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's Exposure to Collateralized Loan Obligations as of Year-End 2018

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Executive Summary

- Despite a steady increase in exposure, collateralized loan obligations (CLOs) continue to represent a small proportion of total assets, at nearly 2% of total cash and invested assets as of year-end 2018.

- CLOs are structured securities collateralized primarily by leveraged bank loans, which include broadly syndicated bank loans (BSLs)—the largest segment of the bank loan market—and/or middle market (MM) loans.

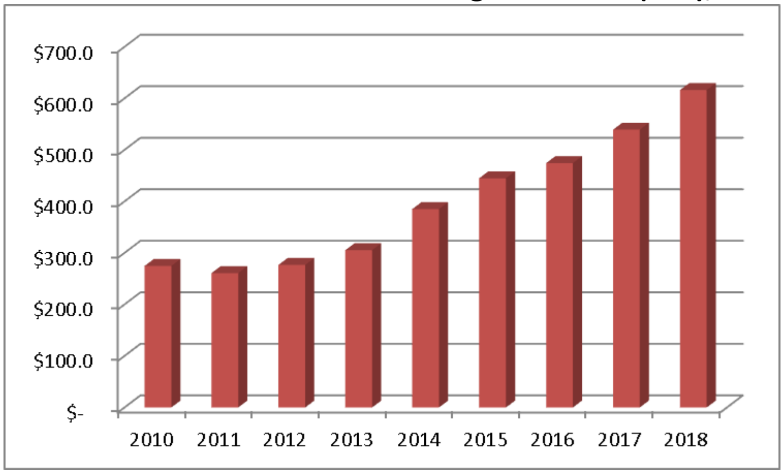
- As of year-end 2018, U.S. insurers had about $122 billion in book/adjusted carrying value (BACV) of CLO investments. The majority were high credit quality, with approximately 80% rated single-A or higher.

- U.S. CLO new issuance (with respect to those collateralized primarily by BSL) was $128.1 billion in 2018, an increase from $118 billion 2017 and exceeding the previous record of $124 billion in 2014. CLOs collateralized by MM loans were about $62 billion in 2018 (according to Securities Industry and Financial Markets Association (SIFMA) data), compared to about $42 billion in 2017.

Please note that in calculating U.S. insurers' year-end 2018 CLO exposure, the NAIC Capital Markets Bureau (CMB) revised its methodology to account for misreported securities. As such, year-over-year analysis of U.S. insurers' CLO exposure (from 2017 to 2018) is not comparable.

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 if interest rates increase as CLO debt is floating-rate. According to SIFMA, there was about $616 billion in CLOs outstanding as of year-end 2018 (see Chart 1), and $605.8 billion outstanding as of May 2019. About 90% of CLOs outstanding were issued on or after 2014; 52.1% were issued on or after 2017.[1]

Chart 1: Historical CLOs Outstanding in the U.S. ($bil), 2010–2018



Source: SIFMA

Standard & Poor's (S&P) research cited about $135 billion in CLO new issuance in 2018, the highest volume for this structured finance sector.[2] The previous record was about $124 billion in 2014.

In addition to the larger BSL-backed market, CLOs may also be collateralized by MM loans, 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)[3]. MM CLOs comprise a smaller proportion of the overall CLO market, and there were $62 billion in MM CLOs outstanding at year-end 2018 according to SIFMA. MM CLO tranches tend to require more subordination to achieve investment grade ratings due to a lower credit quality portfolio of borrowers

[1] Refinitiv LPC, *Leveraged Loan Monthly*, April 2019.
[2] S&P Global Ratings, *Global Financing Conditions: Bond Issuance Is Expected to Expand 1.2% in 2019*, April 2019.
[3] 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).

and a higher historical default rate on the underlying loans.

