

Interest Rates May Be Falling, But Insurers' Demand for CLOs Holds Firm

- We believe CLOs remain compelling investments for insurers despite falling interest rates.
- Insurers are well positioned to benefit from CLOs' potential spread premium over other asset classes, which is attributable largely to their complexity, high levels of regulation, and perceived levels of illiquidity.
- Resilient leveraged loan market fundamentals and transparency into National Association of Insurance Commissioners (NAIC) regulatory changes lend further support to CLO investments for insurers.

Collateralized loan obligations (CLOs) have delivered impressive investment yields in the past few years, but the onset of falling interest rates raises some key questions. Should insurers continue to invest in these floating-rate assets? Or should they instead lock in fixed rates elsewhere?

We believe that the tradeoff between fixed and floating benchmark rates is fairly valued overall, and that floating-rate assets such as CLOs that offer an attractive risk-adjusted spread will remain in high demand. In addition, resilient leveraged loan market fundamentals and transparency into National Association of Insurance Commissioners (NAIC) regulatory changes lend support to CLO investments.

In our view, this is why insurers continue to invest in CLOs, even though further Fed rate cuts are likely – and why we think CLOs will remain compelling investments for insurers.

Benchmark rate differential is largely priced in

Interest rate markets tend to be quite efficient, and we believe today investors can be largely indifferent as to investing in floating-rate products or their fixed-rate equivalents, all else being equal.¹

For example, on 1 October 2024, a five-year average life floating-rate CLO note earned 4.6% (three-month SOFR) plus a spread, while a fixed-rate corporate bond with the same average life was paid 3.5% (the five-year US Treasury rate) plus a spread. Because the yield curves were inverted, floaters such as CLOs earned a higher benchmark rate than that for fixed-rate bonds. However, CLO debt tranches are typically priced off three-month SOFR, which resets every quarter. Based on the three-month SOFR forward curve, a five-year CLO note would earn an average benchmark rate of 3.4% over its life after adjusting for the resets.² Thus, the true benchmark rate differential was only about

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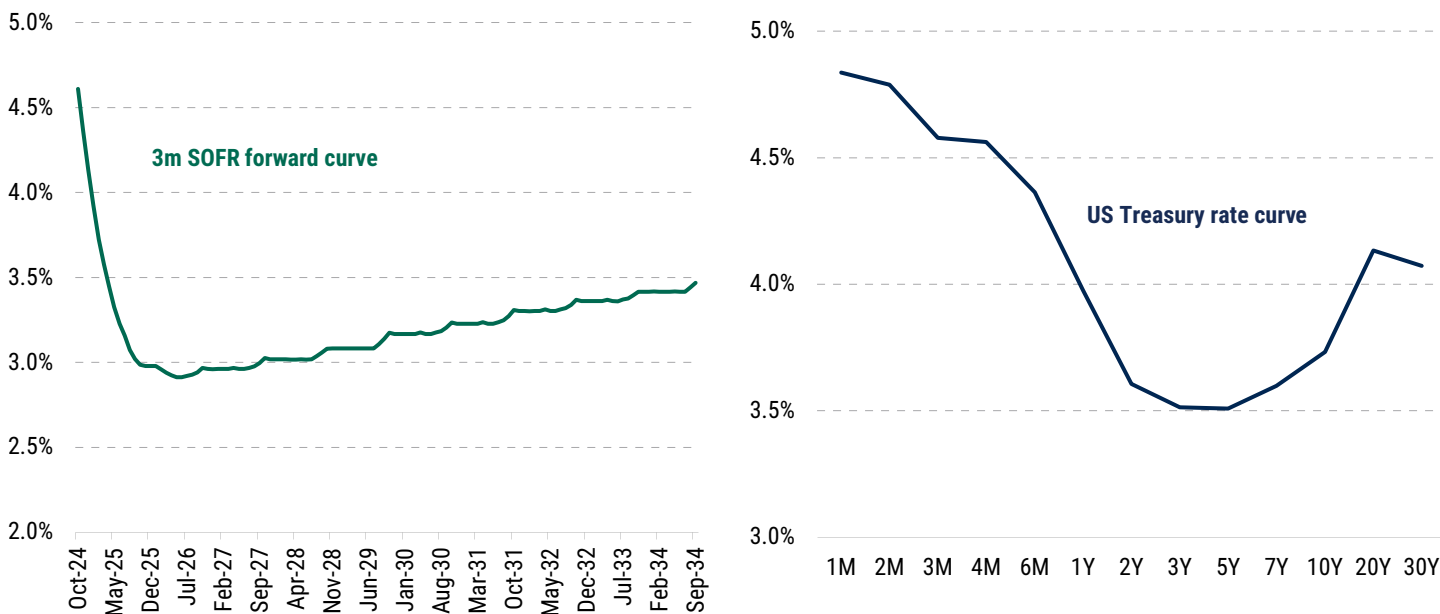
¹ Here, we use a simplified example that is based purely on the benchmark rate difference and not incorporating any assumptions on specific CLO terms, such as portfolio construct, capital structure, reinvestment features, etc.

