NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research
Capital Markets Special Report

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U.S. Insurance Industry's Exposure to Credit Tenant Loans and Equipment Trust Certificates

While credit tenant loans (CTLs) and equipment trust certificates (ETCs) are a relatively small portion of insurer investments, they are noteworthy because of their unique structures and strong performance (in terms of low historical default rates). In addition, they may be considered attractive investments in the current low interest rate environment where investors are seeking alternatives to achieve higher yields. CTLs and ETCs typically have higher interest rates than conventional bonds (such as U.S. Treasuries or corporate debt) because they are structurally more complex investments—they are structured for the most part as indirect obligations, and they are reliant on underlying leases for debt service payments.

Credit Tenant Loans (CTLs)

A credit tenant loan (CTL or credit tenant lease, sale-leaseback) is a real estate loan that is secured by the obligation of a single (usually investment grade) company to pay debt service by means of rental payments under a lease, where real estate is pledged as collateral. In other words, a CTL is a mortgage loan made primarily on reliance of the credit standing of a tenant (through the assignment of lease rental payments to the note or certificate holders) rather than based on the characteristics of the mortgaged property (such as its property value). Because of this structure, certain CTLs are reported by U.S. insurers as long-term bonds —specifically, in the loan-backed and structured securities category (as opposed to recording them as mortgage loans). Structures that are not considered CTLs are those with multiple credit tenants, those with short leases (i.e., leases are shorter than the maturity of the certificates issued by the trust), and those with properties where landlords have substantial responsibilities. As a result, these latter structure-types are not treated as bonds by insurers for regulatory purposes; rather, they are reported as mortgage loans.

CTLs can be made on all commercial property types. The underlying credit or tenant ability to pay rent is the primary underwriting consideration; that is, the primary credit risk of a CTL is the creditworthiness of the lessee/tenant rather than (fundamental) real estate analysis. Note that the lessee is only directly responsible for the lease payments and not directly responsible for payments of principal and interest. However, CTLs are structured such that the lease payments are intended to be able to satisfy debt service; that is, the interest and repayment of principal on the debt. The tenant's long-term debt is typically rated investment grade by one or more of the nationally recognized statistical rating organizations.

There are a few different types of CTLs as defined by the *Purposes and Procedures Manual (P&P Manual) of the NAIC Securities Valuation Office, December 2012 Edition.* A Bond Lease Based CTL is structured around the terms of a bond lease, which is "a lease between a lessor and lessee for a specified period of time with specified rent payments that are at least sufficient to repay the note(s)." This type of lease is also known as a "hell or high water lease" because the lessee must continue to pay rent regardless of what occurs to the lease premises. A Credit Lease Based CTL is known as a "double net" lease; it is similar to a Bond Lease Based CTL except "a small set of landlord obligations or real estate risks must be addressed through well-

recognized mitigation methods." For example, the most common such obligation/risk is the repair and maintenance of the property. Acceptable Credit Tenant Loan Variants (ACVs) are similar to the aforementioned two types of CTLs, except they have one or more variants described in the P&P Manual under *Guidelines for Acceptable CTL Variants* where lease payments are insufficient to cover debt service, and the shortfall is covered by credit enhancement, cash escrow or rent asides. Lastly, Multiple Property Transactions (MPTs) are "a series of single property Bond Lease or Credit Lease Based CTLs (but not both) combined in one transaction."

