NAIC/SVO – Understanding the Evolving Regulatory Capital Landscape

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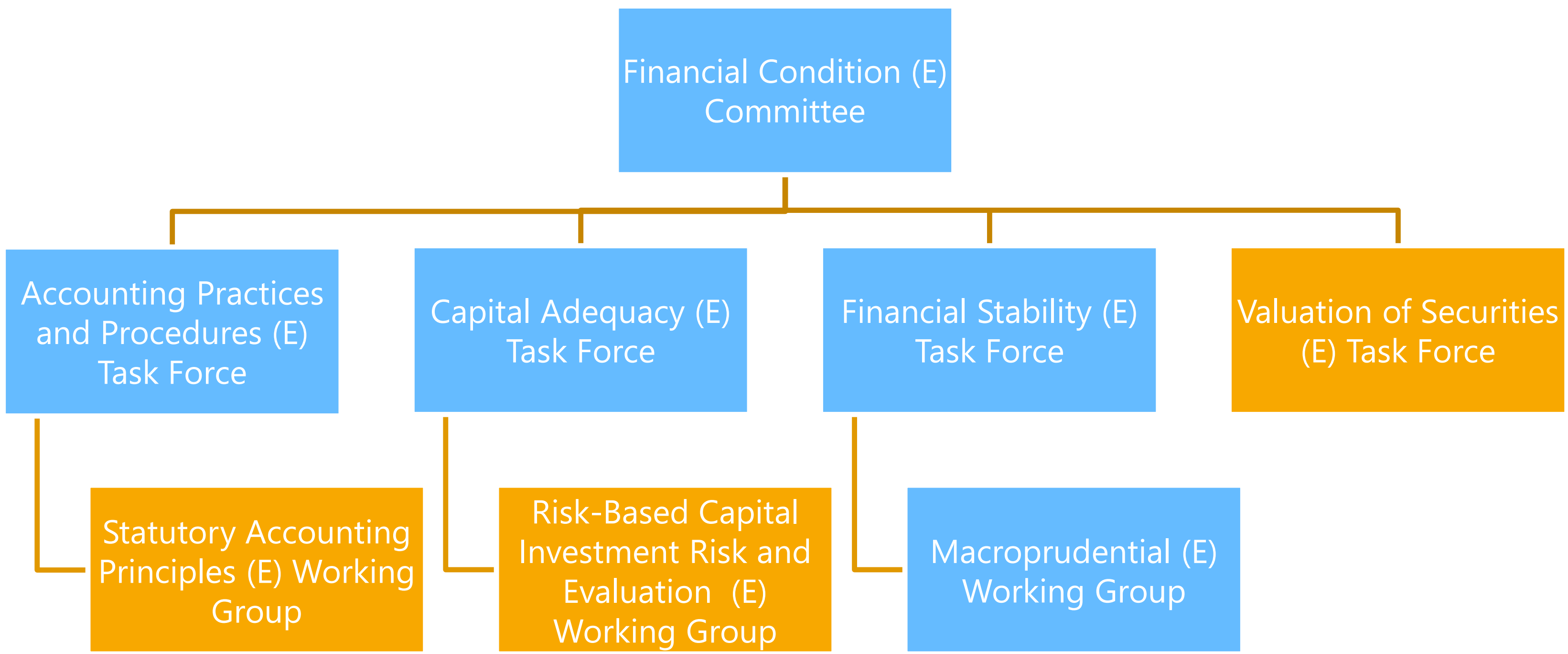
Understanding Who Does What at the NAIC

The Important Role of the NAIC

- Unlike most other countries, the business of insurance in the United States is regulated primarily at the **state** level
- The **National Association of Insurance Commissioners (NAIC)** is a standard setting and regulatory support organization governed by the chief insurance regulators of the 50 U.S. states, the District of Columbia, and five U.S. territories
- The NAIC's **Financial Condition (E) Committee** coordinates the financial aspects of NAIC standard setting and, at last count, had 39 subgroups
- Three of those subgroups have a key role in setting standards for the treatment of insurance company investments and are currently engaged in important initiatives