² We used quarterly geometric average for compounding across five years based on Bloomberg three-month SOFR forward curve on 1 October 2024.

10 basis points in this example – underscoring the relative equivalency between floating- and fixed-rate products (again, all else being equal).

That said, if insurers have a different view on the path of future interest rates than what has already been embedded in the forward curve, they may take a fixed- or floating-rate position to capitalize on that view.

Three-Month Forward SOFR and Treasury Curves



Source: Bloomberg as of 1 October 2024.

Insurers are well positioned to earn CLO yield premiums

In our view, CLOs are an attractive investment for insurers in part because they offer a material spread premium over other asset classes, largely attributable to their complexity, high levels of regulation, and perceived levels of illiquidity. This positions insurers well to earn CLO premium income, for several reasons.

CLO complexity premium. The collateral underlying a CLO consists of a dynamic pool of actively managed leveraged loans, and CLO tranches contain call and reset/refi features that require financial expertise. Though CLO debt spreads are set at issuance, asset spreads, equity distributions, and manager performance are all dynamic – and there is an inherent yield premium associated with this complexity. Insurers can mitigate the complexity risk by performing diligent portfolio analysis, structural and legal reviews, and manager selection.

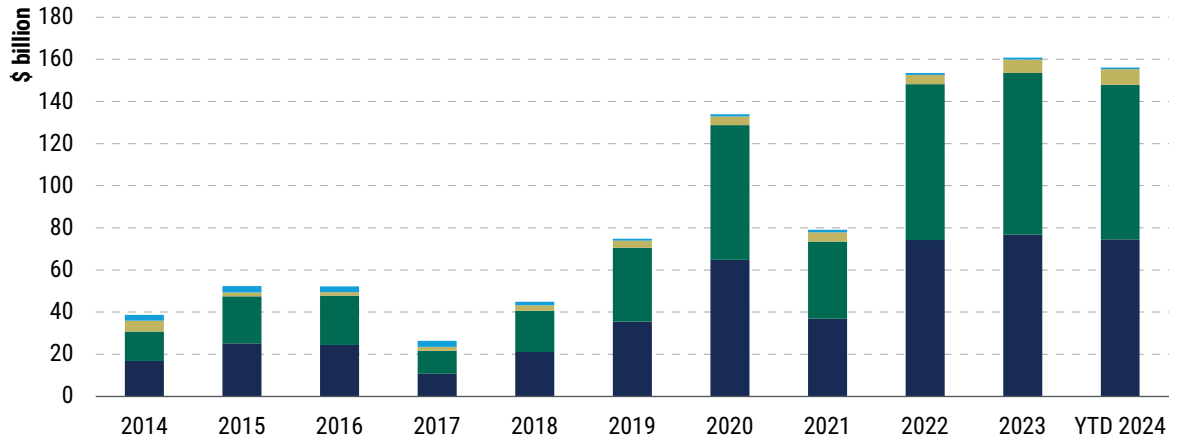
CLO regulation premium. The majority of investment grade tranches are owned by banks and insurance companies. Both banks and insurance companies are highly regulated. Both also have relatively high risk-based capital charges, depending on the rated tranche owned. As a result, banks and insurance companies require a minimum spread to make the investment appealing on an RBC basis.

