

CLIENT ALERT

NAIC Taking Action on Structured Security Investments

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I. Overview

Over the past year, the National Association of Insurance Commissioners (the “NAIC”) has sharpened its focus on overseeing private equity and complex assets in the insurance industry. These efforts, on which we have most recently reported [here](#) and [here](#), have included adoption of a work plan to address a “[List of Regulatory Considerations Applicable \(But not Exclusive\) to Private Equity \(PE\) Owned Insurers.](#)” Among these 13 considerations described by the NAIC is “the material increases in privately structured securities . . . which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency.” In August of 2022, the NAIC adopted a new actuarial guideline for asset adequacy testing for complex assets (including structured securities) supporting annuities, pension risk transfers, and other life insurance products (Actuarial Guideline LIII), as we reported on [here](#).

This alert provides a detailed review of additional pending actions by the NAIC with regard to certain examples of structured security investments: collateralized loan obligations (“CLOs”), collateralized fund obligations (“CFOs”) and rated notes/feeder funds. Currently, NAIC working groups are considering (i) amendments to statutory accounting reporting requirements to ensure that CFOs and rated notes are not automatically reported as “bonds”; (ii) an amendment to Securities Valuation Office (“SVO”) analysis procedures that would apply to CFOs and rated notes; and (iii) an amendment to SVO analysis procedures with respect to CLOs.

As background, SVO analysis procedures result in the assignment of “NAIC Designations,” a rating of a security produced for insurance regulators to assess the quality of a security in the context of the state’s investment laws (which

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often incorporate NAIC model law provisions that relate asset allocations to credit quality or credit risk quantified by NAIC Designations). Because the NAIC Risk-Based Capital (“RBC”) for Insurers Model Act assigns RBC factors to securities based on their credit risk as quantified by NAIC Designations, the amendments to the SVO analysis procedures will also impact RBC treatment of CFOs, CLOs and rated notes/feeder funds.

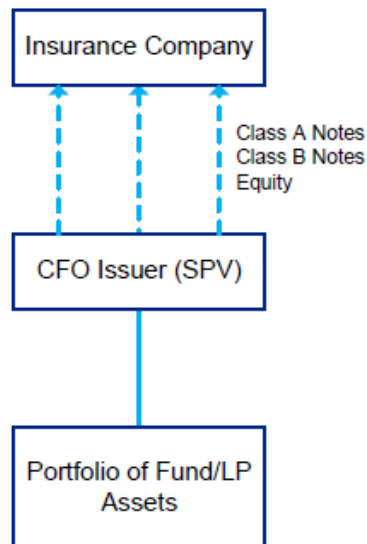
II. Specific Structures of Interest

a. CFO and Rated Note/Feeder Fund Structures

i. *Background—CFO*

In 2019, the NAIC’s Statutory Accounting Principles (E) Working Group (“SAPWG”) defined CFOs as a form of securitization that is backed by interests in funds, often private equity or hedge funds. A CFO can also be backed by other equity interests, such as a limited liability partnership. CFOs can include both debt and equity components. According to SAPWG, after first entering the market prior to the financial crisis in the early 2000s, CFOs have more recently returned to the market, with the majority of holders identified as insurance companies. SAPWG observed that although a CFO appears to have a “debt instrument” cash flow and may receive a credit rating provider (“CRP”) rating, “the backing of the issued security is based on the equity performance of the underlying funds or equity interest.”

Below is a simplified visual of a CFO structure:

