INSURANCE SOLUTIONS

CLOs: Striking Insurers' Balance for Yield Potential & Capital Preservation

How CLOs can provide a capital-efficient way to enhance North Americans insurers' public fixed income portfolios.

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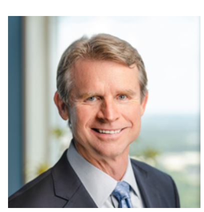

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The secret is out. By design, structured credit seeks to provide diversified exposure and structural protection, particularly for investment grade (IG) investors, reducing their overall credit risk exposure. At the same time, the perceived complexity of the asset class provides the potential for higher spreads on a like-for-like basis in credit rating and regulatory capital. As a result, as highlighted by the NAIC, "ABS and Other Structured Securities"[1] has been one of the fastest growing groups of asset class categories for U.S. insurers in recent years.[2]

The most commonly used asset class within this broader category is collateralized loan obligations (CLOs), accounting for over 40% of U.S. insurers' allocations.[3] The efficiency features of securitized assets are particularly pronounced for CLOs, given that the underlying collateral is, in addition, actively managed. This allows managers to generate alpha and manage risk at both the underwriting stage and throughout the securitization's lifecycle. In addition, CLOs can offer a higher level of liquidity and transparency compared to alternative assets, enhancing insurers' public fixed income portfolios.

What is a CLO?

A CLO is an actively managed securitized product backed by a highly diversified pool of leveraged loans. CLOs aim to provide an efficient, scalable way of investing in floating-rate loans while offering structural protection that has historically performed well through multiple credit cycles.

To simplify, think of a CLO as a company that raises money from debt and equity investors to purchase a pool of diversified senior secured first-lien corporate loans, "**the assets**."

Broadly speaking, there are two main types of CLOs with underlying loans lending to different types of borrowers:

Broadly Syndicated Loan (BSL) CLOs are backed by a highly diversified pool of over 200 leveraged loans from large (greater than $100 million EBITDA), well-known borrowers, such as United Airlines, Virgin Media and Burger King. The underlying loans typically have sub-investment grade credit ratings assigned by a major credit rating agency such as S&P, Moody's or Fitch, with a typical weighted average rating between B and B-, and are distributed among a broad 100+ syndicated lender group. As a result, these loans are quite liquid and tradeable.

Private Credit CLOs, also known as middle market CLOs, are typically backed by more concentrated pools of loans to mid-sized companies with EBITDA values between $15 and $75 million.[4] However, in recent years there has been an uptick in private large-cap CLOs which include larger EBITDA companies from the private credit market. The underlying loans in private credit CLOs are typically unrated or privately rated loans and are syndicated to a smaller lending group. As a result, these pools of loans are often less liquid and rarely traded in the secondary market. On the positive side, middle market loans offer more control to the lender group through tightened credit agreements and more covenants. These covenants allow lenders to work more directly with a company's management team and step in earlier in the process when signs of distress occur—which can ultimately lead to improved recovery rates. Additionally, many of these loans are backed by private equity sponsors who offer added forms of support for borrowers in times of distress via documentation amendments and/or capital infusions that can provide further protection for lenders. Finally, because these loans are directly originated, regulations require the CLO manager to hold 5% of the deal notional to have "skin in the game" and align interests with investors.

1 In other words, structured assets excluding (agency and non-agency) RMBS and CMBS.
2 Source: NAIC. As of December 31, 2023.
3 Source: NAIC. As of December 31, 2023.
4 Source: Barings.