CLO perceived illiquidity premium. CLOs are typically SEC 144A issuances, which are investable only by qualified institutional buyers (QIBs) under certain conditions. Relative to publicly registered bonds, CLOs have a smaller buyer base and therefore tend to be less liquid. While this relative illiquidity has become less of a factor given the remarkable growth of the CLO market (to roughly \$1.2 trillion currently) and an active secondary market, as evidenced by increased trading volumes (see chart), the market still prices in a perceived level of illiquidity premium for owning CLO tranches. Further, insurance liabilities may be long-dated and reasonably predictable – as they are for most life insurance and workers’ compensation writers – which means that insurers can invest in less-liquid assets at higher yields. Moreover, insurers typically specialize in running asset-liability matched portfolios and are well positioned to earn an illiquidity premium.

CLO Trading Volumes Show the Illiquidity Premium May Be More Perception Than Reality

IG-rated CLO/CDO trading volume reported by TRACE

- Residual
- Dealer to dealer trade volume
- Customer sell trade volume
- Customer buy trade volume

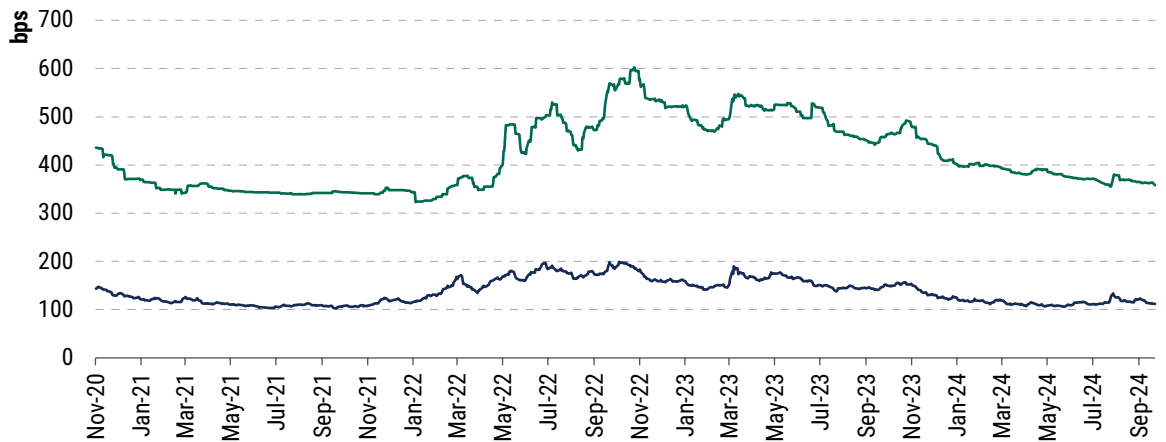


Source: Morgan Stanley Research, FINRA, TRACE as of 30 September 2024.