CTLs are attractive investments to insurers because they generally have minimal prepayment risk and predictable monthly cash flow. As of year-end 2012, the U.S. insurance industry had almost $24 billion in book /adjusted carrying value (BACV) invested in CTLs, which was less than 1% of the industry's total cash and invested assets (approximately $5.3 trillion). The majority, or 95%, of CTLs was with life companies. This total BACV was almost double the $12.5 billion BACV of CTLs invested in by the U.S. insurance industry as of year-end 2011. The increase is due to CTLs representing an attractive investment opportunity in the current low interest rate environment and, in part, a slow-moving commercial mortgage-backed securities (CMBS) market. There was a decrease in exposure from year-end 2010 ($22.2 billion) to year-end 2011, likely attributable to competition for commercial properties by CMBS and real estate investment trusts (REITs). Requests for NAIC designations for CTLs also decreased significantly from 2003 through 2009 for this reason as well—that is, competition from CMBS and REITs for commercial real estate properties "crowded out" the traditional insurance company CTL investors. This is the same phenomenon that occurred with the insurance industry's direct mortgage loan origination business.

As of February 2012, the NAIC had assigned designations to approximately 1,400 CTLs. According to NAIC data, the largest five lessees or tenants of CTLs are listed in the table below, and they accounted for 61% of total U.S. insurance company CTL investments. Note that Walgreen Co. was the largest CTL lessee at 31% of the total number of insurance company CTLs as of February 2012.

Tenant	NAIC Designation	# of CTLs	% of Total
Walgreen Co	2	449	31
CVS Caremark	2	202	14
GSA (U.S. Government)	1	97	8
Wal-Mart Stores	1	77	5
Lowe's Companies	1	49	3
TOTAL:		**874**	**61**
* as of Feb., 8, 2012			

*Top 5 Lessee / Tenants**

Overall, 96% of all U.S. insurance company CTLs were investment grade (NAIC- 1 and NAIC-2) as of year-end 2012. In addition, 60% of the industry's CTL exposure was scheduled to mature in more than 10 years, with 12.5% maturing in 20 years or more. This is a favorable trend given life companies' need for longer-dated assets.

NAIC Designation	BACV($)	% of Total
1	15,415,431,357	64%
2	7,585,294,337	32%
3	425,715,152	2%
4	267,990,235	1%
5	275,616,695	1%
6	18,445,355	0%
Grand Total	**23,988,493,131.00**	**100%**

NAIC Regulatory Treatment of CTLs

Prior to 2011, CTLs were mostly reported, along with many other loan-backed and structured securities, among corporate bonds for valuation and reporting purposes. During a regulatory review of reporting, *Statement of Statutory Accounting Principle (SSAP) No. 43—Loan-Backed and Structured Securities*, *Revised* was clarified so that all bonds that are not issuer obligations, but are issued by a trust, where the investor's recourse is only to the assets in the trust, are subject to SSAP No. 43R reporting and valuation requirements. This category also includes residential mortgage-backed securities, asset-backed securities and CMBS.

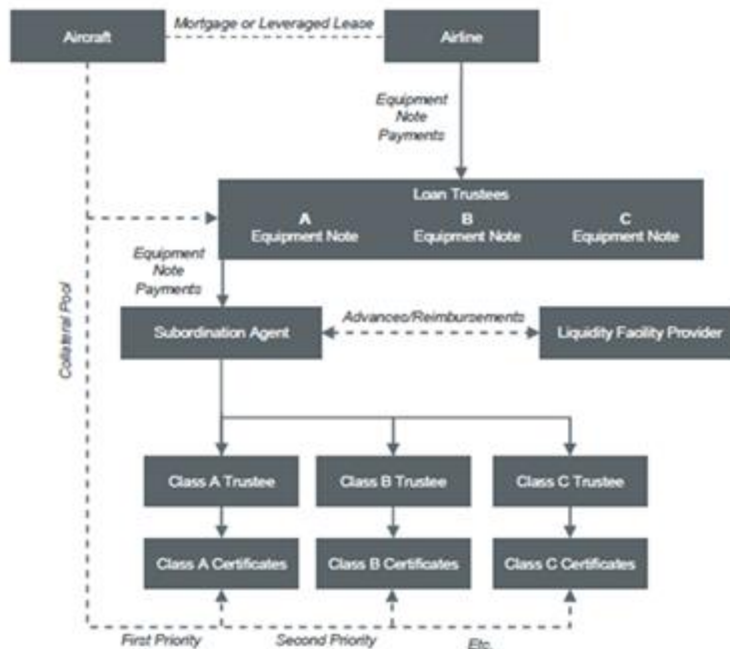
Equipment Trust Certificates (ETCs) & Enhanced ETCs (EETCs)

