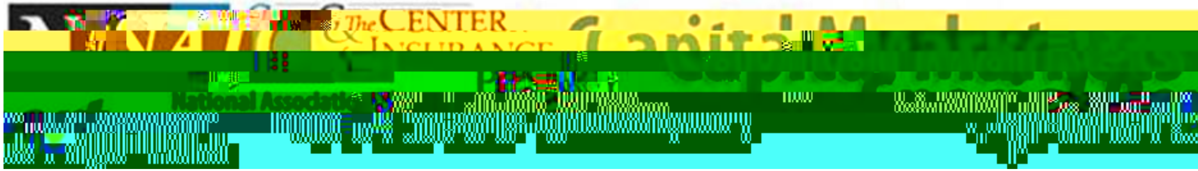


The NAIC's Capital Markets Bureau monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of U.S. insurance companies. Please see the Capital Markets Bureau website at INDEX.

Analyst: Jennifer Johnson

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

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.

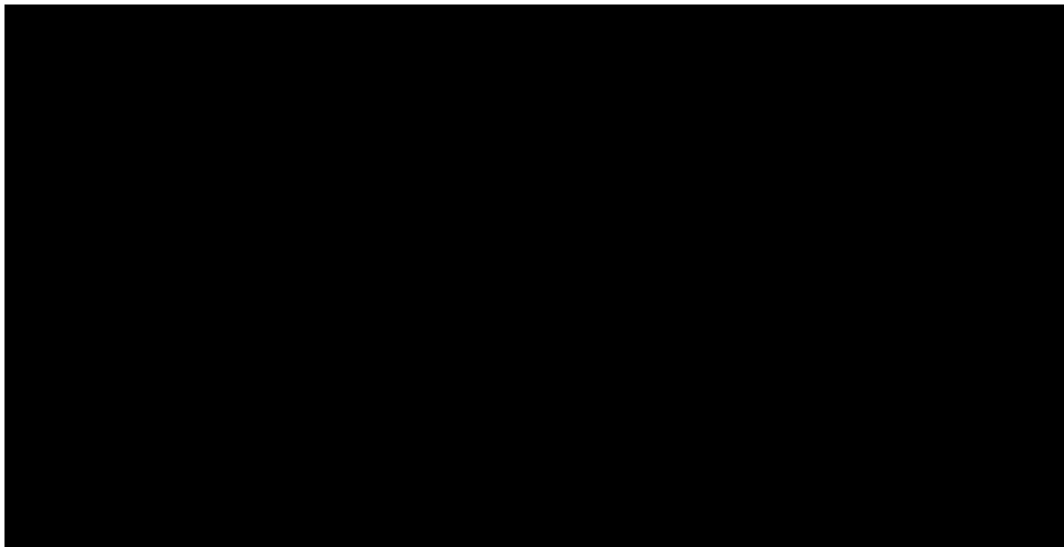
Investor interest in leveraged loans has been fueled in part by expectations of continued interest rate hikes by the Federal Reserve, as increasing interest rates tend to raise investor interest in floating-rate investments, such as leveraged bank loans. CLOs are represent the largest investor of leveraged 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 (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 loancall 2 0.286 0.49 rg0sr8 476. Tf1 0 0 1 155.16 268.49 .122 0.286 0.49 .352 3 EMC /P <MCI

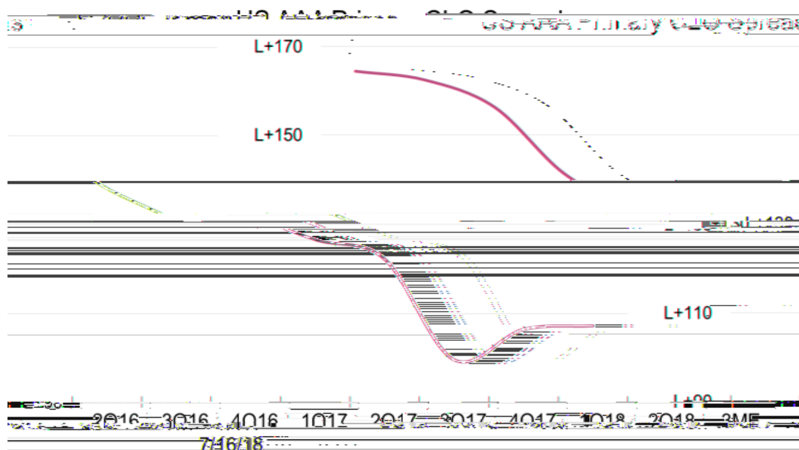
In terms of defaults, for the ten years ending in 2017, the annual leveraged bank loan default rate was below 3% in all but two years according to Fitch Ratings research; it reached 3.2% in 2014 due to a large energy company's bankruptcy, and it peaked at 10.5% in 2009 (see Chart 2). The leveraged bank 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.

Fitch Ratings research identifies CLOs, business development companies (BDCs), alternative asset managers, credit opppor4.03 Tm[(c)-11(re)21(d)3(i)13(t)-12( )9(o)5(p)3(p)3(p)3(o)5(r4.03 Tm[(c)-11(/F3 94(



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.



According to Fitch Ratings research, issuance of MM CLOs tripled in 2017, due, in part, to the continued

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.

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 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).

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%

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

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 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."