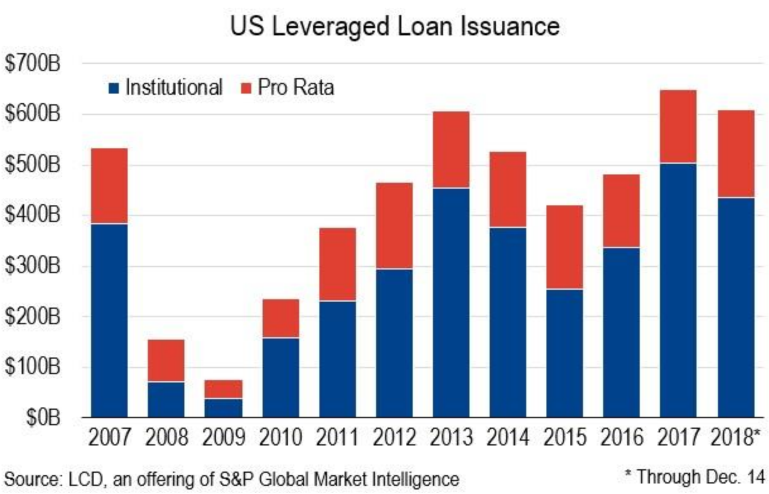
For more background on CLOs, please see the NAIC Capital Markets Bureau primer on Collateralized Loan Obligations published in August 2018.

Leveraged Bank Loans

The underlying portfolio of a CLO consists most often, but not exclusively, of leveraged bank loans—in particular, BSLs. Leveraged loan market volume has been increasing due in part to merger and acquisition activity, as well as investor demand.[4] Total U.S. leveraged bank loans outstanding is approximately $1.2 trillion for institutional loans, according to Leveraged Commentary & Data (LCD), an S&P Global Market Intelligence offering.

Although there's been an increase in outstanding leveraged loans, LCD data showed that leveraged loan new issuance (including both institutional bank loans and pro rata bank loans) has decreased year-over-year, from a record of about $650 billion in 2017 to $609 billion as of mid-December 2018. (See Chart 2.) Through the first quarter of 2019, leveraged loan new issuance was about $150 billion.

Chart 2:



More background on leveraged bank loans can be found in the NAIC Capital Market Bureau's primer on Leveraged Bank Loans published in November 2018.

Covenant-Lite (Cov-lite) Bank Loans

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

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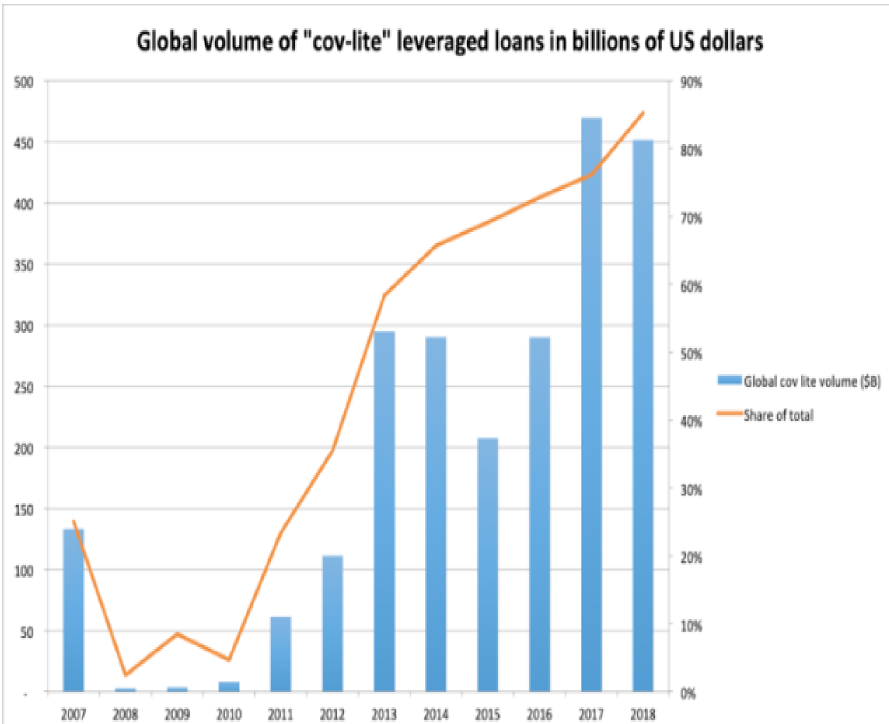
4 FitchRatings, *Leveraged Lending: Where is the Risk in the U.S. Banking System?* December 2018

portion of the loan. About 85% of outstanding U.S. leveraged loans were cov-lite as of the end of March 2019, according to the S&P/Loan Syndicated and Trading Association (LSTA) Loan Index (see Chart 3), which was an increase from 72% of outstanding loans in 2017. In comparison, in 2011, only about 23% of leveraged loans were cov-lite.

