NAIC Investment-Related Developments

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December 11, 2024

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Key NAIC Initiatives Affecting Insurer Investments

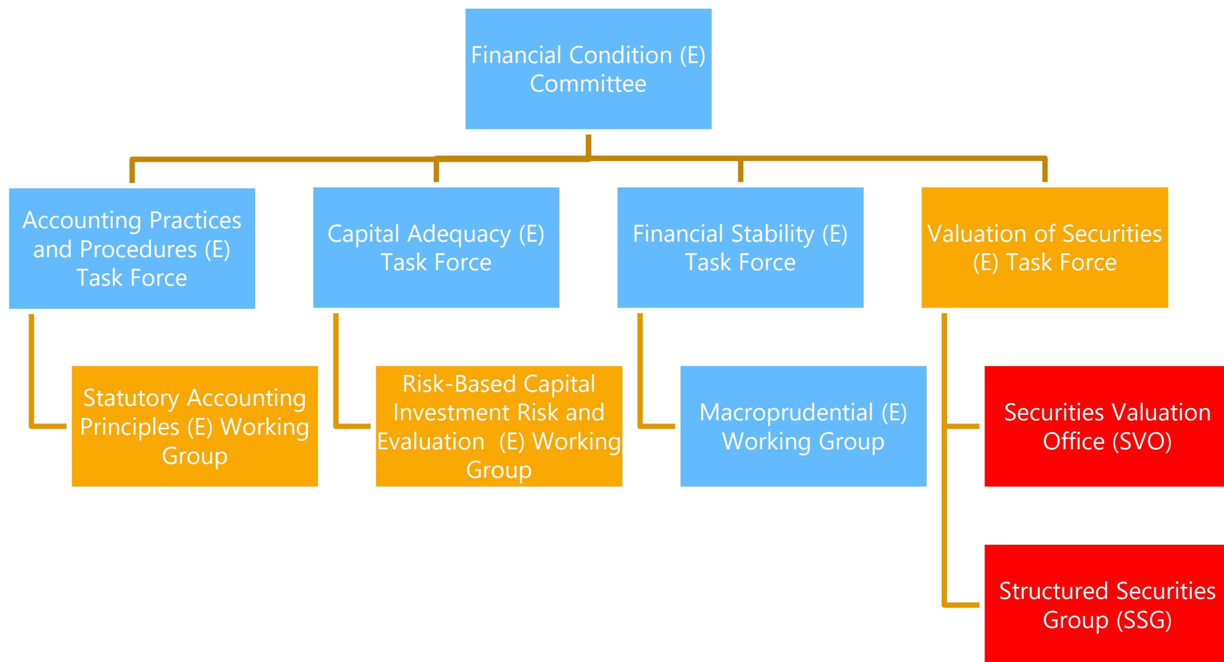
1. The new "principles-based" definition of what constitutes a bond reportable on Schedule D becomes effective on January 1, 2025
2. Risk-based capital (RBC) charges on residual tranches of ABS have increased from 30% to 45% for life insurers, and from 15% to 20% for health and P&C insurers
3. A new process has been adopted, effective on January 1, 2026, allowing the NAIC to challenge and potentially override NAIC designations derived from NRSRO ratings of filing-exempt securities
4. Methodology for CLO modeling is still being developed

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 ("E Committee")** coordinates the financial aspects of NAIC standard setting and, at last count, had 37 subgroups
- Three of those subgroups have a key role in setting standards for the treatment of insurance company investments and have been engaged in major recent 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**)

Risk-Based Capital Investment Risk and Evaluation (E) Working Group (**RBC IRE WG**) launched in 2022

- Reports to the Capital Adequacy (E) Task Force (**CapAd TF**)
- Charged with performing a comprehensive review of the C1 (investment risk) component of the NAIC's risk-based capital (RBC) investment framework
- Since its inaugural meeting on January 12, 2022, has focused on the RBC treatment of asset-backed securities (ABS) including collateralized loan obligations (CLOs), collateralized fund obligations (CFOs) and other securities carrying similar types of "tail risk," including:
  - Methodologies for capturing the risk (including tail risk) of investing in such assets
  - 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 – on both an interim and long-term basis – to reduce arbitrage incentives

Why Insurers Want Investments to Be Treated as Bonds and to Be Filing-Exempt

"Bonds" – the term historically used for fixed-income investments other than preferred stock