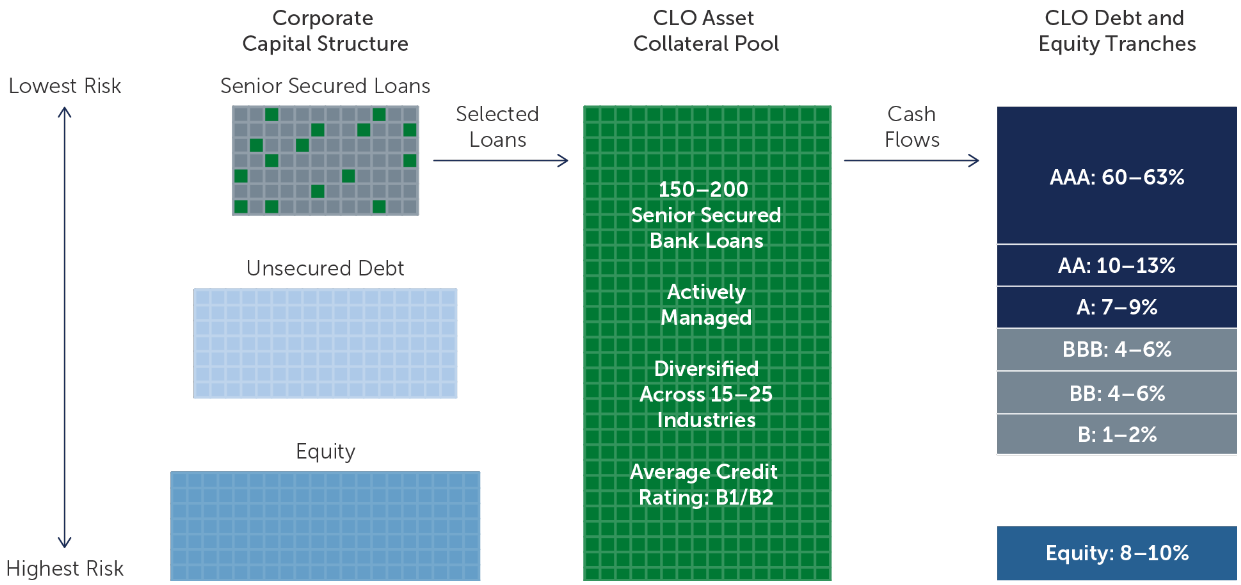
Juxtaposed with the assets are the debt obligations, or "**the liabilities**," which are sliced into "tranches" that re-distribute the risk of direct exposure to the portfolio of loans by offering tiered credit enhancement and structural protections. A typical CLO structure combines five or more classes, from the senior most tranche rated AAA down to the most junior and highest-yielding debt tranche rated BB-. This allows investors to choose the risk/return profile that is suitable to their specific objectives. The CLO tranches pay a floating-rate coupon, like the assets, and are due a coupon on a quarterly basis.

After paying off expenses and liabilities, a residual unrated "**CLO Equity**" tranche captures the excess spread (returns) that the assets generate. As the equity tranche is leveraged exposure to the underlying leveraged loans, it is the riskiest piece of the CLO structure; however, it can also be the most lucrative.

The majority of CLOs are actively managed. Collateral managers construct the portfolio during the ramp-up period and trade in and out of positions during the reinvestment period, with the intent to minimize credit losses and maintain or build par while navigating the investment constraints of a CLO.

Since product inception in the mid-1990s, the CLO market has grown to over **$1.3 trillion**.[5] BSL CLO tranches are actively traded in secondary markets, providing more transparent market values than other illiquid asset classes. However, it is worth noting that private credit CLOs are not as actively traded in the secondary market due in part to the lower transparency on ratings.

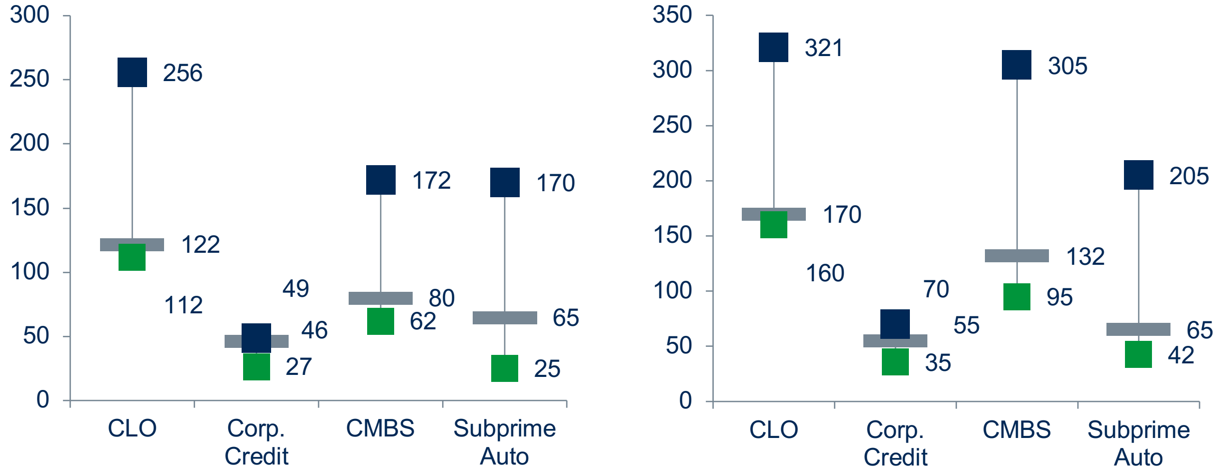
Figure 1: Typical U.S. BSL CLO Structure