Chart 3:



The volume of newly issued "cov-lite" leveraged loans and their percentage share of overall institutional loan issuance. Leveraged Commentary & Data/S&P Global Market Intelligence

Market analysts identify cov-lite loans to be structured like high-yield bonds because of “incurrence” covenants (i.e., they must meet specific financial tests to undertake a particular action), according to LCD research. And in the event of a downturn in the credit cycle, market analysts expect recoveries on cov-lite loans to be negatively affected by the loan structure.

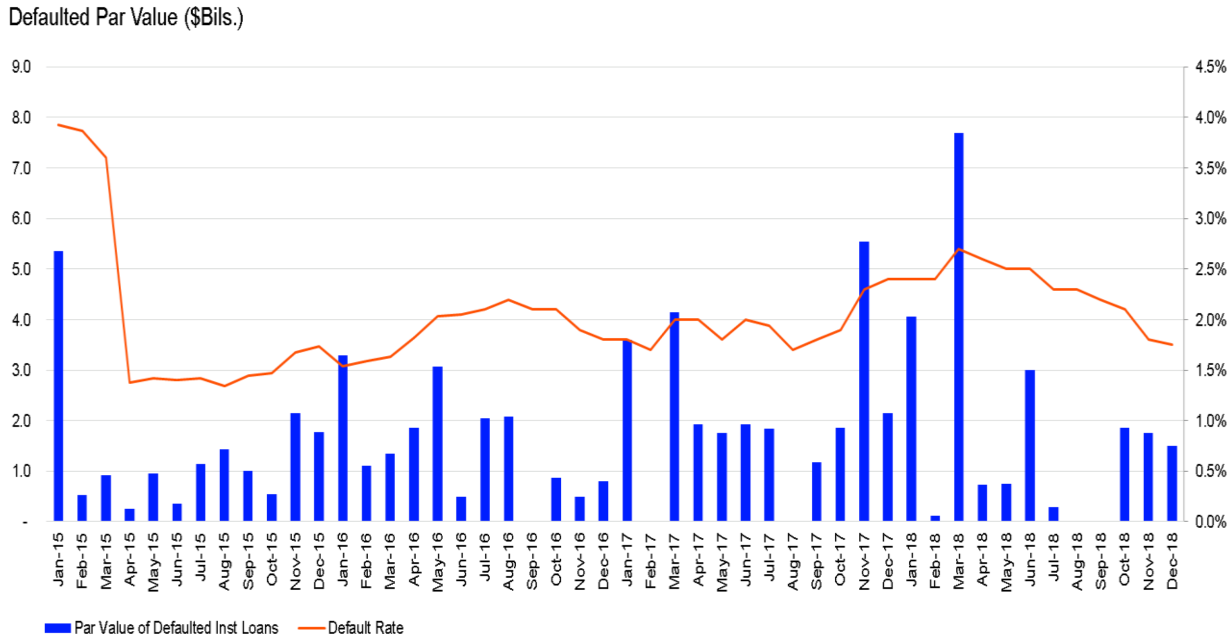
Second Lien Loans

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). Second lien loan new issuance was about $37 billion in 2018, according to Refinitiv LPC (formerly Thomson Reuters LPC), in line with 2017 new issuance.

Leveraged Bank Loan Default Rate

Due to a relatively benign credit environment, the trailing 12-month U.S. leveraged loan default rate was 1.8% as of December 2018, according to Refinitiv LPC (see Chart 2), compared to 2.4% a year prior, which was much lower than its peak of 10.5% in 2009.