- Bonds are reported on **Schedule D** of an insurer's statutory financial statements
- A bond's RBC charge is based on the **NAIC designation category** assigned to it, with NAIC-1.A being the highest and NAIC-6 the lowest
  - The table of RBC charges on the next slide shows how sensitive RBC is to the NAIC designation
  - A three-notch reduction can double the RBC charge
- 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 fair value

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RBC factors for life insurers (pre-tax)

NAIC Designation	NRSRO Equivalents	Life RBC Factor (%)		NAIC Designation	NRSRO Equivalents	Life RBC Factor (%)
1.A	Aaa/AAA	0.158		3.A	Ba1/BB+	3.151
1.B	Aa1/AA+	0.271		3.B	Ba2/BB	4.537
1.C	Aa2/AA	0.419		3.C	Ba3/BB-	6.017
1.D	Aa3/AA-	0.523		4.A	B1/B+	7.386
1.E	A1/A+	0.657		4.B	B2/B	9.535
1.F	A2/A	0.816		4.C	B3/B-	12.428
1.G	A3/A-	1.016		5.A	Caa1/CCC+	16.942
2.A	Baa1/BBB+	1.261		5.B	Caa2/CCC	23.798
2.B	Baa2/BBB	1.523		5.C	Caa3/CCC-	30.000
2.C	Baa3/BBB-	2.168		6	All Lower	30.000

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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 risk assessment and assign an NAIC designation to the bond
- Since the great financial crisis, SVO and SSG staff have felt that NRSRO assessments of the credit risk of certain types of investments are not reflecting the full range of investment risks that regulators care about and have been **seeking to reduce the NAIC's reliance on NRSROs**

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Summary so far – two big things that insurers care about

- **Insurers want their fixed income investments to be treated as bonds** – reported on Schedule D 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**

1. The New Principles-Based Bond Definition

The new principles-based bond definition (*SSAPs No. 26* and *43*)

- 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 (**ICO**) or
    - an asset-backed security (**ABS**)
- No “grandfathering” of existing investments – all portfolio investments must satisfy the new definition effective on 1/1/2025

Definition of "security" for statutory accounting purposes (same as GAAP)

- Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:
  a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer
  b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment
  c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests or obligations

Issuer credit obligations

- An **issuer credit obligation (ICO)** is a bond, the repayment of which is supported primarily by the general creditworthiness of an operating entity or entities
- Issuers can be either operating companies or holding companies that have the ability to access the cash flows of operating company subsidiaries through their ownership rights
- The ICO definition includes:
  - US Treasury and US government agency securities
  - municipal bonds
  - corporate bonds
  - project finance bonds
  - securities for which repayment is "fully supported by an underlying contractual obligation of a single operating entity" (discussed on next slide)
  - bonds issued by REITs
  - bonds issued by funds that represent "operating entities" (discussed below)
  - convertible bonds (including mandatory convertible bonds)

More on the "fully supported" subcategory of ICOs

- Subparagraph 7.g. of the ICO definition includes "investments in the form of securities for which repayment is **fully supported** by an **underlying contractual obligation** of a **single operating entity**"
- Examples given: Credit tenant loans (CTLs), Equipment trust certificates (ETCs), other lease-backed securities and funding agreement-backed notes (FABNs)
- For purposes of applying this concept, repayment is **fully-supported** by the underlying operating entity obligation if it provides cash flows for the repayment of all interest and at least 95% of the principal of the security
- The issuer of this type of ICO can be a special-purpose entity, so this is an exception to the general rule that the issuer of an ICO must be an operating entity or a holding company of an operating entity

When is a fund an "operating entity" (rather than an ABS issuer)?

- A fund representing **an operating entity has a primary purpose of raising equity capital** and generating returns to its equity investors
  - **Ancillary debt** may be issued to fund operations or produce levered returns to equity holders, but this is in service to meeting the fund's primary equity-investor objective
- In contrast, **an ABS issuer has a primary purpose of raising debt capital** and its structural terms and features serve to support this purpose
  - The contractual terms of the structure generally define how each cash flow generated by the collateral is to be applied, with little discretion afforded to the manager/servicer of the vehicle
  - This hardwiring of debtholder protections allows for the issuance of higher amounts of leverage than would be possible for a fund representing an operating entity, further supporting the entity's primary purpose of raising debt capital
  - Feeder funds and issuers of CFOs are **expressly defined** to be ABS issuers