Equipment Trust Certificates (ETCs) are certificates that entitle the holder to the lease payments on the underlying assets. They are a financing vehicle used mostly by railroad companies and airlines to finance their core operating equipment. For railroads, this includes locomotives and rolling stock, and for airlines it includes aircraft and aircraft parts and engines.

According to Standard & Poor's (S&P) research, prior to the mid-1990s, most aircraft that operated in the U.S. were financed via ETCs, which were grouped together into trusts that sold pass-through certificates to investors. This means that the trust owned the asset (i.e., the aircraft) and leased it to a company (i.e., the airline). Certificates were issued by a bankruptcy-remote trust to investors, who, in turn, received lease payments from the company (or lessee – the airline) until the certificate's maturity. Upon maturity, the asset's ownership is transferred to the company (airline).

Enhanced ETCs (EETCs) materialized in the 1990s because the liquidation of airlines in bankruptcy was undesirable given their importance to the overall transportation system. EETCs were developed as a source of financing for aircraft that included structural enhancements to the ETC such as the addition of the liquidity facility and credit support (i.e., enhancement) in the form of multiple classes of debt. This, in turn, resulted in lowering default probability and expected loss for the senior notes, and in general, a more secure structure. And, rather than one certificate, there are two or more classes of securities issued by the trust which have different payment priorities and asset claims, in accordance with inter-creditor agreements. Since the EETC structure emerged, financing for aircraft has predominantly utilized this assembly, while railroads continue to primarily utilize ETCs as a financing source. ETCs do not benefit from a liquidity facility.

Typical EETC Transaction Structure



Source: Fitch, company filings.

With EETC structures, the senior certificates (those with the highest payment priority)—as in those which are labeled *Class A Certificates* in the diagram above—have a higher credit rating because they are supported by more credit enhancement than the subordinated certificates (i.e., the Class B and Class C Certificates). These subordinated certificates represent the first-loss risk. The proceeds of the certificates are used by the trustees to purchase equipment notes from the underlying obligor (airline). The airline issues Individual notes for each aircraft that is included in the EETC financing. All payments flow through the Subordination Agent (as shown in the diagram above).

Benefits of EETC Structure

EETCs are structured with a liquidity facility (usually with an 18-month term) which is available to fund interest payments on the EETC—to avoid a payment default—in the event the airline company files for bankruptcy and elects to not retain the leased equipment and has ceased all payments. The liquidity facility is typically sized to meet three semi-annual interest payments on the EETC; it does not cover principal payments. Failure to pay scheduled principal is not an event of default. According to the contractual terms of an EETC, failure to pay scheduled principal is only an event of default if it occurs at the certificate's legal final maturity date. The legal final maturity date of a certificate is typically 18 months after the final scheduled principal payment.

EETCs also benefit from overcollateralization, particularly with respect to the senior certificate holders (Class A, in the diagram above). As defined by Fitch Ratings (Fitch), overcollateralization with respect to EETCs is the value of the portfolio of aircraft above the outstanding debt. Fitch determines the amount of collateral coverage required for each class of EETC debt by building in stress assumptions derived from prior recessions into the estimated current market value of the aircraft. Also according to Fitch, cross-default provisions "limit a bankrupt airline's ability to choose which aircraft to affirm or reject in Chapter 11." Since EETCs are structured as a pool of equipment notes issued by the airline to the trust, the cross-default mechanism means that an event of default on one aircraft equipment note triggers a default on the whole pool of underlying aircraft financings. EETCs that have been structured in recent

years have included a provision whereby excess proceeds from the disposition of an aircraft due to bankruptcy would be diverted to EETC holders in support of recovery. Previously, these excess proceeds were kept by the airlines post-disposition.