Chart 2:

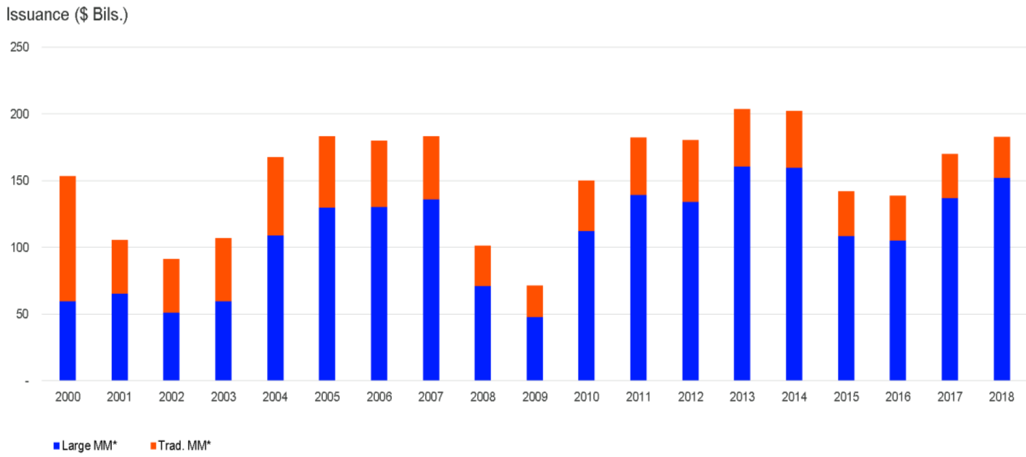


Source: Refinitiv LPC/ Fitch U.S. Leveraged Loan Default Index

MM Loans

In 2018, MM loan new issuance was about $183 billion, an increase from about $137 billion in 2017, according to Refinitiv LPC. (See Chart 3.) Many of the companies that issue MM loans are privately held.

Chart 3: U.S. MM Loan Issuance

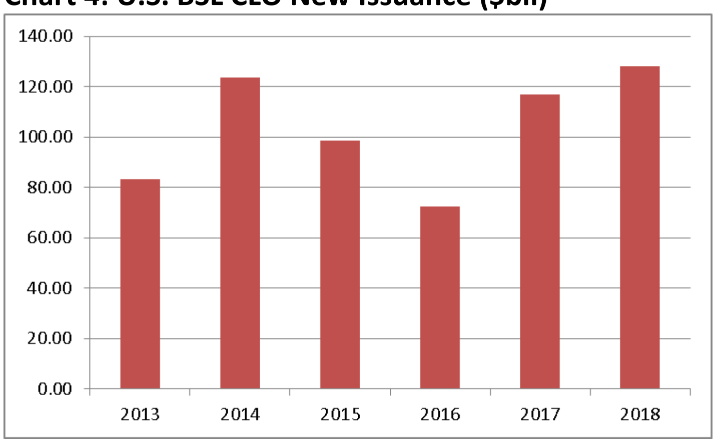


Source: Refinitiv LPC

CLO Market Trends: New Issuance and Outstandings

As of year-end 2018, BSL CLO issuance was $128.1 billion, an increase from $118 billion in 2017; 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[5]).

Chart 4: U.S. BSL CLO New Issuance ($bil)



Source: Refinitiv LPC

MM CLO issuance was about $15.7 billion in 2018, and MM CLOs outstanding at year-end 2018 was $62 billion (according to SIFMA), compared to almost $42 billion at year-end 2017.

[5] 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.

U.S. Insurer Exposure

As of year-end 2018, U.S. insurers had approximately $122 billion[6] in BACV exposure to CLOs as reported in the annual statement filings, as well as through additional analysis, which identified securities that were CLOs but not reported by insurers as such. The majority, or 77%, was held by life companies.