There is a practical "safe harbor" for funds registered under the 1940 Act

- As a practical safe harbor, when 1940 Act-registered closed-end funds (CEFs) and business development corporations (BDCs) issue debt securities in accordance with the leverage ratios permitted by the 1940 Act, such debt securities are treated as debt issued by operating entities and qualify as ICOs
- Funds that are not registered under the 1940 Act cannot rely on this safe harbor by simply issuing debt securities with leverage ratios comparable to those permitted by the 1940 Act
  - Debt securities issued by unregistered funds can only qualify as ICOs based on a determination that the fund represents an operating entity whose primary purpose is raising equity capital and generating returns to its equity investors

Asset-backed securities

- An asset-backed security (**ABS**) is defined as:
  - A debt instrument issued by an entity (an **ABS Issuer**) created for the primary purpose of raising debt capital, provided that it satisfies ***both*** of the following conditions:
    - The debt instrument is backed by either ***financial assets*** or ***cash-generating non-financial assets*** owned by the ABS Issuer, and the primary source of repayment is derived from the cash flows associated with that underlying defined collateral rather than the cash flows of an operating entity
    - The structure of the ABS Issuer **redistributes the credit risk**, such that the ABS holder is in a different position than if it held the underlying collateral directly

Definition of "financial assets"

- *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* defines a financial asset as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right (a) to receive cash or another financial instrument from a second entity or (b) to exchange other financial instruments on potentially favorable terms with the second entity
- Financial assets do not include assets for which the realization of the benefits conveyed by the above rights depends on the completion of a performance obligation (e.g., leases, mortgage servicing rights, royalty rights, etc.). These assets represent non-financial assets, or a means through which non-financial assets produce cash flows, until the performance obligation has been satisfied

Two conditions ABS must satisfy to be a bond (determined as of the date of origination)

- 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 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 the sale or refinancing of the assets)
    - "meaningful" criterion is deemed met if payment of 100% of the interest and at least 50% of the original principal relies on sources of cash other than 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
  (1) the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and
  (2) 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
- A debt instrument that has been successfully marketed to unrelated investors may provide enhanced market validation in contrast to one held by a single insurer or group of affiliated insurers

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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)

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Securities that will *not r*eceive bond treatment under the new *SSAP No. 26* as of 1/1/2025

- **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, credit rating-related interest rate adjustments or nominal 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, equity, real estate or another non-debt variable – will be non-bond securities under *SSAP No. 21 – Other Admitted Assets* and will be reported on Schedule BA

What will happen if a debt security fails to satisfy the PPBD?

- A debt security that fails the bond definition will be a "non-bond debt security" (**NBDS**) governed by *SSAP No. 21—Other Admitted Assets*
- NBDS will be admitted assets **only** if the underlying collateral primarily qualify as admitted assets. (Examples of what would not qualify: student loans, consumer loans, railcar leases)
- NBDS will be reported on Schedule BA, initially at cost and subsequently at the lower of amortized cost or fair value
- NBDS will be segregated on Schedule BA based on what they lacked to satisfy the definition (creditor relationship, substantive credit enhancement or meaningful cash flows)
- NBDS will need to be filed with the SVO to receive an NAIC designation, i.e., they will not be eligible for filing exemption

RBC for non-bond debt securities

- NBDS will not be filing-exempt, meaning that they will no longer be able to derive an NAIC designation from a CRP rating
- For life insurers:
  - If an NBDS has a designation assigned by the SVO, that will flow through the AVR and will determine the RBC, using the bond RBC factors
  - If an NBDS does not currently have an SVO-assigned designation, it will need to obtain one
- For P&C and health insurers:
  - An NBDS will be classified under "Other Invested Assets" with an RBC factor of 20%
  - In 2023, the SAPWG submitted a referral to the CapAd TF to consider allowing an SVO-assigned designation to determine the RBC for P&C and health insurers as well, but the CapAd TF has not yet acted on the proposal

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Treatment of CFOs and rated feeder notes under the new bond definition

- These structures will neither automatically qualify for, nor automatically be disqualified from, bond treatment
- It will be necessary to look through the structure and evaluate the underlying portfolio of assets that generate the cash flows for repayment
- The PPBD will consider the regularity and certainty of the cash flows
  - In particular, whether the assets are debt instruments that generate periodic, scheduled payments of principal and interest
  - The expectation is that CFOs and rated feeders for private credit funds, direct lending funds and similar strategies will qualify for bond treatment
  - If cash flows vary or are irregular (e.g., due to discretion of an underlying fund manager or the need to sell underlying investments, such as private equity portfolio assets), it will be harder to qualify the structure for bond treatment

Treatment of CFOs and rated feeder notes under the new bond definition (cont'd)