Source: Barings.

5 Source: BofA. As of March 14, 2025.

Figure 2: AAA/AA CLO relative value to similar asset classes (September 2020–February 2025)



Sources: CLO spread source: J.P. Morgan. As of February 28, 2025. Corporate Credit and CMBS spread source: Barclays. As of February 28, 2025. Subprime Auto Spread to Swap source: Bank of America. As of February 28, 2025.

How CLOs Work—Structural Features

In addition to the to the diversification and senior secured nature of the underlying loans of the collateral pool mentioned above, CLOs can provide structural protection to investors through the following mechanisms.

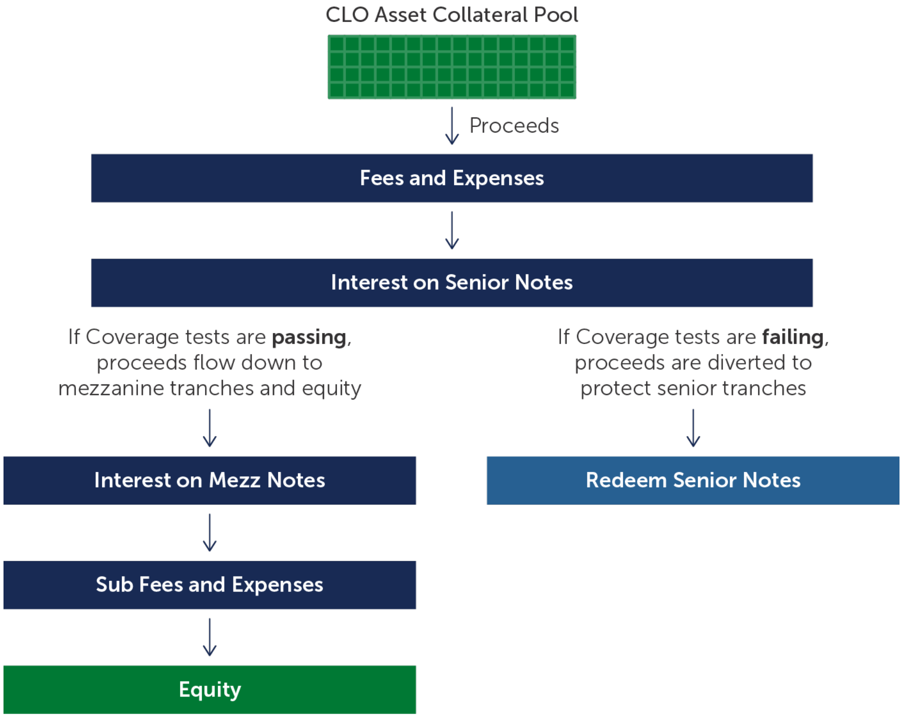
Waterfall

Cash flows from the collateral pool are dispensed via a waterfall that pays the debt, in order, based on seniority, with the highest-rated tranches paid first, followed by the mezzanine tranches and, finally, the equity tranche. If the assets in the underlying collateral pool generate sufficient proceeds, the top tranche (the AAA senior-most tranche) is paid first, followed by the AA tranche and so forth. The equity tranche at the bottom catches all the remaining overflow.

