A Leading Global Investment Management Firm

Viewpoint

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Amid CLO Downgrades, Monitoring, Stress Testing, Robust Credit Analysis Key for Insurers

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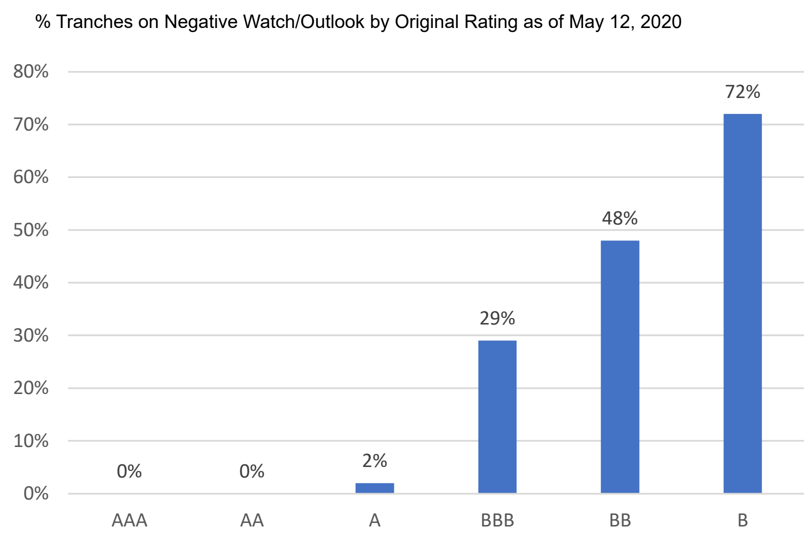
Amid a decade of historically low interest rates, insurance companies have been forced to search beyond traditional fixed income securities for alternatives that provide additional yield to their portfolios without increased credit risk. As a result, insurers' exposure to collateralized loan obligation (CLO) debt securities increased in the past decade as they learned more about certain advantages and protections offered by the structure. CLO assets in insurance portfolios reached $158 billion at the end of 2019, according to the National Association of Insurance Commissioners (NAIC), with a bias to high quality: 61% of CLO securities held by insurers were rated AAA or AA.[1]

The COVID-19 pandemic has led to downgrades across the investment spectrum, including CLOs. While the pandemic's full impact has yet to be determined, some current analyses[2,3] suggest that CLO securities rated AAA and AA may face minimal downgrade pressure, except in cases of extreme and prolonged financial stress. These findings bolster the case that higher quality CLO debt tranches may be an appropriate option for insurance company portfolios, but ongoing monitoring, stress testing and credit analysis of CLO securities are still recommended to safely navigate today's challenging market conditions.

Conning's expertise in managing CLO securities for insurance companies is bolstered through its affiliate Octagon Credit Investors, a credit manager founded in 1994 focused on bank loans and CLOs. Conning's deep understanding of insurance accounting, combined with Octagon's expertise and longstanding experience in the bank loan and CLO asset classes, can be a benefit as insurers seek to stress-test their CLO holdings, navigate any potential impact of downgrades, and stay focused on their long-term goals. (For additional background on CLOs, please review our webinar and Viewpoint.)

Figure 1 US BSL CLO tranches placed on negative watch/outlook are concentrated in originally-rated BB and single-B tranches



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Pressure Rising on Bank Loans

The current pressures on CLOs stem from their collateral pools, which consist of broadly syndicated senior secured bank loans ("BSL"). These companies/borrowers are facing rating downgrades due to the fallout from COVID-19 and the unprecedented government response forcing closure of a large swath of the economy. Challenging end markets and supply-chain disruptions have meaningfully impacted the bottom lines of many loan issuers; as such, rating agencies have acted quickly toward the sectors hit hardest by the virus, including Hotels/Restaurants/Leisure, Consumer Services, and Specialty Retail. At the end of April, a record $119 billion of loans were rated CCC, which represents 10% of the existing loan market.[4] Market participants expect this trend to continue, albeit at a slower pace.

The sharp increase of downgrades in the bank loan universe has led to follow-on concern for CLOs, with rating agencies already placing more than 1,000 CLO tranches on review for potential downgrade. This pressure is concentrated on the subordinated and lower mezzanine tranches (see Figure 1), but it reaches across the market: 89% of all U.S. CLO managers have a tranche from at least one deal on watch.[5]

In light of this increasing pressure from the rating agencies, it bears noting that the CLO structure has historically been resilient during periods of market turbulence, and most CLO tranches have rewarded investors for their patience. There has never been a default of a CLO security rated AAA or AA since the CLO market's inception in 1994, and historical default and recovery rates for CLO securities have outperformed those for similarly rated corporate securities. Moreover, the structure was further enhanced after the global financial crisis to offer additional protections to CLO debt investors.