Key NAIC Units That Address Treatment of Insurance Company Investments



The Roles of SAPWG and VOSTF

- The **Statutory Accounting Principles (E) Working Group (SAPWG)** is responsible for developing and maintaining statutory accounting principles (STAT or SAP) that govern financial reporting by insurance companies
  - It maintains the Accounting Practices and Procedures Manual (**AP&P Manual**), which contains the **Statements of Statutory Accounting Principles (SSAPs)**
- The **Valuation of Securities (E) Task Force (VOSTF)** is responsible for the NAIC's credit assessment process for securities owned by insurance companies
  - It oversees the **Securities Valuation Office (SVO)** and Structured Securities Group (SSG), which, together with the Capital Markets Bureau, constitute the NAIC Investment Analysis Office (IAO)
  - It maintains the **Purposes and Procedures Manual** of the NAIC Investment Analysis Office (**P&P Manual**)

New Risk-Based Capital Investment Risk and Evaluation (E) Working Group Launched in 2022

- Charged with performing a comprehensive review of the NAIC's risk-based capital (RBC) investment framework
- At its inaugural meeting on January 12, 2022, solicited input on the RBC treatment of asset-backed securities (ABS) including collateralized loan obligations (CLOs), collateralized fund obligations (CFOs) and other similar securities carrying similar types of "tail risk," including:
  - Methodologies for capturing the risk (including tail risk) that exists with such assets (*e.g.*, ratings-determined bond factors, a modeling process akin to the current CMBS/RMBS approach, or other proposals)
  - Whether residual tranches in ABS structures can be evaluated in conjunction with and under similar methodologies as the debt tranches
  - Specific proposals for addressing RBC treatment of residual tranches to reduce arbitrage incentives

The Major NAIC Project to Redefine What is a Bond – and Why It Matters

"Bonds" – the NAIC's generic term for fixed-income investments other than preferred stock

- Bonds are reported on **Schedule D-1** of an insurer's statutory financial statements
- A bond's RBC charge is based on the **NAIC designation** assigned to it, with NAIC-1.A being the highest and NAIC-6 the lowest
- Bonds with a designation above NAIC-6 are carried at **amortized cost** on the statutory balance sheet. Bonds with a designation of NAIC-6 are carried at the lower of cost or market
- **RBC factors are highly sensitive to NAIC designations**. Examples:

NAIC-1.A (= AAA) → 0.16%
NAIC-2.B (= BBB) → 1.52%
NAIC-4.B (= B) → 9.54%
NAIC-6 (= below CCC-) → 30%
(same as equity)

NAIC-1.G (= A-) → 1.02%
NAIC-3.B. (= BB) → 4.54%
NAIC-5.B. (= CCC) → 23.80%

How Bonds Get Their NAIC Designations

- Over 80% of insurers' bond investments are "**filing exempt**" - which means they automatically receive an NAIC designation equivalent to their credit rating from an NAIC-recognized credit rating provider (CRP), *i.e.*, NRSRO
- If a bond is not "filing exempt," then it must be **filed with the SVO**, so that the SVO can perform a credit quality assessment and assign a designation to the bond
- Since the financial crisis, SVO and SSG staff have felt that NRSRO assessments of credit risk are not reflecting the full range of non-payment risks that regulators care about and have been **seeking to reduce the NAIC's reliance on NRSROs**

Summary So Far – Two Big Things Insurers Care About

- **Insurers want their fixed income investments to be treated as bonds** – reported on Schedule D-1 and receiving an RBC charge based on their NAIC designation – preferably a lower charge based on an NAIC-1 or NAIC-2 designation
  - This is a matter of statutory accounting and is governed by **SAPWG**
- **Insurers want their fixed income investments to be filing exempt**, so that they automatically receive the NAIC designation associated with their rating by a CRP (*i.e.*, NRSRO) rather than having to be filed with and analyzed by the SVO
  - This process is governed by **VOSTF**

Since 2020 SAPWG Has Been Working on a New Definition of What Counts as a Bond

- On March 18, 2020, SAPWG exposed for comment a preliminary (and partial) draft of an issue paper on potential substantive changes to ***SSAP No. 43R – Loan-Backed and Structured Securities***
- The draft issue paper questioned whether certain types of structured securities that do not meet the SEC definition of ABS – with CFOs being top of mind – should properly be classified within the scope of *SSAP No. 43R* and receive bond treatment
- The narrowed definition of structured securities eligible for *SSAP No. 43R* treatment that was proposed in the issue paper would have administered shock therapy to the investment portfolios of life insurers, and the industry protested vigorously – with a consortium of life insurers submitting a 67-page comment letter before the comment period ended on July 31, 2020