- CFOs and rated feeder notes (like all other bonds) will need to have "substantive credit enhancement"
  - Credit enhancement must result in a holder of the CFO or rated feeder security being in a "different economic position" than if investing directly in the underlying portfolio
  - Credit enhancement cannot be nominal or lack economic substance. It must function as true, substantive first loss. The amount of credit enhancement required will be specific to each transaction or structure
- In the case of rated feeders, NAIC statutory accounting staff were able to get comfortable with stapled structures, provided that the tranches are separate securities (not a single investment unit), preferably with separate CUSIPs, if available, accounted for separately, etc.
  - Debt tranches will be reported on Schedule D of an insurer's statutory investment schedules and the subordinated notes on Schedule BA – as opposed to the entire strip being placed on Schedule BA (as was suggested in an early draft of the principles-based bond definition)

Why it matters whether a fund is an operating entity versus an ABS issuer

- Aside from the obvious rationale for using a uniform set of principles to classify debt leverage issued by registered and unregistered funds, there is a lot riding on the ICO versus ABS classification:
  - ABS must satisfy additional tests that ICOs do not. ABS structures need to provide substantive credit enhancement, and the underlying collateral needs to consist of either financial assets or non-financial assets that produce meaningful cash flows
    - If the underlying collateral consists of equity interests, there is a presumption that the instrument is not a bond, which can only be rebutted by a documented analysis performed at the time an insurer acquires the investment
  - Additionally, while common equity issued by a fund that is an operating entity receives an RBC charge of 30%, residual interests at the bottom of an ABS capital stack receive an RBC charge of 45%

Implications of the definition of "operating entity" for fund finance

- As previously noted, the definition of operating entity has been carefully drafted not to include CFOs and rated feeder notes, which are required to qualify as ABS in order to be classified as bonds
- However, the definition of operating entity provides a path for various types of financing to operating funds, such as subscription and net asset value (NAV) financing, to qualify as ICOs, provided that they meet the statutory accounting definition of a "security"

Important resources for understanding the principles-based bond definition

- The SAPWG has adopted *Statutory Issue Paper No. 169, Principles-Based Bond Definition*
  - Unlike statements of statutory accounting principles (**SSAPs**), NAIC issue papers are not authoritative, but they provide historical documentation of the discussions behind the origination of new or revised SSAPs
- In order to prepare regulators and industry for the January 1, 2025 effective date of the principles-based bond definition, the NAIC is offering an online training course on how to apply the principles-based bond definition
  - The training course is free for all during 2024, but after January 1, 2025 it will only be free for regulators and there will be a charge for non-regulators

Important resources for understanding the principles-based bond definition (cont'd)

- On November 16, 2024, the SAPWG adopted a statutory interpretation called INT 24-01: Principles-Based Bond Definition Implementation Questions and Answers (the "**Q&A Guide**")
- The Q&A Guide provides detailed responses to eleven specific questions about how the PPBD applies to specific investment structures
- The responses were developed by a small group of NAIC staff, state regulators, representatives of the American Institute of Certified Public Accountants and other interested parties
- The Q&A Guide is expected to be expanded over time as new questions arise

Example of an asset class that will lose bond status under the PPBD

- Question 7 in the Q&A Guide addresses single-asset, single borrower (**SASB**) commercial mortgage-backed security (**CMBS**) structures that securitize a single commercial mortgage loan (**CML**) collateralized by one property owned by a single borrower
- SASB CMBS structures can issue multiple tranches with different priorities of payment, but they can also issue a single tranche (a "**uni-tranche structure**") that simply passes through the cash flows of the underlying CML
- If the CMBS has a uni-tranche structure, there is no substantive credit enhancement for the single CMBS tranche (absent some other form of credit support such as an external guarantee), with the result that a uni-tranche CMBS will fail to qualify as an ABS and will be a NBDS
- As NBDS, uni-tranche SASB CMBS will need to be filed with the SVO in order to receive bond RBC factors

VOSTF clarifies the ability of CRPs to provide ratings on specific classes of securities

- On November 17, 2024 the VOSTF adopted **an amendment to the *P&P Manual*** to add the following sentence to paragraph 57 of Part One of the *P&P Manual*:

  The NAIC only recognizes NAIC Credit Rating Provider ratings for those classes of credit ratings (each as defined by the SEC) for which an NAIC Credit Rating Provider is registered with the SEC as an NRSRO. For the avoidance of doubt, SEC definitions are distinct from those used for statutory accounting asset classification purposes in the Statements of Statutory Accounting Principles.

