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NAIC Developments Affecting Insurer Investment Portfolios

This bulletin discusses pending actions of the (a) National Association of Insurance Commissioners (NAIC) Valuation of Securities (E) Task Force (VOS Task Force) to address certain issues associated with insurer investments in feeder funds and collateralized loan obligations and (b) NAIC Statutory Accounting Principles (E) Working Group (SAPWG) with respect to further revisions to the proposed "bond" definition in the statutory accounting principles.

FEEDER FUNDS

The VOS Task Force met on December 14, 2022 (the "Valuation Meeting") and released for public comment a proposed amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "P&P Manual") to add instructions for "structured equity and funds" and to remove their NAIC Securities Valuation Office (SVO) filing exempt status.

Highlights of the Amendment: Specifically, the amendment seeks to add the following definition of "structured equity and funds" to the P&P Manual:

A Structured Equity and Fund investment is a note issued by, or equity or limited partnership interest in, a special purpose vehicle, trust, limited liability company, limited partnership, or other legal entity type, as issuer, the contractually promised payments of which are wholly dependent, directly or indirectly, upon payments or distributions from one or more underlying equity or fund investments. The inclusion of an intervening legal entity or entities between the Structured Equity and Fund investment issuer and the underlying equity or fund(s), does not change the risk that the insurer investment is ultimately dependent, in whole or in part, upon an investment in equity or one or more funds and its underlying investments. Any design that circumvents this definition, and related examples, through technical means but which in substance achieves the same ends or poses the same risk, shall be deemed a Structured Equity and Fund.

Further, the amendment seeks to remove the filing exempt status of "structured equity and funds" by adding the following language to Part Three – SVO Procedures and Methodology for Production of NAIC Designations of the P&P Manual:

The filing exemption procedure does not apply to: . . .

- *Structured Equity and Funds – Transactions meeting the criteria of Structured Equity and Funds as specified in this [P&P Manual] are not eligible for filing exemption and are subject to assessment by [the SVO].*

Additionally, the amendment seeks to add the following guidance to Part One – Policies of the NAIC Valuation of Securities (E) Task Force of the P&P Manual:

118. Transactions meeting the criteria of Structured Equity and Funds as defined in Part Three of [the P&P Manual] must be submitted to the SVO for review.

If a security is filing exempt, the security will automatically be assigned an NAIC Designation corresponding to the rating assigned by certain credit rating providers (CRP) accepted by the NAIC to assess the credit risk of a reported security. If a security is not filing exempt, an insurer that owns such security would be required to file such security with the SVO for review and obtain an analytically determined NAIC designation. In such instance, it is conceivable that the SVO would assign the security a NAIC Designation lower than what such security would receive if it was filing exempt. The NAIC Designation for a specific security would affect the risk-based capital (RBC) factor assigned to such security.

<u>Feeder Funds</u>: At the center of the discussion is a special type of feeder funds that involves investments by insurers in notes issued by, and of equity interests in, a special purpose vehicle, trust, limited liability company, limited partnership or other legal entity that operates as a feeder fund, which itself invests directly or indirectly in other funds or equity investments (the "Investments"). Historically, these Investments have been categorized as bonds and reported on Schedule D of an insurer's statutory statements and have bypassed reporting and RBC requirements for equity investments.

<u>NAIC's Concerns and Comments</u>: The NAIC is concerned about these Investments because it argues that they could (i) circumvent regulatory guidance set by the VOS Task Force, SAPWG, and the Capital Adequacy (E) Task Force (CATF); (ii) rely on CRP ratings that are not permitted for equity investments; (iii) create RBC arbitrage by permitting insurers potentially to incorrectly report the Investments as bonds and receive favorable RBC treatment even though the underlying assets held by the special purpose vehicles are equity interests; and (iv) reduce transparency because of the multiple layers of private entities and private ratings.

<u>(i) Regulatory Arbitrage</u>: During the Valuation Meeting, the VOS Task Force specifically noted that the Investments are in substance equity investments, but by inserting an intervening entity as a debt issuer, the insurers are able to report the Investments as bonds and receive statutory treatment as bonds for accounting, reporting, RBC and NAIC Designation purposes. In particular, the Investments avoid reporting requirements for typical equity and fund investments, use CRP ratings that would not be permitted for equity investments, and create investment limit arbitrage by holding more underlying equity/fund investments than would be permitted under state investment laws.

(ii) Use of CRP ratings: The VOS Task Force also noted that insurers took advantage of the inherent weakness within the filing exempt process, because by categorizing the Investments with CRP ratings, these Investments are automatically treated as bonds, despite their underlying asset structures or risks. Typical fund or equity investments are not allowed to use CRP ratings.