Overarching Theme: A “Principles-Based” Approach

- The principles-based approach originally proposed by staff of the Iowa Insurance Division on October 13, 2020 has won the day
- It has become the basis for the revisions to *SSAPs No. 26R (Bonds)* and *43R (Loan-Backed and Structured Securities)* that are in an advanced stage of development by SAPWG
- The currently targeted implementation date is January 1, 2025
- However, once the new provisions go into effect, they are expected to apply to all investments, with no “grandfathering” of existing investments

Emerging Definition Under the Principles-Based Approach

- A "bond" is a security
  - representing a creditor relationship,
  - whereby there is a schedule for one or more future payments, and
  - which qualifies as either:
    - an issuer credit obligation, or
    - an asset-backed security (**ABS**)

Issuer Credit Obligations *(SSAP No. 26R)*

- **Issuer Credit Obligations** represent the debt of operating entities (or their holding companies), which have a purpose other than the pass-through of investment proceeds. Examples of issuer obligations include (among others):
  - U.S. Treasury securities
  - U.S. government agency securities
  - Municipal securities
  - Corporate bonds, including Yankee and zero-coupon bonds
  - Project finance bonds
  - CTLs, equipment trust certificates, other lease-backed securities and funding agreement backed notes
  - Bonds issued by REITs or 1940 Act-registered funds
  - Convertible bonds, including mandatorily convertible bonds

Non-Security Investments that Will Receive Bond Treatment Under *SSAP No. 26R*

- **Certificates of deposit** that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition
- **Bank loans** that are obligations of operating entities issued directly by an insurance company or acquired through a participation, syndication or assignment
- Debt instruments in a certified capital company (**CAPCO**)
- SVO-Identified Exchange Traded Funds (**ETFs**)
- Mortgage loans in scope of *SSAP No. 37* that qualify under an SVO structural assessment and are identified as SVO-Identified **Credit Tenant Loans**

Securities that Will *Not* Receive Bond Treatment Under the Proposed *SSAP No. 26R*

- **General rule** – A debt instrument does not represent a creditor relationship unless it has pre-determined principal and interest payments (fixed or variable) with contractual amounts that do not vary based on the performance of any underlying collateral value or other non-debt variable
  - **Permitted:** Inflation or benchmark interest rate adjustments, scheduled interest rate step-ups, or credit rating-related interest rate adjustments
- **Structured notes** – for which the contractual amount to be paid at maturity (or the original investment) is at risk for other than the failure of the borrower to pay the principal amount due – are derivatives under *SSAP No. 86 - Derivatives*
- **Principal-protected securities (PPS)** – which have a performance component originating from, or determined by, non-fixed income securities – will be non-bond securities under *SSAP No. 21 – Other Admitted Assets* and will be reported on Schedule BA

Asset-Backed Securities *(SSAP No. 43R)*

- ABS represent debt issued through the securitization of **financial assets** or **cash-generating non-financial assets**. There are two defining characteristics that must be present in order for a security to meet the ABS definition:
  - The assets collateralizing the debt issuance are expected to be the primary source of cash flows for repayment of the debt; **and**
  - The securitization of the assets collateralizing the debt issuance **redistributes the credit risk** of the financial assets, such that the creditor is in a different position than if the underlying collateral were held directly.
- ABS are typically issued from a trust or special purpose vehicle, but the presence or absence of a trust or special purpose vehicle is ***not*** a definitive criterion for determining that a security meets the ABS definition

Subordination Is Key

- Inherent in the definition of a bond, whether represented by an issuer credit obligation or ABS, is the notion that **the creditor has a senior interest** in the assets of the issuer
- The most subordinated interest, sometimes referred to as the first-loss position, represents the interest of an equity holder, rather than a creditor
- Therefore, in order to meet the definition of a bond, **a significant subordinated interest must be present**

Two Conditions ABS Must Satisfy to Be a Bond

- Condition #1: The assets owned by the ABS issuer must be either:
  - financial assets, or
  - cash-generating non-financial assets
    - defined as assets that are expected (at the time of ABS origination) 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 (and not just through sale or refinancing of the assets)
    - "meaningful" criterion is deemed met if less than 50% of the original principal relies on sale or refinancing, but can also be met in other ways
- Condition #2: The holder of a debt instrument issued by an ABS issuer must be:
  - in a different economic position than if the holder owned the ABS issuer's assets directly
  - as a result of "**substantive**" credit enhancement through:
    - guarantees (or other similar forms of recourse),
    - subordination and/or
    - overcollateralization
- This means that the "first loss" tranche in an ABS structure will not be a bond