- The added text clarifies that a CRP that is not registered with the SEC to provide credit ratings for issuers of ABS is not precluded from rating securities that fall within the **PPBD's** definition of ABS unless those securities also fall within the **SEC's** definition of ABS

2. Increased RBC Charge on Residual Tranches of ABS

Background of the initiative

- In 2022, the NAIC created a new Risk-Based Capital Investment Risk and Evaluation (E) Working Group (**RBC IRE WG**) and assigned it two main tasks:
  - Mid- to long-term: review the RBC treatment of ABS such as CFOs and CLOs to assess how best to capture the risk (including "tail risk") of these assets, i.e., should it be based on ratings, modeling (akin to CMBS/RMBS) or some other method?
  - Short-term: address the RBC treatment of residual tranches to reduce arbitrage incentives
- Initially, the membership of RBC IRE WG (and the insurance industry) was divided on the question of whether the 30% equity charge on residual tranches of ABS was too low and needed to be boosted in the near term, or whether any changes should be deferred until better data was available and a more thorough analysis could be performed

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Actions taken in 2023 and 2024 by the RBC IRE WG and CapAd TF

- In 2023, the Life RBC factor for residual interests was maintained at 30%, but with a 15% "sensitivity factor" (essentially a *pro forma* addition to the base factor, to show what the RBC ratio would be with the higher RBC charge)
- In 2024, the Life RBC factor for residual interests is increasing from 30% to 45% on an "interim" basis
- In 2023, the P&C and Health RBC factor for residual interests increased from 15% to 20% as a result of the reclassification of residual interests as a Schedule BA asset rather than as common equity, and the 20% RBC factor was reaffirmed by the CapAd TF in 2024
- Going forward, the RBC IRE WG will continue its work, with the aid of the American Academy of Actuaries, on the long-term solution for RBC for all ABS, focusing initially on CLOs

The definition of residual interest is based on the substance rather than the form of an investment

- The new definition of residual interest was adopted by SAPWG on September 21, 2023 and became effective on December 31, 2023
- A residual interest or a residual security tranche exists in investment structures that are backed—directly, or indirectly through a feeder fund—by a discrete pool of collateral assets. If the senior debt in the structure consists of non-bond debt securities, then the underlying collateral must be admitted assets in order for the residual interest to be an admitted asset
- These collateral assets generate cash flows that provide interest and principal payments to debt holders, and once those contractual requirements are met, the resulting excess funds generated by (or with the sale of) the collateral assets are provided to the holder of the residual interest
- The residual interest holder thus absorbs losses resulting from assets in the collateral pool not performing as expected, before any losses are borne by the debt holders. Consequently, the residual holder may ultimately receive nothing, a reduced amount from original projections, or large returns, based on how the underlying collateral assets perform

Common characteristics of residual interests (illustrative principles)

- Residuals often do not have contractual principal or interest
- Residuals may have stated principal or interest, but with terms that result in receiving the residual cash flows of the underlying collateral. The terms allow for significant variation in the timing and amount of cash flows without triggering a default of the structure
- Residuals do not have credit ratings or NAIC assigned designations. Rather, they provide the subordination to support the credit quality of the typically rated debt tranches
- Residuals may provide payment throughout the investment duration (and not just at maturity), but the payments received continue to reflect the residual amount permitted after other tranche holders receive contractual principal and interest payments
- Frequently, there are contractual triggers that divert cash flows from the residual tranche to the debt tranches if the structure becomes stressed

3. New Process Allowing the NAIC to Challenge and Potentially Override NAIC Designations Derived from NRSRO Ratings of Filing-Exempt Securities

Background of the SVO proposal

- The background of this proposal includes a November 29, 2021 memorandum that the NAIC's Investment Analysis Office (**IAO**) addressed to the VOSTF, which reiterated the IAO's long-held concerns about ratings provided by CRPs and included:
  - 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 3 to 6 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

Initial exposure of the proposal for comment

- After considering various other approaches, on May 15, 2023, the VOSTF exposed for a comment period ending July 14, 2023, a proposal from the SVO to amend the *P&P Manual* to grant the SVO "some level of discretion" over the filing exempt process to address what the SVO called "the NAIC's current blind reliance on credit ratings."
- The initial proposal outlined a process by which a state insurance regulator or IAO staff could contest an NAIC designation assigned through the filing exemption process if it believed the CRP rating was "not a reasonable assessment of risk of the security for regulatory purposes" and where the difference between the CRP rating and the SVO's assessment was at least three notches.