U.S. Bankruptcy Protection

Both ETCs and EETCs benefit from protection of Sections 1110 (airlines) and 1168 (railroads) of the U.S. Bankruptcy Code, which encourages the constructive reorganization of airlines and railroads in bankruptcy such that current payment of principal and interest continues during the reorganization process. As such, it does not permit secured borrowers to foreclose on collateral. As a result, EETCs have lower default probability and higher expected recoveries than debt issued directly by the airline and railroad companies.

Pursuant to Sections 1110 and 1168, the airline or railroad, respectively, has 60 days to decide whether it wishes to continue to utilize the equipment it financed under the ETC or EETC; reject the equipment and relinquish it to the trustee for sale; or negotiate an extension of the lease. If the company decides to continue to keep the equipment and cure past defaults, the bankruptcy code provides for the airline/railroad to bring and/or maintain current payments on the equipment notes or leases that support the financing. If the airline/railroad decides *not* to keep the equipment, the relevant bankruptcy code allows for the "automatic stay"—which generally prohibits secured borrowers from foreclosing on collateral during bankruptcy proceedings—to be waived, allowing the company to repossess and remarket the equipment (thereby monetizing their collateral) early in the bankruptcy. If proceeds realized from liquidating the collateral are insufficient to satisfy the outstanding EETC balance, then the trust will have an unsecured claim against the bankruptcy estate of the underlying airline company. This is a main reason for low default rates and high recoveries on ETCs and EETCs.

As of year-end 2012, the U.S. insurance industry's exposure to ETCs and EETCs was approximately $20.4 billion. Note that this exposure also includes the industry's exposure to direct equipment leases as well as some equipment asset-backed securities (ABSs). Equipment ABSs are structured finance transactions whereby leases on different types of equipment, such as those for commercial or for medical purposes, are pooled into a trust that, in turn, issues debt to investors. Similar to CTLs, ETCs and EETCs are also reported in the "loan-backed and structured securities" bond category.

Life companies composed the largest share at 85% (or $17.4 billion) of total ETC/EETC exposure, followed by P/C companies at 12%. About one quarter of the equipment type for these transactions was identified as aircraft. In addition, for about 30% of the industry's exposure to ETCs/EETCs as of year-end 2012, the interest rate reported was in the 5% range, followed by about 18% (or $3.6 billion) in the 6% range. In comparison, the yield on a 10-year U.S. Treasury bond was 1.75% as of mid-July 2013, and the yield on the investment grade FINRA/Bloomberg Active U.S. Corporate Bond Index (composed of the most frequently traded fixed coupon bonds represented by FINRA TRACE) was 4.03% as of mid-July 2013. Lastly, approximately 45% of insurer ETC/EETC exposure matures in 10 years or more, with 13.6% maturing in 20 or more years.

Approximately 94% of total ETC/EETC exposure had NAIC -1 and NAIC- 2 designations meaning they were investment grade credit quality, with about two-thirds in the highest credit quality category (NAIC-1).

NAIC Designation	BACV ($)	% of Total
1	13,616,454,097	67%
2	5,488,789,448	27%
3	879,668,475	4%
4	293,700,664	1%
5	91,201,926	0%
6	54,699,940	0%
Grand Total	**20,424,514,550**	**100%**

Summary

While CTLs and ETCs/EETCs represent a small overall percentage of the U.S. insurance industry’s total cash and invested assets, they are a source of diversity from “mainstream” investments. And given the challenging interest rate environment, perhaps these investments represent an attractive alternative to corporate bonds and U.S. government bonds that made up 51% and 6.7% of the industry’s total bond exposure as of year-end 2012, respectively. The Capital Markets Bureau will monitor developments relative to CTLs and ETCs/EETCs and report as deemed appropriate.