When ABS Are Backed by Equity (*e.g.*, CFOs), Special Rules Apply

- There is a **rebuttable presumption** that debt instruments collateralized by equity interests do not qualify as bonds because they do not reflect a creditor relationship in substance
- Notwithstanding this rebuttable presumption, it is possible for such a debt instrument to represent a creditor relationship if the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer
- A **documented analysis** supporting the predictability of cash flows must be completed *at the time the investment is acquired* in order to overcome the rebuttable presumption

Non-Exhaustive List of Factors To Be Considered in Overcoming the Rebuttable Presumption

- Number and diversification of the underlying equity interests
- Characteristics of the equity interests (vintage, asset-types, etc.)
- Liquidity facilities
- Overcollateralization
- Waiting period for the distributions/pay-downs to begin
- Capitalization of interest
- Covenants (e.g., loan-to-value trigger provisions)
- Reliance on ongoing sponsor commitments
- Source(s) of expected cash flows to service the debt (*i.e.*, dividend distributions from the underlying collateral vs. sale of the underlying collateral)

Current Status of the SAPWG Bond Initiative

- On August 10, 2022, SAPWG exposed the following documents for a comment period ending October 7, 2022:
  - a revised draft of the principles-based bond definition
  - a draft "statutory issue paper"
    (a "statutory issue paper" provides a detailed rationale for SAPWG's adoption of a new or revised SSAP)
  - the text of draft amendments to *SSAP No. 26R – Bonds* and *SSAP No. 43R – Loan-backed and Structured Securities*
- On November 16, 2022, SAPWG will discuss comments received and will vote on exposing for comment revised drafts of *SSAP No. 26R* and *SSAP No. 43R* that NAIC staff have prepared in response to comments
- On December 13, 2022, NAIC staff will present a revised issue paper and updated reporting documents for exposure

Special Note Regarding Rated Feeders

- Rated feeder structures, which have become a popular investment for insurers, especially in private credit, infrastructure debt and similar strategies, have received significant attention as part of the “bond” definition deliberations
- Prompted by input from industry representatives, the draft issue paper states that if the underlying fund holds only debt instruments and passes those fixed income cash flows through the structure to the ultimate debt holder, the rated note issued by the feeder fund may have substance aligned with a debt investment rather than an equity investment
- This willingness to “look through” the structure to the substance of the underlying debt exposures is a promising development since insurance regulators have traditionally focused almost exclusively on the form of instrument that an insurance company directly holds
- The next draft of the issue paper will include “refined language” identifying “elements that may call into question the determination that an investment is in substance debt”

Changes in the Works for RBC Treatment of CLOs

IAO Proposal Regarding CLOs

- On May 25, 2022, IAO staff addressed a memo to VOSTF, asserting that the aggregate RBC factor for holding all tranches of a CLO should be the same as that required for holding the underlying loan collateral, and if it is less, that means there is RBC arbitrage
- The IAO memo recommended that:
  - NAIC designations be assigned to CLO investments based on an SSG modeling process that would eliminate the RBC arbitrage (rather than based on CRP ratings) – the modeling of RMBS/CMBS that was instituted in 2009-2010 was invoked as a precedent
  - the current NAIC-6 designation be split into three categories, with a referral to the Capital Adequacy (E) Task Force and its Risk-Based Capital Investment Risk and Evaluation (E) Working Group (**RBC IRE WG**) to assign RBC factors to the new categories 6.A, 6.B and 6.C of 30%, 75% and 100%, respectively

Initial Responses to the IAO Proposal

- At the next VOSTF meeting on June 9, 2022, the Chair of the Task Force directed that the IAO memo be exposed for a 30-day comment period and directed the staff to start drafting amendments to the P&P Manual to implement the recommendations
- Eight comment letters were submitted, highlighting concerns about:
  - The seemingly aggressive timeline, and whether there would be adequate opportunity for evaluating such an important change to the system
  - Transparency and an opportunity for interested parties to scrutinize the methodologies being used and participate in developing them
  - The importance of CLOs to the financial markets and the importance of insurance company investors to the CLO market
  - The strong historical performance of CLOs and the need to appreciate the effect of CLO structures and active management on that performance