Early warning triggers

During the CLO lifecycle, should some assets perform poorly or default, CLOs employ early warning triggers to divert proceeds to protect the more senior tranches. One of these is called the overcollateralization test (OC Test). The OC Test ensures there is a sufficient ratio of assets to liabilities. If the OC Test ratio is breached, the payments that would have flowed through to equity are diverted to pay down senior classes or purchase additional assets until that ratio is back in compliance.

Figure 3: CLO Waterfall



Source: Barings.

Subordination

While payments are distributed in order of seniority, losses are applied in the reverse order. CLO equity is also called the first loss piece and typically absorbs the first 8-10% of losses, after which the losses start to impact the junior debt. The senior AAA tranche has the largest subordination levels, typically in the range of 35-40%, up from 25-28% during the Global Financial Crisis (the CLO 1.0 era).[6]

CLO Lifecycle

A typical CLO has a 10-12 year life with multiple segments:

Warehouse (6-12 months)

The CLO manager receives financing from a warehouse provider to purchase the initial loans that make up the collateral pool before the closing date.

Ramp-up (1-6 months)

After the CLO's closing date, the CLO manager continues to purchase loans with the proceeds received from issuing debt tranches.

6 Source: Barings. As of February 28, 2025.

Reinvestment (1-5 years)

After the ramp-up period, the manager may trade in and out of loan collateral positions during the pre-defined trading period.

Non-call (1-2 years)

During the non-call period, the liability spreads will be locked into the rate issued at closing. After this period elapses, the majority equity investor has the right to call the deal and refinance the debt tranches at a lower spread should market conditions become attractive to do so.

Amortization (1-4 years)

After the end of the reinvestment period, the transaction will begin to pay down the tranches in order of seniority via the waterfall priority of payments set out in the CLO's governing indenture.

CLOs on an Insurer's Balance Sheet

How do these qualitative features of CLOs translate into quantitative figures?

Asset-Liability Management

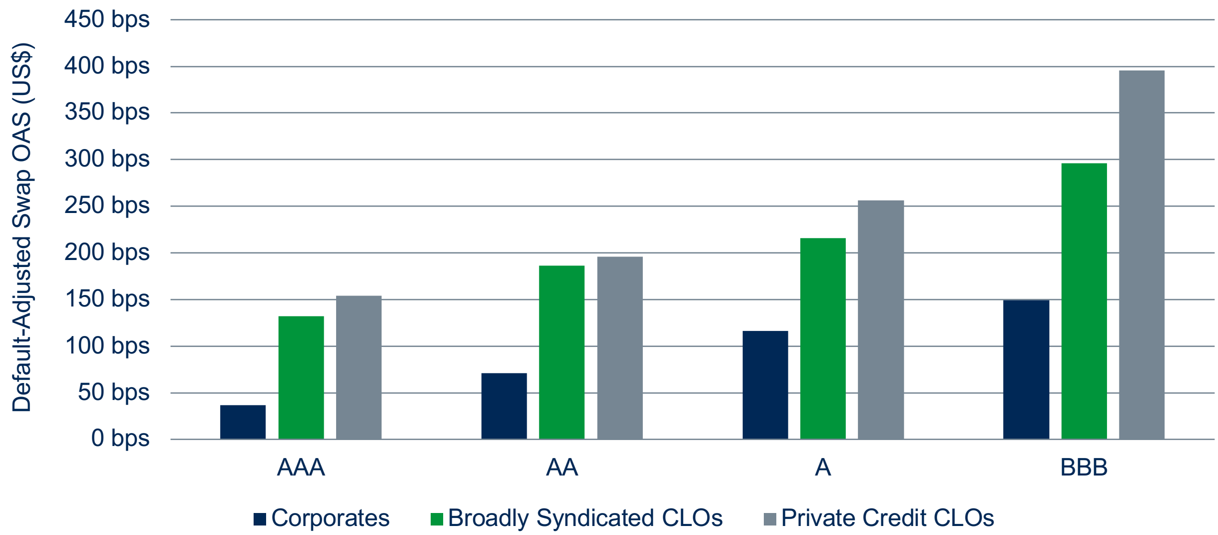
Due to the nature of the underlying loans, the vast majority of CLOs are floating-rate, although fixed-rate tranches do exist. As floating-rate assets, CLOs allow insurers flexibility in their asset-liability matching (ALM) program. For Property & Casualty insurers that have short-dated assets, and for any insurer holding CLOs as surplus (non-liability-backing) assets, the floating-rate nature of CLOs minimizes insurers' interest rate risk exposure and hence balance sheet volatility. From a regulatory perspective, CLOs as floating rate, surplus assets would also minimize any capital charge due to interest rate mismatch.