The original proposal was significantly revised before its adoption on August 13, 2024

- The proposal was revised repeatedly over the ensuing 15 months, with exposures for public comment at each iteration, and with modifications to the final version being made right up to the time of the August 13, 2024 VOSTF meeting
- The main thrust of the comments, and the resulting revisions to the proposal (which were worked out by the IAO and members of the VOSTF in consultation with trade groups), was to add "checks and balances" that would ensure "due process" for insurers, who will have the ability to make their case for maintaining the CRP rating—first to the IAO, and ultimately to a subgroup of the VOSTF, which would make the final decision
- The process is scheduled to go into effect on January 1, 2026, due to the need to modify NAIC systems

The VOSTF also voted on August 13, 2024 to amend the definition of an NAIC designation

- The amended definition of an NAIC designation in the *P&P Manual* includes a clarification that an NAIC designation focuses on "investment risk," which is distinguished from "credit risk"
  - "Investment risk" is defined as "the likelihood that an insurer will receive full and timely principal and expected interest"
  - "Credit risk," by contrast, "traditionally focuses on the ability of an issuer to make payments in accordance with contractual terms"
- An example of where investment risk and credit risk could differ is a PPS with 100% principal protection, but with an interest component based on the performance of a non-debt variable
  - Based on the performance of the non-debt variable, the PPS could pay no interest without causing a default by the issuer
  - If the contractual principal payment is made, the non-payment of interest would not affect the credit risk, but it would affect the investment risk

Summary of the challenge process as adopted— 1. How the review process will be initiated

- The review of a security may be initiated by either a state insurance regulator or the IAO staff if they believe that the NAIC designation category assigned through the filing exemption based on a CRP rating "may not be a reasonable assessment of investment risk of the security for regulatory purposes"

2. Who will decide whether to proceed with a full review

- The IAO Credit Committee will convene to determine whether, in its opinion, the NAIC designation category assigned through the filing exemption based on a CRP rating is a "reasonable assessment of investment risk of the security for regulatory purposes"
- The Credit Committee may consider (i) a comparison to peers rated by different CRPs; (ii) consistency of the security's yield at issuance or current market yield to securities with equivalently calculated NAIC designations rated by different CRPs; (iii) the IAO's assessment of the security applying available methodologies; and (iv) any other factors it deems relevant
- If the Credit Committee's opinion is that the NAIC designation category assigned through the filing exemption based on a CRP rating is not a "reasonable assessment of investment risk of the security for regulatory purposes," then the security will be placed under review and designated in NAIC systems (though not in insurers' statutory reporting schedules) with the symbol "UR"
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3. How the IAO will gather information to conduct its full review

- The IAO staff will issue an information request to each insurer that holds the security, asking them to provide the information that would be required if they were filing the security with the SVO, including each insurer's internal analysis
- Insurers must respond within 45 days, but can request an extension of up to 45 additional days
- If the requested information is not provided to the IAO within 90 days, then the security will be removed from filing exemption

4. How insurers will be able to provide their own input to assist in the IAO's full review

- At any time during the information request submission period or during the IAO's subsequent analysis of the security, insurers who hold the security are encouraged to provide additional information to the IAO, such as their internal analysis, presentations from the issuer, and meetings with the issuer's management team
- The IAO will provide the insurers with a written summary of its analysis as to why it believes the CRP's risk assessment is an unreasonable assessment of investment risk of the security for regulatory purposes, and the insurers will have an opportunity to respond and to ask questions about the IAO's analysis
- The insurers may also invite other authorized parties that have agreed to the NAIC's confidentiality provisions (including CRP representatives) to participate in these discussions with the IAO

5. What will be the materiality threshold for overriding the filing-exempt designation

- Upon completion of the IAO's analysis, the IAO Credit Committee will reconvene to determine its own opinion of the NAIC designation category
- The IAO may proceed with the process only if the Credit Committee determines, based on its review, that the IAO's assessment is **three or more notches different** from the NAIC designation category determined by the eligible CRP credit rating
- Recall that a reduction of the NAIC designation category by three notches will in most cases result in an approximate doubling of the RBC factor

6. How the final decision will be made

- If the Credit Committee determines that the three-notch materiality threshold is met, then a call will be scheduled with a subgroup of the VOSTF, at which both the IAO and the insurers who hold the security will be able to make their case
- The IAO will be required to submit its position in writing and its supporting rationale in advance of that meeting
- The domestic state regulators of the insurers will be invited to participate in that meeting
- The insurers may also invite other authorized parties that have agreed to the NAIC's confidentiality provisions (including CRP representatives) to participate
- After hearing both sides, **the VOSTF subgroup will decide** whether or not it agrees with the Credit Committee's opinion