(iii) RBC Arbitrage: For illustration purposes, the VOS Task Force presented two examples of debt feeder fund structures and demonstrated how holding the Investment instead of directly holding the underlying assets created RBC arbitrage.

In each example, described in detail below, the structure starts with a main fund, which holds various types of underlying assets. The main fund issues equity interests to an intermediate fund (i.e. the debt feeder fund). The intermediate fund then issues notes (or, in some cases, an investment unit with a debt component and an equity component) to the insurance company investor. As part of the transaction between the intermediate fund and the insurance company investor, a CRP rating for the notes is obtained.

If the main fund were to sell the equity interests directly to the insurance company, the equity interests would typically fall under Statement of Statutory Accounting Principles (SSAP) No. 48 – Joint Ventures, Partnerships and Limited Liability Companies – and be reported on Schedule BA (Long-Term Assets). The investment would not be allowed to use a CRP rating and qualify for a filing exemption but instead would typically receive an equity RBC charge unless it was filed with the SVO for a NAIC Designation. However, by utilizing the debt feeder fund structure, the equity interests are routed through the debt feeder fund, and the insurance company investor is able to utilize a CRP rating and potentially report the investment as a bond under Schedule D. The VOS Task Force compared the scenarios where the insurance company investor purchases the equity interests directly from the main fund versus through a debt feeder fund structure.

In the first example presented by the VOS Task Force, the main fund issues $100 million of limited partnership interests to the debt feeder fund. The debt feeder fund then issues an investment unit of $90 million in notes and $10 million in limited partnership interests to the insurance company investor. The main fund uses the $100 million proceeds from the debt feeder fund to invest in “B” rated fixed income securities, which are the underlying assets. According to the VOS Task Force, if the insurance company investor directly purchased the limited partnership interest from the main fund and directly held the “B” rated fixed income securities, the RBC factor would be 9.535%. However, when the insurance company investor purchases the investment unit from the debt feeder fund and a CRP rating is obtained, the resulting RBC factor would be 4.135%. The VOS Task Force concluded that by comparing the two scenarios, the insurance company investor dramatically reduces the RBC factor by 5.4% and risk-based capital by 56.6%, despite being exposed to the same economic risks. Therefore, the RBC arbitrage opportunity resulting from this structure would be 5.4%.

Similarly, in the second example, instead of directly purchasing $110 million of private equity interests in a commercial real estate investment brokers partnership, the insurance company investor purchases $55 million of BBB- term loan and $55 million of BB term loan from an intermediate entity that directly holds such private equity interests (and no other assets). By holding the term loans rather than the private equity interests directly, the insurance company investor is able to reduce its RBC factor by 26.6% and risk-based capital by 88.8%. Therefore, the RBC arbitrage opportunity from this structure would be 26.6%.

(iv) Lack of Transparency: The VOS Task Force noted that the Investments usually involve multiple layers of private entities and private rating agencies, which can reduce the transparency of the true underlying risks and credit exposures. By looking at the information on Schedule D, the regulators currently may not always be able to determine whether the transactions involve complex structures and whether the investment assets involve affiliate investments, non-fixed income investments, derivatives, borrowing for leverage purposes or non-admitted assets.

New Definition of Bonds: SAPWG is currently updating the NAIC's definition of bonds (*see* discussion of Schedule D Bond Project below). Under the proposed principles-based definition of bonds, many of these Investments will no longer be qualified as bonds eligible for Schedule D reporting.

Non-Payment Risks: The VOS Task Force noted that the Investments also permit deferral of interests and principal payments without capitalization or without an event of default, which introduces nonpayment risks that are not reflected in the CRP ratings.

Responsibilities of the VOS Task Force: The VOS Task Force clarified that it is not responsible for assigning RBC factors or calculating the exact investment risks of securities, which are done by the CATF. However, the VOS Task Force is responsible for ensuring that any NAIC Designation assigned to an investment provides an appropriate and reasonable assessment of its credit rates, which is currently not the case regarding structured equity and fund investments.

Takeaways: Given the significance of the concerns over the Investments and the fact that the new principles-based bond definition will not become effective until 2025, the VOS Task Force proposed to amend the P&P Manual to add a definition of "structured equity and funds" and to require that such Investments be submitted to the SVO for review and assignment of a NAIC Designation (i.e., they would no longer qualify as filing exempt securities).