CLOs Offer Attractive Spreads

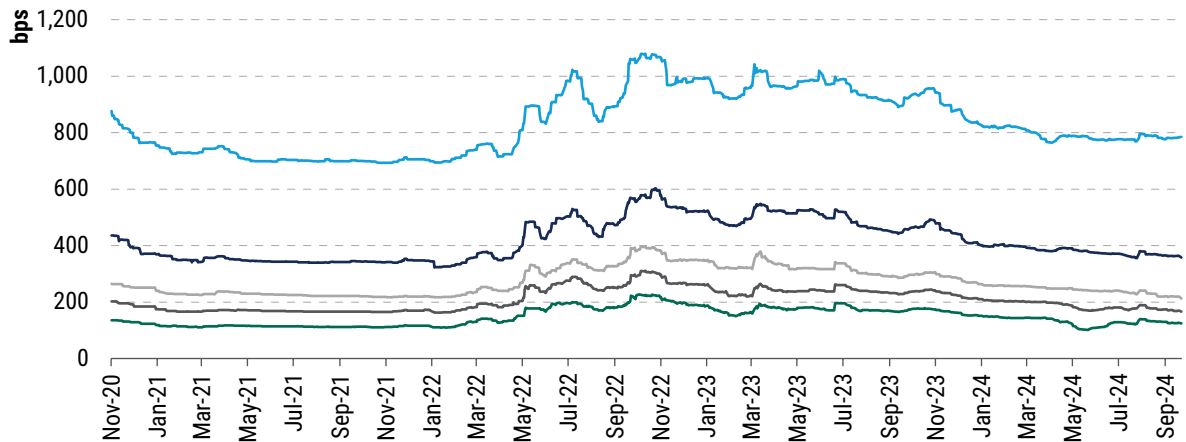
BBB spreads

- CLO BBB
- Corporate Baa



CLO spreads

- CLO AAA
- CLO AA
- CLO A
- CLO BBB
- CLO BB

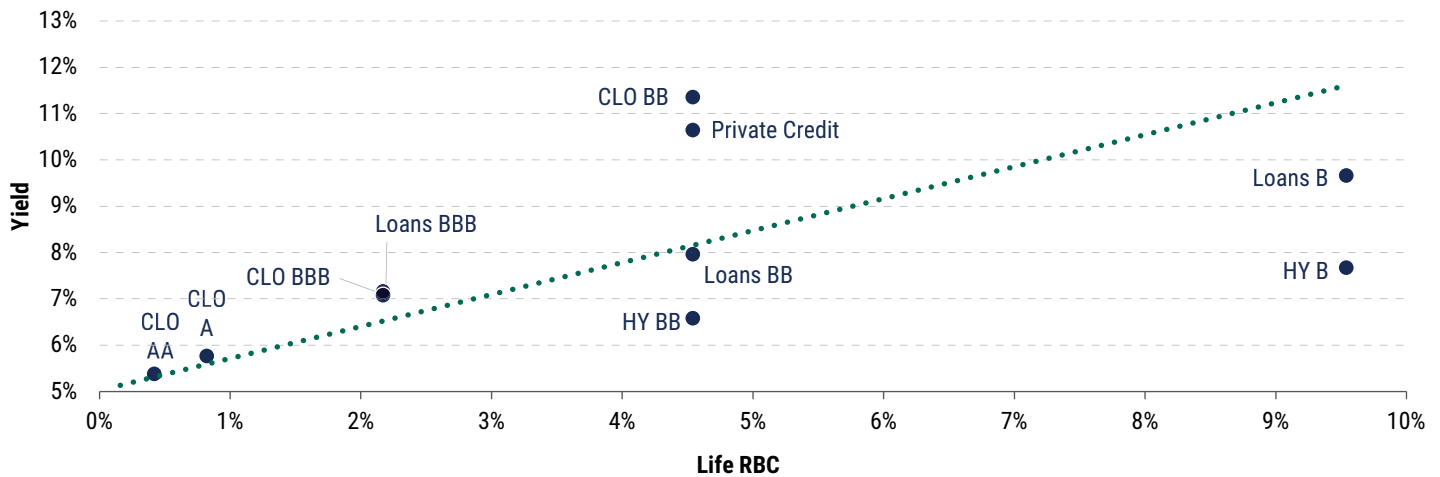


Source: Bloomberg and JPMorgan as of 30 September 2024.

CLOs tend to earn higher yields per unit of RBC charge

CLOs also generally earn higher yield per unit of market risk and per unit of risk-based capital (RBC) charge relative to single-name corporate bonds and leveraged loans. As the chart shows, investors in CLO tranches have generally earned above-the-line yields on an RBC-adjusted basis.

CLOs Have Earned Higher RBC-Adjusted Yields



As of 30 September 2024. Sources: CLO data JPM CLOIE. US Corps data Bloomberg US Credit Index. Loan data Morningstar LSTA Leveraged Loan Index. High Yield data Bloomberg US Corporate High Yield Index. Private Credit data LSEG LPC Middle Market First Term Lien Direct Lending Only. CML yields are observed market data, Blue Vista. For illustrative purposes only. We are not soliciting or recommending any action based on this material. This information does not imply that any investor recommends or otherwise endorses an investment in any fund or other product and the materials are not intended to convey any client approval or disapproval of the advisory services.

Leveraged loans and CLOs are poised to weather the rate-cutting cycle

Leveraged finance assets may be vulnerable during rate-cutting cycles, largely because rate cuts are often accompanied by recessionary environments, which may lead to higher default rates. However, we are entering this rate-cutting cycle at a time when economic growth, while slowing, remains firm; unemployment is relatively low; and the chances of a soft landing are high – a fundamental economic picture that is supportive of leveraged finance.

A key benefit of rate cuts to the leveraged loan market is that a subset of issuers – particularly loan-only capital structures – have experienced constriction in cash flows due to high floating rates. Falling rates will provide immediate relief, benefiting cash flows and in turn improving the fundamental ratios and outlooks for these issuers. In addition, CLOs are now much more dominant buyers of leveraged loans than they were even a decade ago, representing 70% of the US leveraged loan market, which supports demand and makes loans more resilient from a technical standpoint.