7. What will happen if the IAO's view prevails

- If the VOSTF subgroup agrees with the Credit Committee's opinion, the security will be removed from filing exemption, and the IAO's determination of the NAIC designation category will be entered in the NAIC's systems with an analytical symbol of "ER"
- However, if the security has (or subsequently receives) one or more other eligible NAIC CRP ratings that have not been removed, then it can receive its NAIC designation category through the filing exemption process based on those other NAIC CRP ratings that have not been removed
- An insurer can also ask the IAO to reevaluate an eligible NAIC CRP rating that was removed from filing exemption eligibility for possible reinstatement in a subsequent filing year by following the SVO's appeal process

8. How decisions will be published

- Within 45 days of a security being removed from filing exemption, the IAO will publish an anonymized summary of “each unique situation encountered” on an insurer-accessible web location
- The anonymized summary will not include references to specific securities, CRPs, or impacted insurers
- The IAO will also publish an annual anonymized summary of actions taken to remove filing exemption during the prior calendar year

How often will the process be used, and will it target specific CRPs or asset classes?

- In prior discussions, the VOSTF Chair has indicated that the process to remove filing exemption from a specific security is intended to be used sparingly and is not directed against any specific CRP or against an entire asset class
- Accordingly, the text that was adopted on August 13, 2024 includes the following statement: "The process in this section will be consistently applied to all CRPs without favor to any individual CRP or class of CRPs, and is not expected to be used often."
- There is also a provision in the adopted text that states that if the IAO Credit Committee identifies a recurring analytical pattern or concern, it is to inform the VOSTF Chair, and they will decide whether to bring the concern to the attention of the full VOSTF to decide if an issue paper, referral, amendment to the *P&P Manual* or some other action is needed to address that broader concern

Concerns regarding methodology

- Concerns have been expressed throughout the VOSTF discussion process about the fact that the IAO is not required to use any published methodology in the way that rating agencies are required to do
- In response, the VOSTF Chair stated on August 13, 2024 that the SVO considers multiple published rating agency methodologies and uses the methodology (or methodologies) that it believes will produce a reasonable assessment of investment risk for regulatory purposes

Concerns regarding the relationship between the SVO and rating agencies

- Concerns have been expressed throughout the VOSTF discussion process that the SVO is trying to compete with or replace rating agencies
- In response, the VOSTF Chair stated on August 13, 2024 that the SVO is not a rating agency, but rather a consumer of rating agency ratings, and that the goal is for the NAIC to use CRP ratings responsibly
- She said that the process for removal of an eligible CRP rating of a specific security from filing exemption would not be overruling a particular CRP rating, but rather choosing not to use a particular CRP rating for regulatory purposes
- The distinction discussed above between "credit risk" and "investment risk" may make it possible for the NAIC to say, when it removes a security from filing exemption, that the CRP rating may be a reasonable assessment of "credit risk" but not a reasonable assessment of "investment risk"

Concerns regarding the "one way" time frames for the IAO process

- Commenters have noted that in the final process as adopted there are strict time frames for insurers to respond to the IAO's information requests, but no time frames for the IAO to act on the information that insurers provide
- Some have suggested that there should also be time frames specified for the IAO, given the uncertainties created for an insurer when a security in its investment portfolio is placed under IAO review
- The VOSTF Chair stated on August 13, 2024 that it is difficult to set deadlines for the IAO, but that the IAO would perform its work expeditiously when the required information is provided to it

The role of CRPs in the IAO review process and the final hearing before the VOSTF subgroup

- A comment letter from a CRP urged that CRPs should be informed at the outset of the IAO review process, should be provided all materials generated by the IAO and should have a right to participate in the IAO review and the VOSTF subgroup hearing, whether or not they were invited to participate by the insurers
- At its August 29, 2024 meeting, the E Committee declined to make that change; the reason given was that the involvement of state insurance regulators at every stage of the process places the entire process under the statutory examination authority granted to the regulators under state insurance codes, which provide confidentiality protections to the insurers being examined that only those insurers can waive
- The E Committee and VOSTF Chairs stated that the involvement of CRPs in the process is both permitted and encouraged—but needs to be at the discretion of the insurers because of those statutory confidentiality protections

PPS (as defined by the VOSTF) have not been filing-exempt since January 1, 2021

- On May 14, 2020, the VOSTF amended the *P&P Manual* to include a new definition of "**principal protected securities**" (**PPS**) that were removed from the filing-exempt category as of January 1, 2021
- Because PPS are no longer filing-exempt, they need to be filed with the SVO for analysis and the assignment of an NAIC designation, rather than automatically receiving a designation based on a CRP rating
- PPS typically have both a principal protected component and a **performance component** whose payments originate from, or are determined by, non-fixed income-like sources and therefore pose the risk of non-fixed income-like cash flows