July 19, 2013 Major Insurer Share Prices			Change %			Prior		
		Close	Week	QTD	YTD	Week	Quarter	Year
Life	Aflac	$59.39	0.4	2.2	12.3	$59.14	$58.12	$52.89
	Ameriprise	86.31	(0.3)	6.7	38.2	86.60	80.88	62.45
	Genworth	13.17	3.4	15.4	75.8	12.74	11.41	7.49
	Lincoln	40.89	3.4	12.1	58.7	39.56	36.47	25.77
	MetLife	48.64	(0.9)	6.3	48.5	49.08	45.76	32.76
	Principal	39.68	2.0	6.0	39.8	38.90	37.45	28.38
	Protective	43.12	3.3	12.3	51.5	41.75	38.41	28.47
	Prudential	78.19	0.4	7.1	47.3	77.89	73.03	53.09
	UNUM	31.46	(0.3)	7.1	51.8	31.57	29.37	20.73
PC	ACE	$94.74	1.3	5.9	19.2	$93.50	$89.48	$79.50
	Axis Capital	46.87	(1.9)	2.4	36.0	47.78	45.78	34.46
	Allstate	52.10	1.9	8.3	30.1	51.11	48.12	40.05
	Arch Capital	55.42	2.9	7.8	26.5	53.86	51.41	43.82
	Cincinnati	49.55	0.8	7.9	27.2	49.18	45.92	38.95
	Chubb	88.64	1.0	4.7	18.2	87.76	84.65	75.01
	Everest Re	129.80	(1.0)	1.2	18.4	131.08	128.26	109.67
	Progressive	26.30	1.3	3.5	25.2	25.97	25.42	21.01
	Travelers	84.66	0.6	5.9	18.4	84.18	79.92	71.53
	WR Berkley	44.26	1.0	8.3	17.7	43.82	40.86	37.59
	XL	32.88	2.7	8.4	31.8	32.01	30.32	24.94
Other	AON	$67.48	0.7	4.9	21.8	$67.02	$64.35	$55.41
	AIG	46.88	0.3	4.9	32.9	46.74	44.70	35.28
	Assurant	53.18	0.2	4.5	54.2	53.09	50.91	34.48
	Fidelity National	24.49	2.0	2.9	3.9	24.01	23.81	23.58
	Hartford	31.74	(1.5)	2.7	41.8	32.21	30.92	22.39
	Marsh	41.80	0.4	4.7	21.9	41.65	39.92	34.30
Health	Aetna	$64.49	1.6	1.5	39.7	$63.50	$63.54	$46.17
	Cigna	77.84	2.4	7.4	46.1	76.03	72.49	53.29
	Humana	89.08	4.2	5.6	30.2	85.53	84.38	68.43
	United	71.45	5.1	9.1	32.0	68.00	65.48	54.12
	WellPoint	86.80	1.6	6.1	42.9	85.40	81.84	60.73
Monoline	Assured	$22.86	1.0	3.6	61.9	$22.63	$22.06	$14.12
	MBIA	13.36	(3.7)	0.4	68.7	13.87	13.31	7.92
	MGIC	6.77	11.5	11.5	150.7	6.07	6.07	2.70
	Radian	13.20	8.3	13.6	114.6	12.19	11.62	6.15
	XL Capital	32.88	2.7	8.4	31.8	32.01	30.32	24.94