COLLATERALIZED LOAN OBLIGATIONS

The NAIC is in the process of creating its own financial model to evaluate collateralized loan obligations (CLOs). This task has been assigned to the Structured Securities Group (SSG). During the Valuation Meeting, the VOS Task Force released for public comment an amendment to Part Four – the NAIC Structured Securities Group of the P&P Manual – to include CLOs as a financially modeled security. This amendment seeks to be the first step of SSG's project to develop the CLO financial model. Further, during the Valuation Meeting, the SSG released for public comment its current methodology that would be used in the financial model.

Amendment to Part Four of the P&P Manual: The NAIC defines a CLO as a structured security issued by a special purpose vehicle to investors in several different tranches and collateralized by a pool of below-investment grade, first lien, senior secured, syndicated bank loans, with smaller allocations to other types of investments such as middle market loans and second lien loans. The VOS Task Force believes that insurers who purchase every tranche of a CLO hold the exact same investments risks as if they directly purchased the entire pool of loans backing the CLOs.

Under the current NAIC rules, it is possible to reduce materially capital requirements through a CLO structure by securitizing a pool of assets and inserting an intermediate special purpose vehicle between an insurer and the pool of loans backing the CLOs, which would create RBC arbitrage in a similar manner to the feeder fund structures discussed above. The SVO seeks to eliminate the current RBC arbitrage by ensuring that the aggregate RBC factor for owning all tranches of a CLO is the same as directly owning all of its underlying loan collateral. The VOS Task Force stated that it intends to perform, by itself, the surveillance work and regulatory analysis of CLOs. Further, the VOS Task Force noted that its goal is to ensure the policy holders are protected by prudent financial solvency policies and, at the same time, allow insurers to continue to participate in the CLO market without assuming risks associated with arguably aggressive investment structures.

CLO Financial Model: During the Valuation Meeting, the SSG released for public comment its current methodology for the CLO financial model. The financial model will evaluate all tranche-level losses across all debt and equity tranches using a series of calibrated and weighted collateral stress scenarios. The financial model seeks to eliminate RBC arbitrage by ensuring that the NAIC Designations assigned to the CLOs create equivalence between securitization and directly holding the underlying loans.

The financial modeling project involves three phases: (i) receiving authorization from the NAIC to model CLOs, which will be completed through the amendment to Part Four of the P&P Manual as discussed above, (ii) setting up modeling assumptions, and (iii) running the model and producing excluding scenarios and probabilities. The VOS Task Force is currently focused on phase two and, during the Valuation Meeting, released for comment its current modeling assumptions. The NAIC staff encouraged interested parties to review, and provide comments as to the reasonableness of, these modeling assumptions. If any parties challenge these assumptions, NAIC staff asks such parties to address the following:

a. Are there any actionable alternatives?

b. What are the quantitative justifications for the alternatives?

c. Are there any references to the alternatives in other rating agency’s methodologies?

The SSG expects to refine the methodology until mid-2023 and then to develop the scenarios, probabilities and the RBC tie out by the end of 2023. The SSG expects to finally implement the CLO financial model at year-end 2024.

SCHEDULE D BOND PROJECT

SAPWG is in the process of developing a principles-based bond definition, which will be reflected in revisions to SSAP No. 26R, SSAP No. 43R and other related guidelines, that clarifies which securities should be considered a bond and be eligible for reporting on Schedule D-1 (the “Bond Project”). Investments will be eligible for reporting on Schedule D-1 only if they comply with the principles-based bond definition or are specifically noted as within the scope of SSAP No. 26R or SSAP No. 43R.

Background – Collateral Fund Obligations (CFOs) and Equity Investments: The discussion of the principles-based bond definition originally began in August 2019 with agenda item 2019-21: SSAP No. 43R – Equity Instruments. This agenda item was drafted to clarify SSAP No. 43R, particularly with regards to CFOs and similar structures that reflect underlying equity interests.

SAPWG defines CFOs as a form of securitization backed by interests in funds (such as private equity or hedge funds) or other equity interests (such as a limited liability partnership). In late 2019, SAPWG became concerned that although a CFO appeared to have a debt instrument cash flow and receive a CRP rating, the issued security was supported by the equity performance of the underlying private equity, hedge funds or other equity interests. At the time, CFOs were historically reported as bonds, but because of the underlying equity-like characteristics, SAPWG attempted to exclude these CFOs from bond reporting under Schedule D-1. Subsequently, SAPWG expanded its mandate to create a principles-based bond definition that seeks to provide holistic evaluations of all types of bond investments.