If the assets were held to cover longer-dated liabilities, a duration overlay can be added to hedge the floating-rate cash flows to fixed-rate. The weighted-average life of CLOs is typically 5-7 years—which means that with a duration overlay, CLOs can be suitable for the shorter end of a portfolio backing longer-dated liabilities such as life insurance.

Capital Efficiency

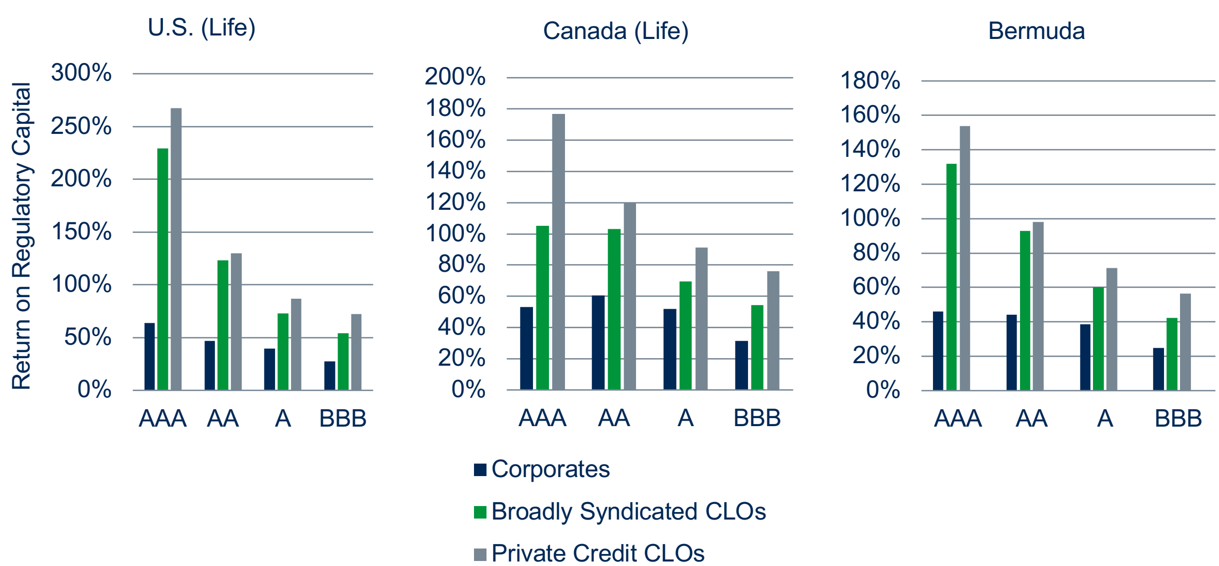
Investment grade CLOs are capital-efficient in insurance capital regimes across North America, not only in the US but also in Canada and Bermuda. In particular, while CLOs generate additional complexity and illiquidity premia over corporates, there is currently no or little increase in capital charge relative to corporates. In the U.S., the NAIC is in the process of reviewing capital charges for all structured assets insurers hold, so capital requirements may be adjusted by year end 2025 or 2026. In Bermuda, although securitized assets do receive higher charges than bonds, CLOs would still outperform corporate bonds on a capital-adjusted basis.

Figure 4: CLOs Deliver Considerable Spread Over Corporates on a Rating and Spread Duration Like-For-Like Basis



Source: Barings, Refinitiv, Moody's. As of April 8, 2025. Based on U.S. CLOs and 1-10 year U.S. corporates.