July 19, 2013 Major Market Variables	Close	Change % Week	QTD	YTD	Prior Week	Quarter	Year
Dow Jones Ind	15,543.74	0.5	4.3	18.7	15,464.30	14,909.60	13,099.80
S&P 500	1,692.09	0.7	5.3	19.0	1,680.19	1,606.28	1,422.10
S&P Financial	279.31	1.8	6.6	26.3	274.37	262.06	221.17
S&P Insurance	261.36	0.9	5.9	30.9	258.99	246.78	199.67
US Dollar $		Change %			Prior		
/ Euro	$1.31	0.6	1.0	(0.5)	$1.31	$1.30	$1.32
/ Crude Oil bbl	108.42	2.2	12.3	18.3	106.11	96.53	91.62
/ Gold oz	1,295.40	0.9	5.0	(22.6)	1,283.90	1,233.50	1,673.70
Treasury Ylds %	%	Change bp			%	%	%
1 Year	0.10	(0.01)	(0.05)	(0.04)	0.11	0.15	0.14
10 Year	2.49	(0.10)	(0.00)	0.73	2.58	2.49	1.76
30 Year	3.56	(0.06)	0.07	0.61	3.63	3.50	2.95
Corp Credit Spreads -bp		Change %			Prior		
CDX.IG	34.56	1.5	(13.7)	(39.4)	34.06	40.05	57.04

July 19, 2013										
Major Insurer Bond Yields				Weekly Change					YTD
				Price			Spread over UST		Spread
	Company	Coupon	Maturity	Current	Change	Yield	B.P.	Change	Change
Life	Aflac	8.500%	5/15/2019	$130.26	$1.41	2.82%	120	(10)	(7)
	Ameriprise	5.300%	3/15/2020	$115.15	$0.60	2.79%	92	(4)	(26)
	Genworth	6.515%	5/15/2018	$113.91	$0.89	3.37%	204	(10)	(186)
	Lincoln National	8.750%	7/15/2019	$130.34	$1.32	3.11%	150	(11)	(34)
	MassMutual	8.875%	6/15/2039	$148.39	$2.27	5.39%	198	(4)	(50)
	MetLife	4.750%	2/15/2021	$110.39	$1.35	3.19%	115	(9)	6
	New York Life	6.750%	11/15/2039	$124.78	$0.52	5.04%	162	4	(1)
	Northwestern Mutual	6.063%	3/15/2040	$115.70	$1.07	4.99%	154	1	9
	Pacific Life	9.250%	6/15/2039	$139.91	$2.94	6.15%	275	(10)	(56)
	Principal	6.050%	10/15/2036	$117.55	$1.69	4.79%	151	(6)	(30)
	Prudential	4.500%	11/15/2020	$108.49	$1.31	3.19%	117	(10)	(23)
	TIAA	6.850%	12/15/2039	$124.88	$1.65	5.12%	168	(2)	(2)
P&C	ACE INA	5.900%	6/15/2019	$119.85	$0.48	2.28%	66	6	(11)
	Allstate	7.450%	5/15/2019	$127.83	$0.94	2.31%	65	(9)	(46)
	American Financial	9.875%	6/15/2019	$130.92	$1.38	3.94%	226	(14)	(87)
	Berkshire Hathaway	5.400%	5/15/2018	$116.14	$0.72	1.87%	59	(5)	(4)
	Travelers	3.900%	11/15/2020	$107.63	$1.00	2.74%	73	(4)	8
	XL Group	6.250%	5/15/2027	$113.73	$0.33	4.87%	205	2	(36)
Other	AON	5.000%	9/15/2020	$110.29	$0.26	3.37%	138	10	6
	AIG	5.850%	1/15/2018	$113.95	$0.54	2.53%	138	(1)	17
	Hartford	5.500%	3/15/2020	$113.25	$1.05	3.28%	143	(3)	(30)
	Marsh	9.250%	4/15/2019	$131.38	$1.01	3.20%	161	2	(35)
	Nationwide	9.375%	8/15/2039	$142.02	$5.05	6.13%	270	(23)	(52)
Health	Aetna	3.950%	9/15/2020	$104.41	$0.83	3.25%	124	(5)	4
	CIGNA	5.125%	6/15/2020	$111.24	$0.50	3.29%	136	1	(8)
	United Healthcare	3.875%	10/15/2020	$105.63	$0.58	3.00%	102	(1)	5
	Wellpoint	4.350%	8/15/2020	$107.52	$0.81	3.15%	122	(2)	(16)

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

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