While further downgrades of CLO securities are likely, the National Association of Insurance Commissioners' (NAIC) designations 1 through 6 are what directly impact insurers' portfolios. (The NAIC uses the ratings of nine Nationally Recognized Statistical Rating Organizations [NRSROs] to calculate its designations.) Downgrades from the various independent agencies, however, are a warning to insurers (and/or their asset managers) to re-evaluate the CLO securities in question to assess the potential portfolio impact.

Higher Quality Securities

The pressing question for rating agencies and investors alike is whether CLOs will once again prove themselves to be stalwarts during the current COVID-19-related market dislocation as they have been during other periods of stress, most notably during the global financial crisis. During that period, loan defaults peaked at 9.6% while CCC-rated loan exposure topped out at 8.5%.[6] In a recent report, Standard & Poor's (S&P) examined the potential impact on CLO securities under a number of hypotheticals with varying degrees of economic stress, including one example which included a default rate of 10% (up from 2.3% at the end of April), and CCC exposure of 20% (twice the level of April 30).[7] Under these conditions, the projected ratings impact at the top of the CLO liability stack would be minimal, with only a small percentage of AAA (8%) and AA (17%) tranches subject to any downgrade risk, the result of which in almost all cases would be limited to a one-notch move, thus preserving their NAIC 1 rating status.[7]

Moreover, the projections are also encouraging for holders of the A tranche. While S&P anticipated downgrades for 65% of A tranches in this scenario, all are projected to remain at the A or BBB level post-downgrade, again maintaining their status as investment grade.[7] Without question, downgrade risk intensifies as more dire market conditions are considered, as demonstrated in additional scenarios examined by S&P.

Impact of CLO Downgrades on Insurance Portfolios

Based on its long-standing track record and well-developed expertise with insurers, Conning understands the accounting implications that downgrades can have on insurance company portfolios. In particular, Conning works closely with clients to determine the potential impairment of certain securities in their portfolio.

In overseeing their clients' CLO holdings, Conning and Octagon proactively look for potential areas of concern and continually monitor multiple factors that could lead to a security downgrade or impairment, including the market value of each security (versus book value), the weighted average price migration and CCC exposure in the underlying loan portfolios, and the current status of the CLO portfolio quality (i.e., interest diversion and over-collateralization) tests.

When this ongoing portfolio monitoring process indicates that a security will still be able to make all of its interest and principal payments as scheduled, no special accounting treatment is needed for that position. However, if it is determined that there is some risk to meeting these obligations, discussions with clients will center around impairing the security.

In addition, once the NAIC lowers a security's designation, the statutory accounting treatment (book-adjusted carry value) differs for property/casualty (P/C) and life companies. For both, if the security remains investment grade (NAIC 1 or 2), the impact is negligible with respect to risk-based capital charges and insurers can continue to carry the security at amortized cost.

For P/C companies, once a security falls below investment grade (becoming NAIC 3 or lower) it must be carried at the lower of fair market value or amortized cost, while for life companies that treatment is required only once the security becomes NAIC 6. Additionally, the downgrade to below investment grade will directly affect a P/C company's surplus, which could hamper its ability to write business.

If it's determined the security won't meet all interest and/or principal obligations and must be impaired, statutory rules require a write down to the fair market value.

Selling the security still requires an insurer to write it down first. For life companies looking to sell, if the downgrade is only one NAIC level (e.g., NAIC 1 to 2), then any gain/loss is captured in the interest maintenance reserve and is amortized over the remaining life of the security. However, if it falls more than one NAIC level, the loss is captured in the asset valuation reserve and affects surplus.

Summary

As many insurers are invested in investment-grade CLO securities, mainly in the AAA and AA tranches, their risk of ongoing CLO downgrades is low. However, with the pandemic still underway, the outcome for the corporate credit markets is still far from certain.

We believe that investment expertise is key when investing in CLO securities, particularly in today's challenging environment. Of paramount importance in selecting CLO securities, regardless of their rating, is a keen understanding of the loan market and the mechanics of the CLO structure. Both are critical when gauging how a CLO will perform when stressed. Octagon's expertise and experience in the loan market is a key benefit, especially when investing in A-rated (and lower rated) securities. Today's market environment reminds us that CLOs are not all alike and investors should favor managers that have a disciplined and proven investment process.

Conning continues to urge insurers to build well-diversified portfolios to withstand inevitable market disruptions. We consider CLO debt securities an asset class that may provide favorable spreads relative to similarly rated corporate debt and longer-term capital preservation through structural protections and investor-oriented covenants designed to mitigate against risk of default. Our understanding of insurance portfolio management, coupled with Octagon's expertise in CLOs, may offer insurers the valuable guidance they need to respond to today's market conditions and stay focused on their long-term needs.