Figure 5: For North American Insurers, CLOs Deliver Enhanced Return Over Regulatory Capital Compared to Public Fixed Income



Source: Barings, Refinitiv, Moody's. As of April 8, 2025. Based on U.S. CLOs and 1-10 year U.S. corporates. Barings' interpretation of U.S. NAIC, Canada LICAT and Bermuda EBS rules. Return on regulatory capital is calculated as return over regulatory capital held, where (1) return is default-adjusted spread over SOFR; (2) regulatory capital held is fixed income (U.S., Bermuda) or credit (Canada) risk charge adjusted for diversification benefit (assumed to be 20%) and target solvency ratio (assumed to be 450% for U.S. life insurers, 150% for Canadian life insurers and 250% for Bermudan insurers).

Reduced Default Risk

An insurer's priority is to deliver on policyholder benefits across all stages of an economic cycle. As a result, capital preservation is crucial for insurers—and attractive spread levels and balance sheet efficiency must be backed by solid fundamentals.

CLO debt tranches historically have significantly lower default rates than similarly rated corporate loans, and since their inception, no AAA CLO tranche has ever defaulted (Figure 6).

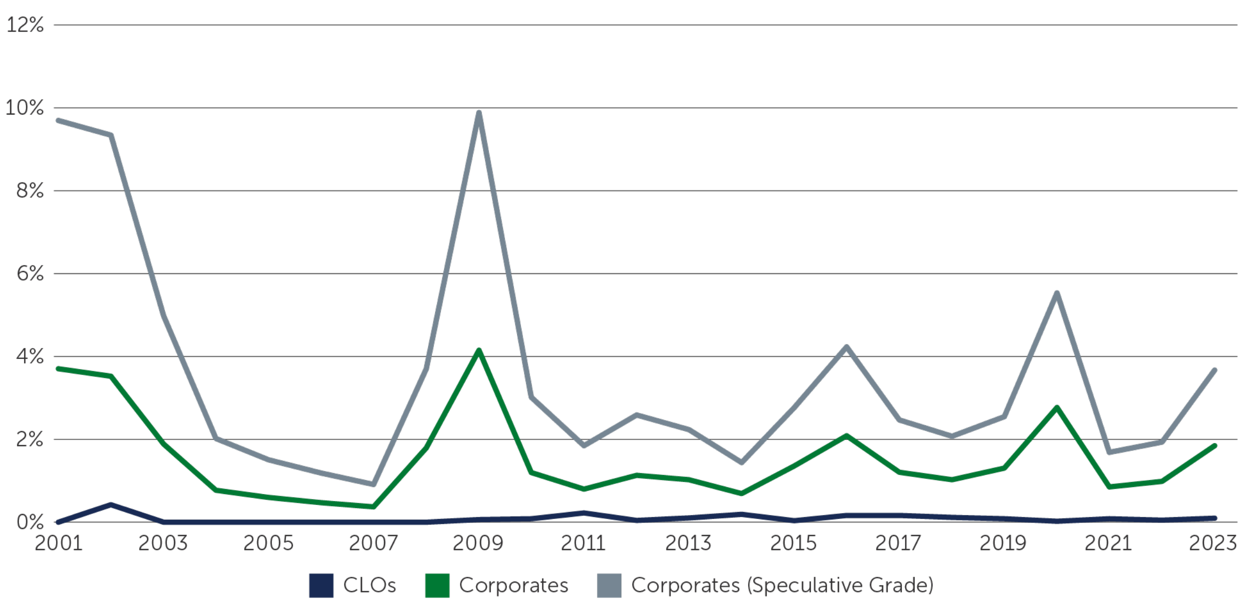
Figure 6: Historical CLO Default Rates

S&P U.S. CLO TRANCHE DEFAULT HISTORY (1996 – Q1 2024)				
RATING	TOTAL TRANCHES	DEFAULTED TRANCHES	DEFAULT RATE	S&P AVG US CORP 5-YEAR CUMULATIVE DEFAULT RATE
AAA	5,380	0	0.0%	0.4%
AA	3,728	1	0.03%	0.4%
A	3,372	5	0.1%	0.6%
BBB	3,138	9	0.3%	1.8%
BB	2,484	31	1.2%	7.1%
B	424	14	3.3%	17.2%

Source: S&P. As of April 2, 2024.

