

US insurers' exposure to CLOs passed \$132 billion in 2019: AM Best

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The share of collateralized loan obligations in the fixed-income portfolios of life/annuity companies rose to 4.0% in 2019 from 2.7% in 2016, according to the ratings agency.

US life/annuity and property/casualty insurance companies have ramped up their investments in collateralized loan obligations (CLO) in recent years, to \$132.7 billion in 2019 from \$75.1 billion in 2016, according to a new AM Best report.

The asset managers who have been acquiring, investing in, providing investment expertise to life/annuity companies since 2010—Apollo was the first of several—saw the opportunity to profit by investing part of the assets supporting fixed annuities into the investment-grade senior tranches of CLOs.

CLOs are securitized bundles of below investment-grade loans to businesses with strong cash flows but poor credit—like equipment leasing companies, cellphone tower companies and music royalty companies. Certain asset managers have expertise originating the loans inside the CLOs, creating the CLOs, and selling off tranches with different credit ratings to clients with different risk/return targets.

“CLOs have become a popular alternative asset class that insurers have been increasing allocations to as they shift away from traditional investment-grade corporate holdings to mitigate the decline in portfolio yields from maturities and newer low-yielding high-grade corporate assets,” said the Best’s Special Report, “Collateralized Loan Obligations Holdings Continue to Grow, But Exposures Are Manageable.”

Rated life/annuity insurers drove growth of more than 40%, to more than \$114 billion in 2019 from \$65 billion in 2016. The rated property/casualty insurers also have also increased their CLO holdings during the same period, by about 45% to \$18.5 billion.

The steady rise has pushed the share of CLOs in the fixed-income portfolios of life/annuity companies to 4.0% in 2019 from 2.7% in 2016. Property/casualty companies’ exposure is lower—still below 3%—but is also growing.

According to the report, the investor-friendly structural features and protections of CLOs have attracted insurers. For example, CLOs cannot short securities or use derivatives, as well as over-concentrate, over-lever or stray from tight indenture requirements.

"Historically favorable performance, attractive yield and credit quality have further made CLOs appealing to insurers," AM Best said in a release. "As a result, not only have insurers been expanding their positions, but there also has been steady growth of companies newly investing in this asset class."

The credit quality of the US insurers' CLO exposures has declined slightly from 2018. The underlying fundamentals of the leveraged loan market and a possible mismatch between risk and rating emanating from the COVID-19 pandemic could exacerbate fears of a decline in CLO performance and foreshadow downgrades and write-downs.

However, AM Best notes that the majority of the insurance companies' exposure has been in senior and higher-quality tranches that are less likely to default.

"In the event of credit rating downgrades to CLO securities, insurers with larger exposures may be hit with higher capital charges," said Jason Hopper, associate director, industry research and analytics.

"Worsening performance and potential write-downs also would further pressure risk-adjusted capital levels for some, although the far majority of insurers' CLO exposure is held by carriers at the high end of AM Best's credit rating scale."