Principles-based Bond Definition: SAPWG is targeting a January 1, 2025 effective date for the adoption of a principles-based bond definition. In developing a principles-based bond definition, the NAIC discussed several key concepts with respect to bonds and equity investments. For example, with the proposed definition the NAIC indicated that:

- a bond is a security structure that represents a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation or an asset-backed security;
- an issuer credit obligation is a bond, for which the general creditworthiness of an operating entity or entities through direct or indirect recourse is the primary source of repayment, and the operating entity or entities includes holding companies with operating entity subsidiaries where the holding company has the ability to access the operating subsidiaries' cash flows through its ownership rights;
- the analysis of whether a security represents a creditor relationship should consider the substance of the investment, rather than solely its legal form;
- the analysis should also consider all other investments the reporting entity owns in the investee as well as any other contractual arrangements;
- however, a security that in substance possesses equity-like characteristics or represents an ownership interest in the issuer that lacks a creditor relationship would be considered an equity investment. Such a security, under the principles-based bond definition, is not allowed to be reported as a bond under Schedule D-1; and
- examples of equity investments include any security ultimately reflecting an ownership or membership interest in an entity (such as common stock, preferred stock, private equity holdings, investments in joint ventures, partnerships, and LLCs) as well as any structure that reflects the performance of an entity (such as dividends or capital gains). Examples of equity instruments also include any debt instrument where the risk or reward profile is substantially similar to an equity interest.

In light of the above, the NAIC recognized that the determination of whether debt instruments collateralized by equity interests qualify as bonds inherently requires significant judgment and analysis. With respect to CFOs, for example, SAPWG has not decided whether to exclude CFOs from bond treatment entirely. SAPWG recognizes that there are certain CFO securitizations of well-diversified, seasoned funds under which there will be sufficient cash distributions to amortize the debt and structure protections to minimize residual equity exposure. Accordingly, under the current principles-based bond definition, there is a rebuttable presumption that debt instruments collateralized by equity interests do not qualify as bonds because they lack a credit relationship in substance. The presumption may be rebutted if the characteristics of the underlying equity interests of such debt instruments lend themselves to the production of predicable cash flows and if the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer. Some of the factors that will be considered in making this determination include the following:

- Number and diversification of the underlying equity interests

- Characteristics of the underlying equity interests (vintage, asset-types, etc.)
- Liquidity facilities
- Overcollateralization
- Waiting period for distributions/paydowns to begin
- Capitalization of interest
- Covenants (e.g., loan-to-value trigger provisions)
- Reliance on ongoing sponsor commitments

A debt instrument (i) collateralized by fewer, less diversified equity interests would require more extensive and persuasive documented analysis than one collateralized by a larger diversified portfolio of equity interests and (ii) that has been successfully marketed to unrelated and/or non-insurance company investors may provide enhanced market validation of the structure, in each case compared to one held only by related party and/or insurance company investors where capital relief may be the primary motivation for the securitization.

Furthermore, the NAIC's proposed bond definition provides that in order for a debt instrument to represent a creditor relationship, it must have pre-determined principal and interest payments (whether fixed interest or variable interest) with contractual amounts that do not vary based on the appreciation or depreciation (i.e., performance) of any underlying collateral value or other non-debt variable. For example, an issued security that has varying principal and interest payments based on the appreciation of referenced equity, real estate or other non-debt variable is precluded from bond treatment.

A debt instrument could also fall under the proposed principles-based bond definition if it constitutes an "asset-backed security" – "a bond issued by an entity… created for the primary purpose of raising debt capital backed by financial assets [(e.g., cash, ownership interests or a contract that conveys to one entity a right to receive cash or another instrument from another entity or to exchange other financial instruments on potentially favorable terms with such other entity)] or cash generating non-financial assets owned by the [bond issuer], for which the primary source of repayment is derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity." "Cash-generating non-financial assets" is defined as "assets that are expected to generate a *meaningful level of cash flows* toward repayment of the bond through use, licensing, leasing, servicing or management fees, or other similar cash flow generation" (emphasis added) other than from the sale or refinancing of the underlying collateral. Determining whether assets produce a "meaningful" level of cash flows to service the debt requires consideration of the following factors:

- The price volatility in the principal market for the underlying collateral;
- The liquidity in the principal market for the underlying collateral;
- The diversification characteristics of the underlying collateral (i.e., types of collateral, geographic location(s), source(s) of cash flows within the structure, etc.);
- The overcollateralization of the underlying collateral relative to the debt obligation; and
- The variability of cash flows, from sources other than sale or refinancing, expected to be generated from the underlying collateral.

The NAIC also noted in its proposed bond definition that "[t]he factors for price variability and the variability of cash flows are directly related to the "meaningful" requirement. That is, as price volatility or variability of cash flows increase, the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral must also increase. The factors for liquidity, diversification and overcollateralization are inversely related to the "meaningful" concept. That is, as liquidity, diversification or overcollateralization increase, the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral may decrease."