New regulatory treatment is likely favorable for senior CLO tranches

The NAIC's RBC framework measures the minimum amount of capital required to support overall business operations. The NAIC has been rethinking the regulatory frameworks for structured securities, specifically regarding their designations and RBC charges, due to considerations around "equal risk, equal capital" across collateral portfolios and capital structures. Given CLOs' highly transparent data and documentation, they have become another asset class for which the NAIC is pursuing a model-based designation approach, in addition to residential and commercial mortgage-backed securities (RMBS and CMBS). Separately, the NAIC, in partnership with the American Academy of Actuaries (AAA), plans to revise RBC charges for CLOs and for asset-backed securities more broadly.

Overall, we expect the model-based designations to be largely unchanged for senior or higher-rated tranches. More clarity is likely by year-end 2025, and the NAIC has stressed transparency and aims to offer a prescribed methodology for assigning the model-based CLO designations. A few recent developments include:

- In June 2024, the NAIC adopted a Purposes and Procedures (P&P) Manual Amendment for the implementation of CLO model-based designations and changed the effective date to 2025 from 2023.
- In September 2024, as a key step toward establishing NAIC model-based designations, the NAIC's Structured Securities Group (SSG) released its modeling results (including projected losses) for about 1,900 broadly syndicated loan CLOs. The losses were measured across 10 scenarios with varying default and loss assumptions.
- The NAIC CLO Ad-Hoc Group (for which PineBridge is a designated speaker and the only third-party asset manager) met the week of 30 September 2024 and decided to revise certain reinvestment assumptions.
- The next thing to watch is the NAIC's release of its updated modeling methodology, reflecting the new reinvestment assumptions and revised modeling results. And importantly, a set of probabilities will be determined and assigned to the 10 scenarios.
- Market consensus seems to be that the model-based designations will be either largely unchanged or better than the FE (filing exemption)-based designation for higher-rated tranches (AAA, AA, A). The outcomes may be mixed for BBB CLO tranches and negative for BB and below rated tranches.
- It remains to be seen how the SSG's modeling results may or may not be used as an input to the NAIC's parallel ongoing effort to revise RBC charges to CLOs and more broadly to other structured securities overall.

The table below offers a comprehensive summary of current asset risk charges for insurers' CLO investments, although the NAIC RBC charges for CLOs may change as early as 2026.

Summary of Key Regulatory Capital Charges

Rating	Designation	NAIC (RBC)			S&P Capital	AM Best Capital (BCAR)	Bermuda Capital (BSCR)		
		Life	P&C	Health	All	All	BSCR Class	Corp/ Sov	Structured
AAA	1.A	0.16%	0.20%	0.30%	0.25%	1.10%	1	0.40%	0.50%
AA	1.C	0.42%	0.60%	0.80%	0.79%	1.10%	2	0.80%	1.00%
A	1.F	0.82%	1.30%	1.60%	2.25%	1.10%	3	1.50%	1.80%
BBB	2.B	1.52%	2.10%	2.50%	4.24%	4.70%	4	3.00%	3.50%
BB	3.B	4.54%	6.00%	7.60%	14.08%	11.70%	5	8.00%	10.00%
B	4.B	9.54%	7.70%	9.70%	23.12%	22.90%	6	15.00%	20.00%
CCC	5.B	23.80%	10.90%	13.70%	88.66%	42.70%	7	26.30%	30.00%
D	6	30.00%	30.00%	30.00%	100.00%	54.80%	8	35.00%	35.00%

Source: National Association of Insurance Commissioners (NAIC) as of October 2024. S&P charges are based on 99.8% confidence interval or A stress for structured securities with five- to 10-year maturity. AM Best data are based on the latest criteria published in April 2018. Bermuda capital charge (BSCR) data as of 2024.

CLOs remain compelling investments for insurers

Despite Fed rate cuts, we expect insurers to remain invested in or increase allocations to floating-rate asset classes such as CLOs. While the tradeoff between fixed and floating benchmark rates is largely priced in, by investing in CLOs, insurers may earn an attractive risk-adjusted yield, largely attributable to complexity, regulatory, and perceived illiquidity premiums. In addition, CLO investing is supported by resilient fundamentals in the leveraged loan market and more clarity about regulatory changes that will affect CLOs in the coming years. All told, we believe CLOs remain compelling investments and that insurers are well positioned to benefit from their advantages.

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