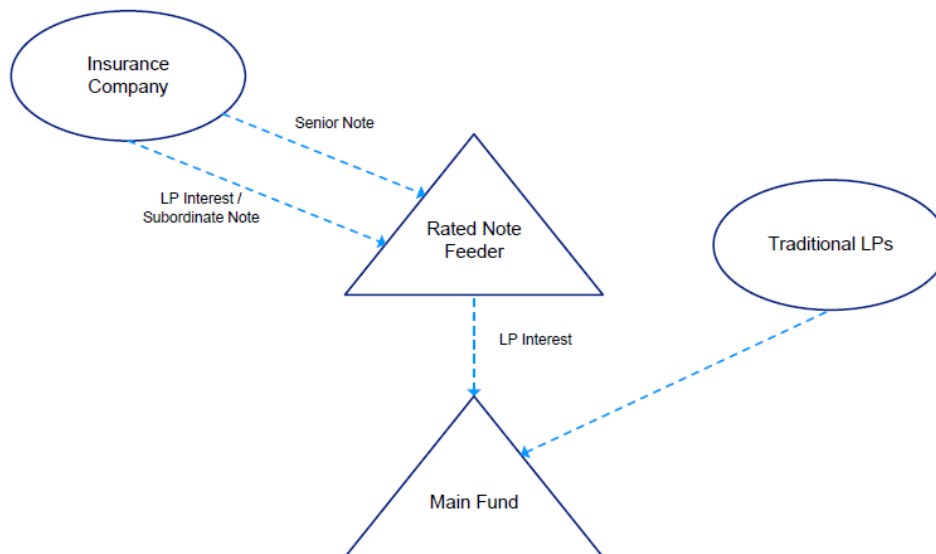


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ii. Background—Rated Note/Feeder Fund

A rated note or “feeder fund” structure typically refers to an investment whereby a main fund, which holds some type of underlying assets, issues limited partnership interests to an intermediate fund. The intermediate fund then issues notes, which have received a CRP rating, to the insurance company investor. The investment may also include a tranche of equity in the intermediate fund. Historically, like CFOs, such structures have qualified as “bonds” for statutory accounting and SVO investment analysis purposes due to the rated debt feature of the investment.

Below is a simplified visual of a rated note structure:



iii. NAIC Activities Related to CFOs and Rated Note/Feeder Funds

1. The Bond Project

As we recently reported on [here](#), SAPWG is in the midst of a project to re-evaluate what should qualify as a bond for statutory accounting purposes (the “Bond Project”). As noted, CFOs and feeder funds have historically been reported as bonds. The Bond Project arose out of a specific concern about CFOs in late 2019 and SAPWG’s desire to exclude CFOs from the definition of bond. SAPWG then expanded its focus to create a principles-based definition of bond that would apply to all types of bond investments.

The latest Bond Project Issue Paper dated December 12, 2022, available [here](#), discusses the treatment of both CFOs and feeder funds under the proposed bond definition. The Issue Paper states that “there is a significant incentive

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for insurers to characterize equity exposures . . . as bonds due to the favorable capital treatment. Transferring or acquiring them as debt issued by an SPV (such as through a [CFO] type structure) is a mechanism to reclassify these equity instruments and characterize them as bonds.” SAPWG decided not to exclude CFOs from bond treatment entirely because “there is a position that there are CFO securitizations (or other investments) of well-diversified, seasoned funds for which there is compelling evidence that there will be sufficient cash distributions to amortize the debt and structure protections that minimize the residual equity exposure. The approach to allow such CFO securitizations/investments only works when there are appropriate safeguarding principles established, which require a relatively high standard of proof.”

Accordingly, under the proposed new bond definition, with respect to CFOs, “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.” However, this presumption may be rebutted “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.” The Issue Paper includes factors to make this determination.

Similarly, with respect to feeder funds, the Issue Paper states that “[f]eeder fund structures shall not automatically be assumed to qualify for bond classification . . . nor be automatically precluded bond classification. The substance of the investment should be the determining factor.” In particular, “the assessment of feeder fund structures should evaluate whether the structure ensures the pass through of the underlying cash flows, or whether uncertainty as to the timing or amount of cash flows is introduced by the structure.” For example, “discretion of an underlying fund manager to withhold distribution of the underlying cash flows passed through from underlying debt instruments” or “a feeder fund structure that is not expected to provide for regular cash interest payments” would “call into question the substance as a debt-backed investment.”

Comments on the current draft Bond Project guidance are due to SAPWG by February 10, 2023. SAPWG is targeting a January 1, 2025 effective date for reporting changes related to the Bond Project.

2. SVO Action

On December 14, 2022, the NAIC’s Valuation of Securities (E) Task Force (“VOSTF”) [exposed for public comment](#) proposed instructions for the assessment of “Structured Equity and Funds” investments. The instructions are contained in an amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the “P&P Manual”), which sets forth the rules that VOSTF adopts for the credit assessment of insurers’ investments by the SVO. The proposed amendment would impact CFOs and rated notes/feeder funds.

Like SAPWG, the SVO was concerned that these investments have been reported as bonds and subject to more favorable reporting and RBC treatment as compared to equity and fund investments. These investments have also relied on CRP ratings to qualify for an exemption from filing with the SVO for review, whereas the use of CRP ratings would not

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be permitted for the fund or equity investments which underlie the notes, if the fund or equity investments were held directly. The SVO was also generally concerned that such structures lack transparency since there are multiple “layers,” including different private parties and CRP ratings, and the SVO has a limited view into the underlying assets involved. The SVO acknowledged that some of these structures may no longer qualify for bond treatment in the future as a result of the Bond Project. However, the SVO indicated that it did not want to wait until the Bond Project is effective in 2025 before taking action.