Table 1: Year-End 2018 U.S. Insurer Exposure to CLOs ($BACV)

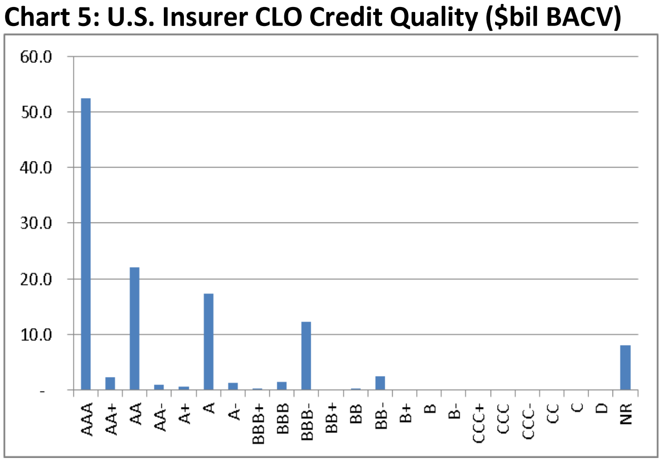
Industry Type	$BACV	% of Total
Life	94,329,892,802	77%
P/C	23,839,742,875	20%
Fraternal	445,524,227	0%
Health	3,547,637,632	3%
Total	**122,162,797,536**	100%

During the last 10 years, U.S. insurer exposure to CLOs has been increasing. Notwithstanding, life companies have consistently accounted for the majority exposure, and CLOs have consistently accounted for a relatively small portion of the industry's overall bond investments.

The top 20 insurance companies with CLO exposure accounted for about half of the U.S. insurance industry's total CLO investments at year-end 2018, while the top 10 companies accounted for 34%. The top 10 were all large life companies (i.e., more than $2.5 billion assets under management), a few of which have CLO asset manager subsidiaries. In addition, four of the top 10 companies with CLO exposure are private equity-owned (two of which have CLO management subsidiaries).

In terms of credit quality, as of year-end 2018, 43% ($52.4 billion) of U.S. insurer CLO exposure was rated AAA (see Chart 5), with 81% rated BBB or higher.

Chart 5: U.S. Insurer CLO Credit Quality ($bil BACV)



[6] Please see "A Note on Methodology" below.

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, if a CLO is defined as a loan-backed and structured security (LBASS), then it follows the guidance of *Statement of Statutory Accounting Principles (SSAP) 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." Note that for year-end 2018 reporting, U.S. insurers setting designations for certain securities — including CLOs — were subject to guidance provided by SSAP No. 43R such that U.S. insurers could adjust the rating agency-derived ratings based on BACV. This process was known as Modified Filing Exempt (MFE), and it was deleted effective year-end 2019. As a result, some of the reported designations for CLOs (and other affected securities) may change when year-end 2019 statements are filed, and the data becomes available.

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 2018, U.S. insurers had approximately $122 billion in CLOs under management. Most U.S. insurers' CLO investments were investment grade or higher in terms of credit quality.

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

A Note on Methodology

In calculating U.S. insurers' year-end 2018 CLO exposure, the NAIC Capital Markets Bureau (CMB) revised its methodology to account for misreported securities. As such, year-over-year analysis of U.S. insurers' CLO exposure (from 2017 to 2018) is not comparable. Previously, the CMB calculated CLO exposure based on data that was reported by U.S. insurers in the annual statements, netting out any bonds that were not CLOs. For this year's analysis, the CMB first extracted data reported by U.S. insurers as filed with the NAIC in the annual statements, particularly bonds reported in Schedule D Part 1 and coded as "CLOs/CDOs" in the Collateral Type field for structured securities. Next, any securities that were inadvertently reported as

CLOs in this field were removed from the data set. Then, with assistance from the NAIC Structured Securities Group, and working line by line, the two NAIC teams cross-matched remaining securities that were reported in Schedule D Part 1 with third-party data sources to identify bonds that were not reported as CLOs but should have been. For example, this includes bonds reported in Schedule D Part 1 that were coded as "Other" in the Collateral Type field for structured securities, as well as bonds reported elsewhere in Schedule D Part 1.

Useful Links:

NAIC Capital Markets Primer – Leveraged Bank Loans, November 2018

NAIC Capital Markets Primer—Collateralized Loan Obligations, July 2018