Daniel Mainolfi, CFA, is a Managing Director and Portfolio Manager, responsible for general account assets for life, health and property-casualty clients. He joined Conning in 1992 and is a member of the firm's Investment Policy Committee and co-manages a team of portfolio managers. Mr. Mainolfi has more than three decades of experience managing insurance portfolios across all asset classes and sectors. Mr. Mainolfi earned a BA in finance and investments from Babson College.

Doug McDermott joined Octagon Credit Investors in 2016 and serves as a Managing Director of Business Development and Client Portfolio Manager, with responsibilities for product development, capital formation and investor relationships. He came to the firm from Deutsche Bank, where he was most recently Managing Director & Head of Loan Sales. Previously he was an investment banker in Deutsche Bank's Financial Sponsors and Leveraged Finance Groups and was an attorney at Simpson Thacher and Bartlett, specializing in mergers & acquisitions and securities transactions. Mr. McDermott earned a BA in government & law from Lafayette College and a JD from Boston College Law School, and holds FINRA Series 7, 63 & 24 registrations.

About Octagon Credit Investors, LLC

In 2016, Conning acquired a majority stake in Octagon Credit Investors, LLC (www.octagoncredit.com), a below-investment grade corporate credit investment adviser. Octagon has more than 25 years of experience managing CLOs, bank loans and high yield bonds on behalf of institutional investors.

About Conning

Conning (www.conning.com) is a leading investment management firm with a long history of serving the insurance industry. Conning supports institutional investors, including pension plans, with investment solutions and asset management offerings, award-winning risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.

CLO Risk Factors

Risk factors include but are not limited to the below; for further discussion of material risks, please refer to Octagon's Form ADV Part 2A.

Structure: CLOs often involve risks that differ from those associated with other types of debt instruments. The complex structure of the security may produce unexpected investment results not based on default or recovery statistics. Ratings agencies may downgrade their original ratings of CLO debt tranches. Majority equity holders retain the right to call or refinance/reprice a CLO, creating cash flow variability for minority equity and debt holders.

Liquidity: CLOs may be difficult to value and may constitute illiquid investments. Valuation of structured credit products are provided by third parties, based on models, indicative quotes, and estimates of value, in addition to historical trades. There is inherent difficulty in valuing these assets, and there can be no assurances the assets can be disposed of or liquidated at the valuations established, or that published returns will be achieved.

Default: During periods of economic uncertainty and recession, the incidence of modifications and restructurings of investments may in-crease, resulting in impairments to the underlying asset value and reduced "subordination" to the CLO liabilities.

Regulatory: Volcker Rule provisions in section 619 of the Dodd–Frank Wall Street Reform and Consumer Protection Act could affect liquidity, returns, and new CLO creation.

General Market and Economic Conditions: Changing economic, political, regulatory or market conditions, interest rates, general levels of economic activity, the price of securities and debt instruments and participation by other investors in financial markets may affect the value of CLOs and all other asset classes.

Disclosures

Past performance is not a guarantee, predictor or indication of future results. Similar investments likely would produce different results under different economic and market conditions.

These materials contain forward-looking statements. Investors should not place undue reliance on forward-looking statements. Actual results could differ materially from those referenced in forward-looking statements for many reasons. Forward-looking statements are necessarily speculative in nature, and it can be expected that some or all of the assumptions underlying any forward-looking statements will not materialize or will vary significantly from actual results. Variations of assumptions and results may be material. Without limiting the generality of the foregoing, the inclusion of forward-looking statements herein should not be regarded as a representation by the Investment Manager or any of their respective affiliates or any other person of the results that will actually be achieved by the fund. None of the foregoing persons has any obligation to update or otherwise revise any forward-looking statements, including any revision to reflect changes in any circumstances arising after the date hereof relating to any assumptions or otherwise.

1. Source: Barclays Credit Research, "CLOs – Making Moves on a Friday Night," April 20, 2020. Used with permission. Source: Barclays Credit Research, "CLOs – Making Moves on a Friday Night," April 20, 2020. Used with permission.
2. Source: Barclays Credit Research, "CLOs – Making Moves on a Friday Night," April 20, 2020. Used with permission. Source: Barclays Credit Research, "CLOs – Making Moves on a Friday Night," April 20, 2020. Used with permission.
3. Source: S&P Global Ratings, "U.S. CLOs, Corporate Loans & COVID" webinar, May 12, 2020. Used with permission.
4. Source: LCD, an offering of S&P Global Market Intelligence, Copyright 2020. "Leveraged loans gain 4.50% in April, staunching COVID-related losses," May 1, 2020. Used with permission.
5. Source: Barclays Credit Research, "CLOs – Making Moves on a Friday Night," April 20, 2020. Used with permission.
6. Source: Data Query, S&P Global Market Intelligence, a division of S&P Global Inc, Copyright 2020. S&P/LSTA Leveraged Loan Index. May 12, 2020.
7. Source: S&P Global Ratings, "U.S. CLOs, Corporate Loans & COVID" webinar, May 12, 2020. Used with permission.

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