Further, the NAIC included in its proposed principles-based bond definition a quantitative test that can be utilized to determine whether there is a "meaningful" level of cash flows –

> *As a practical expedient to determining whether a cash generating non-financial asset is expected to produce meaningful cash flows, a reporting entity may consider an asset for which less than 50% of the original principal relies on sale or refinancing to meet the meaningful criteria. In applying this practical expedient, only contractual cash flows of the non-financial assets may be considered. This practical expedient should not be construed to mean that assets cannot meet the meaningful criteria if they rely on sale or refinancing to service greater than 50% of the original principal or if they rely on cash flows that are not contracted at origination. Rather, such instances would require a complete analysis of the considerations described within the meaningful level of cash flows definition…*

A second factor used in determining whether an asset can be considered an "asset-backed security" for purposes of the proposed bond definition is if the holder of the debt instrument would be in a different economic position that if the holder owned the issuer's assets directly (i.e., the debt instrument is subject to substantive credit enhancement (e.g., guarantees (or other similar forms of recourse), subordination and/or collateralization)) and such enhancement within the structure would absorb losses before the debt instrument would be expected to do so.

Based on the criteria described above (subject to review of the transaction structure and terms of the securities issued to investors) securitization of certain assets (e.g., franchise agreements, wireless tower contracts, etc.) should not preclude debt instruments issued by a SPV that hold such assets as collateral from qualifying as "bonds" (or specifically, asset-backed securities) under the proposed definition given that such assets may produce "meaningful" levels of cash flow and such debt instruments may receive substantive credit enhancement.

Feeder Funds: Similarly, SAPWG believes that the feeder fund structures will not automatically be assumed to qualify for bond classification, nor be automatically precluded from bond classification. The analysis of a feeder fund structure will focus on the substance of the investment. In particular, the analysis should evaluate whether the terms of the structure ensure a predictable pass through of the underlying fixed income cash flows, or whether there is any uncertainty as to the timing and/or amount of the cash flows. For example, a feeder fund structure that is not expected to generate regular cash interest payments would call into question the substance of a debt-backed investment; and a feeder fund structure where the underlying fund manager has discretion to withhold distribution of the cash flows may create uncertainties as to the timing or amount of cash flows and will likely be classified as equity investments. Ultimately, in order to qualify for bond reporting, the feeder fund arrangements would have to go through a holistic review by the NAIC that considers the substance of equity interests supporting the debt, the underlying source of cash flows and the uncertainties or vulnerabilities of the pass through of the cash flows. SAPWG stressed that substance over form should be the determining principle in the Bond Project.

Updates on the Bond Project: SAPWG met again on December 13, 2022 (the "Statutory Accounting Meeting"). SAPWG released for public comment its latest revisions to SSAP No. 26R and SSAP No. 43R. Key revisions include: (i) incorporating the entire bond definition in SSAP No. 26R, (ii) adding examples of asset-backed securities where the issuer holds the collateral in the form of a legally assigned note from the borrower rather than an ownership interest in the collateral and application of the “meaningful” level of cash flow and substantive credit enhancement criteria (discussed above) to each example, (iii) clarifying that working capital finance investments, surplus notes and structured settlements are specifically covered under separate SSAP guidance and will not be discussed as part of the Bond Project, and (iv) adding specialized transition and disclosure guidance for securities that are reclassified and no longer reported as bonds, specifically that such securities should be reported as disposals from Schedule D-1 at amortized cost and recognized as reacquisitions on the appropriate reporting schedule (e.g., Schedule BA) with an actual cost consistent with its disposal value (i.e., amortized cost).

Additionally, SAPWG released revisions to other statutory accounting principles for consistency with the changes that will be made as part of the Bond Project. This include adding details to the short-term and cash equivalent restrictions for asset-backed security in SSAP No. 2R and guidance for debt securities in SSAP No. 21R and revising the Investment Schedules General Instructions and Schedule D-1-1 and D-1-2. And in light of the Bond Project and the separation of Schedule D into Schedule D-1-1 and Schedule D-1-2, SAPWG reviewed all blank schedules and reporting instructions and identified other documents where corresponding edits are needed. Such recommendations have been released for public comment.

CONCLUSION

It is clear that the NAIC and the SVO will continue to take a granular approach in reviewing risks associated with complex structured securities. Despite pushback regarding some of the current proposals, the NAIC seems committed to reduce what it perceives as regulatory and RBC arbitrage by insurers that structure investment transactions without holding the underlying assets (and receive different RBC treatment associated with such assets). There will likely be further back-and-forth between the industry and the NAIC or SVO regarding such investments. We will monitor these developments.