, and other relationships with, hedge funds or private equity funds."

In addition, compliance requirements vary based on the size of the banking entity and the scope of activities conducted. Consequently, some banks would be prohibited from holding certain investments, including some existing CLOs, with which they would have to divest by July 2015. However, in April 2014, the Federal Reserve gave banks a two-year extension, so that the window for holding these investments was extended to July 2017. Note that CLOs structured in 2014 have been "Volcker compliant"; that is, if they were structured with a bucket for bond investments, the issuer clarified compliance with the Volcker Rule or the CLOs were prohibited from investing in bonds. To evidence compliance with the Volcker Rule, CLOs structured in 2014 with bond buckets must receive written consent from the CLO's controlling class of investors that one of the following is true: (i) ownership of the particular bond types would not cause the issuer to be deemed a covered fund as defined by the Volcker Rule; (ii) the CLO notes would not be considered ownership interests under the Volcker Rule; or (iii) ownership of the CLO notes by the bank would be considered exempt from the Volcker Rule.

According to Fitch Ratings, CLOs structured prior to the financial crisis are expected to be paid in full or be redeemed in full before a forced sale occurs by the July 2017 deadline. According to data from Babson, insurance companies and asset managers have picked up the AAA-rated, as well as the AA- and BB-rated, CLO tranches that banks have not purchased due to uncertainty over the impact of the Volcker Rule.

New Issuance and Outstanding CLOs

According to Fitch Ratings, new issuance for CLOs in 2013 was $81.3 billion, the third-highest year ever. The largest new issuance occurred in 2006 at $94.9 billion according to Standard & Poor's (S&P), compared to a low of $4 billion at year-end 2010.



According to S&P, new CLO issuance through April for 2014 was about $34 billion, which was close to the March 2014 post-crisis high. It is expected to be between $60 billion and $80 billion for calendar year 2014. As of early June, new issuance volume was approximately $47 billion according to S&P research. Investor uncertainty relative to Volcker Rule treatment has not slowed CLO new issuance. Spreads on newly issued CLOs rated AAA, the highest credit quality, hovered around 150 basis points (bps) over three-month LIBOR for the first quarter of 2014, and ranged between 148 bps and 153 bps.

In terms of outstanding CLOs, as of year-end 2013, there were approximately $295 billion CLO assets under management spread across 718 CLOs, according to S&P. Notwithstanding high redemption levels of older vintage transactions, strong new issuance in 2013 resulted in a net increase of 51 CLOs in the amount of $15 billion in notes outstanding from 2012. As of April 2014, CLO assets under management were $316 billion.

"CLO 1.0s" are characterized as those issued prior to the financial crisis (i.e., 2008), whereas "CLO 2.0s" are characterized as those issued since then. As of year-end 2013, there were $151 billion in CLO 1.0 notes outstanding compared to $143 billion of CLO 2.0s. According to S&P, about 200 CLO 1.0s have been paid down in full, two-thirds of which were due to optional redemption at the request of the equity investors. Overall, CLO 2.0s represent about half of the overall CLOs under management.

Rating Stability and Credit Quality of CLOs

A study by S&P shows that in their 20-year history to date (1994–2014), CLOs "have experienced solid credit performance historically, with few negative ratings actions on senior notes due to underlying collateral deterioration, few defaults and minimal loss rates." In the fourth quarter of 2013, CLOs accounted for 75% (or 150) of a total of 200 U.S. structured credit ratings placed on CreditWatch with positive implications by S&P.

Underlying collateral for CLOs is predominantly bank loans but may include "buckets" (or carved-out, limited allocations) for other types of investments such as corporate bonds and structured finance securities for portfolio diversification purposes. With respect to non-loan assets, approximately 50% of CLOs issued post-2008 had a 10% allowable bucket for bonds, with another 23% having a 5% allowable bucket. Some CLOs issued in 2014 are coming to market without a bond bucket. As of first quarter 2014, Fitch Ratings research showed that

about one-third of all CLOs outstanding had no investments in bonds or structured finance securities.

Bank loans rated BB- and higher accounted for 21% of U.S. CLO collateral, with 53% rated B/B+ and 10% rated B- and below. In addition, to somewhat address the search for yield, Thomson Reuters data shows that about half of all CLO collateral for 2012 through 2014 vintage CLOs were "covenant lite" (or "cov-lite," meaning the loan agreements offer less protective covenants to lenders than standard bank loan agreements); and second-lien loans (that is, those that have a second priority security interest in the assets securing the first priority lien loans) accounted for 2.0%, or $5.3 billion of CLO assets as of April 2014. Both cov-lite and second-lien loans represent somewhat riskier investments than the traditional first-lien bank loans that comprise the majority of CLO portfolios.