VOSTF Meeting on August 11, 2022

- At the VOSTF meeting on August 11, 2022, the Chair of the Task Force set a different tone, clarifying that the project will be handled through an iterative process, with full transparency, deliberation, and opportunity for industry input on the fine tuning of the methodology, and done in collaboration with the RBC IRE WG
- The Chair also said that increasing RBC charges on residual tranches is a shorter-term project than the longer-term development of a modeling process for assigning credit quality designations to CLOs
- The IAO staff also presented slides responding to the comment letters, basically defending their original positions, but also including a timeline that showed the bulk of the work being done in 2023 and probably 2024, with a likely effective date of 12/31/2024
- The staff's slide presentation was exposed for a comment period ending on September 12, 2022

RBC IRE WG Meeting on August 11, 2022

- The Chair emphasized that the RBC IRE WG and VOSTF need to collaborate on both current initiatives—the longer-term project to model NAIC designations for CLOs and the shorter-term project to address RBC treatment of residual tranches to eliminate RBC arbitrage
- He also stated the following as objectives:
  - It should be possible to easily determine from looking at an insurer's annual statutory statement how an investment is classified for RBC purposes
  - It should be clear what risk criteria are included in and excluded from the SVO's analysis when the SVO assigns a designation so that the RBC IRE WG can assess whether the designation should directly translate to an RBC factor (as is currently the case) or whether more inputs are needed.
  - There needs to be a way to assign an RBC charge to new types of assets during the time period before the SAPWG and VOSTF have determined where to classify them.

Other Key Points Discussed by RBC IRE WG on August 11, 2022

- At the August 11, 2022 meeting of the RBC IRE WG, the Chair announced that the American Academy of Actuaries would be assisting the RBC IRE WG and VOSTF with the CLO project
- The Chair asked whether the RBC IR&E WG needs to be concerned with RBC arbitrage in tranches besides the residual tranche
  - The SAPWG Chair responded that the SVO's analysis has shown that even a 100% RBC charge on residual tranches will not necessarily cure arbitrage, so it may be necessary to look at the lower-rated mezzanine tranches
  - The VOSTF Chair stated that she would prefer that the interim solution be limited to the residual tranche and that other tranches be addressed as part of the longer-term modeling project

P&P Manual Amendments Exposed at October 20, 2022 VOSTF Meeting

- On October 20, 2022, VOSTF exposed for a comment period ending on December 5, 2022 proposed amendments to the P&P Manual drafted by the IAO. Under those amendments:
  - Beginning with year-end 2023, the SSG would assign CLO investments an NAIC credit quality designation based on a financial modeling methodology (as is currently the case for RMBS/CMBS)
  - SSG would model CLO investments and evaluate all tranche level losses across all debt and equity tranches under a series of calibrated and weighted collateral stress scenarios to assign NAIC designations for a specific CLO tranche
  - The goal is that the aggregate RBC factor for owning all of the CLO tranches should be the same as that required for owning all of the underlying loan collateral

More Details on the P&P Manual Amendment Proposal

- SSG staff advocated that the P&P Manual amendments be adopted as a "first step" for budgeting purposes, and explained that a proposed methodology would be presented later, and scenarios after that
- SSG staff also stated that they are only looking to model broadly syndicated CLOs, and middle-market CLOs would be addressed later
- Evidently, the intent is to make the fundamental decision to shift CLO designations to an SSG-modeled process a "done deal" and to limit opportunity for industry input to the "fine tuning of the methodology"
- At the October 20, 2022 meeting, VOSTF also referred its P&P Manual amendment proposal to the RBC IRE WG, indicating a greater measure of coordination with the RBC IRE WG than was initially the case
- The next meetings of VOSTF and the RBC IRE WG will be held on December 14, 2022 at the NAIC Fall National Meeting, and the P&P Manual amendments could be adopted at that time

Developments Relating to the Use of Ratings

Recap of Notable Developments That Became Effective in 2021 and 2022

- Since January 1, 2021, insurers need to file PPS investments with the SVO for review and assignment of an NAIC designation, rather than benefiting from a filing exemption whereby they could simply use the NAIC designation equivalent to the credit rating assigned by a CRP
  - On August 11, 2022, the VOSTF amended the PPS definition to clarify that PPS need not involve an SPV or "repackaging" of underlying securities, but include notes with a variable return tied to reference assets
- Since January 1, 2022, as a general rule, insurers that invest in securities that have a private letter rating are required to provide the SVO with a copy of the related private letter rating rationale report from the applicable CRP
  - The SVO is analyzing the data gleaned from the private letter rating rationale reports and is expected to use that data to build a case for giving the SVO the ability to override the CRP rating and substitute its own analysis to determine the NAIC designation