CLOs have also shown resilience during market distress. During the 2008 financial crisis, for example, CLOs experienced a lower level of defaults compared to corporate bonds (Figure 7). Meanwhile, in 2020, while defaults rose for corporate bonds and leveraged loans, CLO defaults declined—which demonstrates the benefits of diversified collateral pools, inherent structural protections, and active management.

Figure 7: Annual Global Default Rates: CLOs vs. Corporates



Source: S&P Global Ratings Credit Research & Insights. As of December 31, 2024. Default rates for 'CLOs' and 'Corporates' include all rated entities. 'Corporates (Speculative Grade)' includes only companies rated BB+ and below.

Accessing the Opportunity

Broadly speaking, there are two ways an insurer can access CLOs:

1. **Directly investing in CLO tranches:**

   This requires individual manager and CLO deal diligence. Investors must be well-connected to the platform and the deal placement agent in order to get access to a specific transaction and be in a position to negotiate deal specifics.

2. **Partnering with a third-party CLO investment manager:**

   This method outsources the deal and manager diligence to a broader structured credit team that can access multiple CLO managers' tranches in both the primary and secondary market. Strong CLO investment managers typically offer greater access to deal flow and market intelligence that may not be available through direct investment.

Given the complex nature of the asset class, CLO investment requires specialist expertise. Whether investing directly or through a third-party manager, there are key characteristics to look for in a manager:

Large and Experienced Team

Insurers looking to maximize their CLO investment potential could benefit from partnering with a firm which has a well-resourced team of CLO portfolio managers, credit researchers, and traders. Teams with long, consistent track records across multiple market cycles are well-positioned to navigate different market conditions.

In particular, CLOs are a complex and specialized asset class. Given they are different to other types of securitized credit in their structure, management style and underlying collateral, a dedicated team is key to capitalizing on opportunities in this asset class.

Access to New Opportunities

Managers with longstanding and active participation in the CLO ecosystem can often negotiate favorable terms for their clients, including allocations to coveted new issue CLO tranches, early "first looks" at primary and secondary market investment opportunities, and strong trade execution.

Commitment to Underwriting

An effective CLO manager should employ rigorous, bottom-up fundamental credit analysis. In addition, CLO teams positioned within investment managers that have a broad public and private fixed income offering can benefit from leveraging the firm's wider research and market insights.

For CLO tranche investors, it is imperative to have the resources and capability to qualitatively and quantitatively assess each CLO's collateral manager, the underlying portfolios, and the structural nuances of each CLO to better understand how they impact the quality and relative value of potential investments. Broadly speaking, the CLO tranche investment manager should be able to assess a specific CLO's:

COLLATERAL MANAGER	UNDERLYING COLLATERAL	STRUCTURE	RELATIVE VALUE
Investment style and process *Historical track record* *Commitment to the high yield market*	*Detailed breakdown of the entire portfolio* *Leverage internal high yield research*	*Thorough review of the entire capital structure and payment waterfall* *Consider additional features that will impact performance* *Detailed legal documentation review* *Cashflow stress analysis*	*Large, well-resourced teams allow efficient deployment of capital across the capital structure* *Use data systems, market observances, and collaborative effort to determine CLO tranche relative value*

Key Takeaway

CLOs offer investors a diversified investment with an attractive return potential and inherent structural protections throughout their existence. For insurers in particular, CLOs strike a compelling balance in the search for yield enhancement with capital preservation—and combined with active management and the floating-rate nature of the asset class, CLOs are a natural component of an insurer's toolbox. With the right partner, educated insurers may unearth attractive opportunities in this growing market segment.

Barings' CLO Capabilities

1998	100+	Top 20
Inception of Barings CLO Platform	*CLOs Managed*	*Global CLO Issuers by AUM*
60+	**$52 B+**	**$26 B+**
Dedicated Investment Professionals	*In Global Capabilities*	*In CLO Tranche Investments Managed for Insurance Companies*

CLO Management

GLOBAL BSL CLOS	PRIVATE CREDIT CLOS
$19 B+	**$3 B+**
In AUM	*In AUM*

CLO Investment

CLO STRUCTURED CREDIT

$27 B+	**$4 B+**
In Senior CLO Tranche Investment AUM	*In Mezzanine & Equity CLO Tranche Investment AUM*

Source: Barings. As of December 31, 2024.

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