The PPS definition is complex

- PPS includes "any security that **repackages** one or more underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an underlying bond(s) (including principal and, if applicable, interest, make whole payments and fees thereon) that if purchased by an insurance company on a stand-alone basis would be eligible for Filing Exemption" and for which two additional conditions are satisfied (*see next slide*)

Two additional considerations for a PPS

- **In addition** to the first part of the definition mentioned previously, **both** of the following conditions must be fulfilled:

1. The insurer would obtain a more favorable RBC charge or regulatory treatment for the PPS through filing exemption than it would if it were to separately file the underlying investments in accordance with the *P&P Manual*

   and

2. **Either**:
   - The repackaged security structure enables potential returns from the underlying investments in addition to the contractually promised cash flows paid to such repackaged security according to a fixed schedule; or
   - The contractual interest rate paid by the PPS is zero, below market or, in any case, equal to or below the comparable risk-free rate

An issuer credit obligation can be a PPS

- In 2022, the VOSTF added the following example of a PPS to the *P&P Manual*: A financial institution issues notes pursuant to which it is obligated to make:
  1. fixed quarterly coupon payments which are less than the comparable risk-free rate
  2. performance payments linked to the performance of referenced equity and futures indices and the net asset value of a basket of undisclosed securities and
  3. a principal payment at maturity
- In the above example the issuer is an operating entity, rather than an SPV with underlying assets
- Even though the payment of all amounts is the obligation of the issuing financial institution, the size of the performance payments is wholly dependent on the performance of non-fixed income-like reference assets, so this is considered a PPS

Example of the impact of the loss of filing exemption on RBC if a security is a PPS

- In the SPV structure, a PPS with an underlying US Treasury zero coupon bond and performance assets linked to the S&P 500 Index would have a CRP rating of AAA/AA+ or an NAIC 1.A, based solely on the risk of the US Treasury bond.
  - Resulting RBC factor = 0.158%
- In contrast, the Weighted Average Ratings Factor (WARF) methodology applied by the SVO would result in an NAIC 4.B when it includes the exposure to the call options on the S&P 500 Index
  - Resulting RBC factor = 9.535%

4. CLO Modeling Project

CLOs – The poster child for addressing "regulatory arbitrage"

- On May 25, 2022, IAO staff addressed a memo to VOSTF, asserting that the aggregate RBC charge for holding all tranches of a CLO should be the same as that required for holding the underlying loan collateral, and to the extent it is less than that, then problematic "regulatory arbitrage" is occurring. 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 CapAd TF and its RBC IRE WG to assign RBC factors to the new categories 6.A, 6.B and 6.C of 30%, 75% and 100%, respectively, on the theory that an equity RBC charge of 30% is insufficient for "first loss" tranches of some structured investments

The decision to make CLOs a financially modeled security

- On February 21, 2023, VOSTF agreed to the first part of the SVO's proposal and amended the *P&P Manual* to make CLOs a financially modeled security like RMBS and CMBS
- An *ad hoc* group, led by the SSG and including representatives of industry and the American Academy of Actuaries (the "**Academy**"), was formed to develop the methodology (see dedicated web page)
- At the December 2, 2023 VOSTF meeting, Eric Kolchinsky, director of the SSG, reported that the *ad hoc* group had exposed 10 scenarios, including tail scenarios, and associated cash flows, and that the next step would be to set probabilities based on those cash flows
- The modeling process would not apply to residual tranches of CLOs, which have been addressed separately, as discussed below

Update on the CLO model development

- At the March 16, 2024 VOSTF meeting, Eric Kolchinsky requested that the effective date for implementing the CLO modeling be extended to December 31, 2025, stating that this will allow for an alignment of his committee's work with the Academy's C1 Subcommittee and the E Committee's holistic framework
- At the August 13, 2024 VOSTF meeting, Mr. Kolchinsky stated that the SSG had completed running its 10 scenarios for each CLO owned by an insurer, and that the results would be posted on the *ad hoc* group's web site and sent to the Academy for analysis
- He also stated that the *ad hoc* group had completed the analysis of the methodology adjustments that were previously proposed by interested parties
- At the November 17, 2024 VOSTF meeting, Mr. Kolchinsky reported that the ad hoc group had selected a preliminary probability distribution designed to minimize the mean square error and would start posting monthly data in early 2025

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