2021 Memorandum from IAO Senior Staff

- At the December 12, 2021 VOSTF meeting, the VOSTF received a memorandum from the senior staff of the IAO reiterating the IAO's concerns about CRP ratings. The memorandum included reports on:
  - An SVO staff review of a sample of privately rated securities, where the NAIC designations equivalent to the CRP's rating differed significantly from the staff's own analysis (being three to six notches higher than staff's estimates)
  - An IAO analysis of both publicly rated and privately rated securities, showing significant rating notch differences between CRPs that rated the same security
- The IAO staff pointed out the potential for significant distortion of an insurer's RBC ratio that can result from a CRP rating that does not reflect a reasonable assessment of a security's risk

2021 IAO Memorandum Recommendations

- Require at least two (or more) CRP ratings for every security and use the lowest rating to determine the NAIC designation. If a security has only one rating, require it to be reviewed by the SVO to determine whether the SVO deems the rating reasonable (i) pursuant to its own analysis, (ii) when benchmarked to NRSRO peers and methodology, or (iii) compared to a spread implied rating, and, if not, to determine whether a full filing and SVO analysis would be appropriate
- Conduct an in-depth study of the NAIC's use of CRP ratings and SVO-assigned NAIC designations as to their consistency and comparability for regulatory purposes, specifically the determination of RBC factors
- Put the CRP process under a contractual relationship by offering NRSROs the opportunity to respond to a request for qualifications
- The VOSTF has the authority to direct the SVO to remove any rating agency from the CRP list at any time

VOSTF Response to the 2021 IAO Memorandum

- The VOSTF did not take any action on the IAO memorandum at the December 12, 2021 meeting other than to receive it as a starting point for discussion in 2022
- Then, in early 2022, the new VOSTF Chair, Carrie Mears of the Iowa Insurance Division, appointed an informal study group consisting of selected VOSTF members, other state regulators, NAIC staff and industry representatives
- At the August 11, 2022 VOSTF meeting, Chair Mears stated that the study group process was ongoing and that there was not yet anything to report

October 20, 2022 VOSTF Actions Relating to Ratings

- VOSTF adopted two new charges for 2023:
  - Implement additional and alternative ways to measure and report investment risk
  - Establish criteria to permit staff's discretion over the assignment of NAIC designations for securities subject to the filing exempt process (the use of credit rating provider ratings to determine an NAIC designation) to ensure greater consistency, uniformity and appropriateness to achieve the NAIC's financial solvency objectives
- VOSTF exposed a P&P Manual amendment for a comment period ending December 5, 2022 to define an NAIC designation as follows:
  - "Designations identify a category or band of credit risk that reflects the likelihood of timely payment of principal and interest, as appropriate, the probability of principal and interest payment default, and the appropriateness and consistency of its use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) including the risk-based capital model factor that will be applied to the security given its level of risk"

Potential Challenge to VOSTF Actions

- The VOSTF proposal to revise the P&P Manual definition of NAIC designations appears to be a reaction to assertions by the law firm of Paul Hastings (representing Egan Jones Ratings Company) that NAIC designations are equivalent to NRSRO ratings, and that certain recent and proposed VOSTF actions are an attempt by the NAIC to monopolize the ratings market for insurer investments in violation of antitrust laws
- Speaking at the October 20, 2022 VOSTF meeting, a Paul Hastings partner objected, on behalf of Egan Jones, to the following:
  - The VOSTF's adoption of the new charge giving NAIC staff discretion to override credit rating provider ratings, and
  - The proposal to implement a financial modeled process for CLOs in place of credit rating provider ratings
- Paul Hastings had sent a letter to the NAIC to similar effect in August, which was answered by a Wilson Sonsini letter on behalf of the NAIC in September
- It is too early to tell whether this is just "noise" or if legal action will ensue

Additional Resources

LinkedIn Group. Stay up to date on structured and market-linked products news by joining our LinkedIn group.

Suggestions? *REVERSEinquiries* is committed to meeting the needs of the structured and market-linked products community, so you ask and we answer. Send us questions that we will answer on our LinkedIn anonymously or topics for future issues.

To request to join the LinkedIn group or send us suggestions/comments, please scan the QR code, which will notify us via email at REVERSEinquiries@mayerbrown.com.

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