CLO Portfolio Characteristics

Because of benign credit conditions, according to S&P, non-financial U.S. speculative grade companies have experienced stable ratings performance, evidenced by low leveraged loan default rates. Thomson Reuters reported that only 1.2% of U.S. CLO assets were in default as of April 2014. Additionally, S&P reported that underlying assets rated CC or defaulted ranged from a high of 4.42% for 2005 vintage CLOs to a low of 0.29% for 2012 vintage as of year-end 2013. According to S&P, weighted average spreads for CLOs (that is, the spread differential between the interest earned on the underlying portfolio and interest paid to noteholders) have ranged from a low of 3.34% for 2005 vintages to a high of 4.34% for 2010 vintages based on their cohort index CLO data, as of year-end 2013. Spreads widen when investments are perceived to be at risk in terms of receiving timely payments, particularly when economic conditions wane. Excess spread (i.e., remaining funds after interest earned on the underlying portfolio is utilized to pay interest to the noteholders and other transaction fees and expenses) may be used not only as additional credit enhancement, but also to pay down additional principal on the notes, and/or to pay out to equity holders.

CLO Managers

CLO managers are responsible for investment management decisions for the CLO's underlying portfolio of assets, so a comprehensive assessment of a potential CLO manager's infrastructure is essential for investor due diligence. According to S&P, as of year-end 2013, there were 134 collateral managers.

According to Fitch Ratings, having a diversity of CLO managers provides investors with a variety of investment styles. In addition, having a variety of CLO managers is especially helpful, given current market uncertainty with respect to proposed regulatory rules. New regulations stemming from the Dodd-Frank Act and the Volcker Rule propose that CLO managers retain a 5% vertical interest (that is, an aggregate 5% of the total capital structure from senior to subordinated notes) or 5% horizontal interest (that is, within one tranche) in the CLOs they manage.

CLO managers include affiliates of private equity firms (e.g., Ares Management), hedge funds, large financial institutions, insurance companies (e.g., New York Life Investment Management, Babson Capital Management, Allstate Investment Management and Prudential Investment Management), as well as smaller, independent firms.

U.S. Insurance Industry CLO Exposure

As of year-end 2013, the U.S. insurance industry had approximately $28 billion in book/adjusted carrying value (BACV) in CLOs, which is a conservative calculation given the complexity and broad definition of the collateralized debt/loan obligations asset type. In comparison, the industry held approximately $22 billion in CLOs as of year-end 2011 and $13.7 billion as of year-end 2009. Similar to year-end 2011, more than 80% of CLO investments were held by life companies as of year-end 2013.

U.S. Insurance Industry CLO Exposure - YE2013		
Industry Type	**$ Book/Adjusted Carrying Value**	**% of Total**
Life	22,768,548,725	80.2
Property/Casualty	5,431,059,289	19.1
Health	153,044,344	0.5
Fraternal	23,159,938	0.1
Title	-	-
Total	**28,375,812,296**	100.0

With respect to credit quality, the industry's CLO investments evidence some improvement over the past few years. As of year-end 2013, 91% of the industry's CLOs carried NAIC 1 designations, with an additional 3.6% and almost 3% each in CLOs carrying NAIC 2 and NAIC 6 designations, respectively. In comparison, as of year-end 2011, about 87% carried NAIC 1 designations, with 6% carrying NAIC 2; 5% in NAIC 3 and 6% in NAIC 5 and NAIC 6 combined.

NAIC Designation	% of Total
1	91.0%
2	3.6%
3	1.3%
4	0.5%
5	0.9%
6	2.8%

CLO exposure represents a small percentage of the industry's overall $3.7 trillion bond exposure as of year-end 2013, but it is inclusive of an asset type — namely, structured finance securities — that have experienced volatility in recent years. New issuance of CLOs decreased significantly immediately following the financial crisis; however, due in part to the strength in performance of the underlying collateral (bank loans), sound structural features and a relatively benign credit environment, CLOs fared relatively well through the crisis, evidenced by minimal rating downgrades. CLOs are also attractive in terms of yield compared to similarly rated bonds. In addition, many seasoned CLO managers (that is, those who have been managing CLOs since the late 1990s) continue to dominate market share with respect to CLO assets under management and new issuance activity.

The NAIC Capital Markets Bureau will continue to monitor trends within the CLO market and report as deemed appropriate.

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

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