The proposed P&P Manual amendment would introduce “Structured Equity and Funds” as a specific asset class, defined as: “[A] note issued by, or equity or limited partnership interest in, a special purpose vehicle . . . 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 definition states that 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.” The proposed amendment also indicates that any structure designed to circumvent this definition, but which in substance achieves the same ends or poses the same risk, would also be deemed a Structured Equity and Fund.

Transactions meeting the definition would need to be submitted to the SVO for review and assignment of an NAIC Designation—that is, such transactions would no longer be eligible for a filing exemption based on a CRP rating.¹ The analytical procedures that the SVO would undertake to review the investment and assign an NAIC Designation would include (i) a “look-through assessment” to identify all securities and assets underlying the investment, and (ii) a credit risk assessment using any methodology that the SVO deems appropriate to assess the risk of the investment and its ultimate underlying assets.

Comments on the proposed amendment are due to VOSTF by February 13, 2023.

3. Risk-Based Capital

The NAIC’s Risk-Based Capital Investment Risk and Evaluation (E) Working Group (“RBCI WG”), which was formed in early 2022 to review the RBC investment framework for all business types, has a working agenda item for 2023 to “Evaluate the appropriate RBC treatment of Asset-Backed Securities (ABS), including Collateralized Loan Obligations (CLO), collateralized fund obligations (CFOs), or other similar securities carrying similar types of tail risk (Complex Assets).” The RBCI WG is currently prioritizing CLOs (see Section II.b.iii, below). However, we anticipate that any

¹ At the same December 2022 meeting where it exposed the proposed Structured Equity and Funds amendment, VOSTF also adopted revisions to the P&P Manual requiring certain related party transactions be filed with the SVO, further limiting reliance on ratings from CRPs. We reported on this development [here](#).

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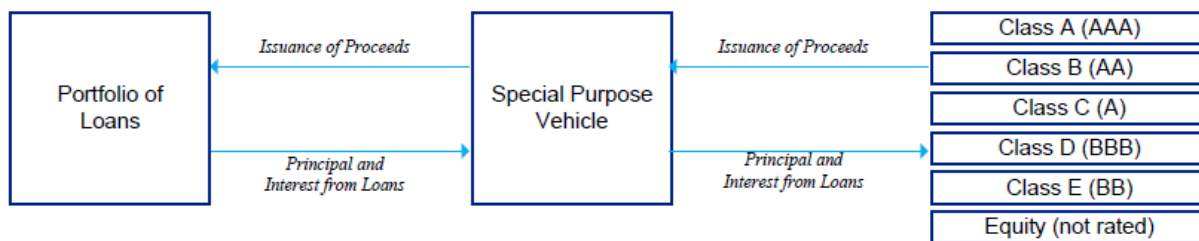
revised SVO treatment for CFOs and rated notes/feeder funds would be accompanied by corresponding adjustments to RBC treatment.

b. CLOs

i. *Background*

The NAIC's Capital Markets Bureau has defined CLOs as "structured finance securities collateralized predominantly 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 CLO debt issued to investors "consists of several tranches, or layers, with different payment priorities and, in turn, differing credit quality and credit ratings."²

Below is a simplified visual of a CLO structure:



ii. *NAIC Activities Related to CLOs*

The NAIC, coordinated by VOSTF, is reviewing CLOs as part of its overall private equity-related work plan. The SVO has asserted that "[a]n insurer that purchases every tranche of a CLO holds the exact same investment risk as if it had directly purchased the entire pool of loans backing the CLO," notwithstanding the insertion of an intermediate securitization vehicle. Under current rules, it is possible to "materially and artificially" reduce capital requirements under RBC just by securitizing a pool of assets. Therefore, the SVO has proposed revisions to SVO analysis procedures to ensure 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. VOSTF [exposed for comment](#) an amendment to the P&P Manual to require the NAIC's Structured Securities Group to financially model CLO investments to "evaluate all tranche level losses across all debt and equity tranches under a series of calibrated and weighted collateral stress scenarios to assign NAIC

² See NAIC Capital Markets Bureau Collateralized Loan Obligations (CLOs) Primer, available [here](#).

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Designations that create equivalency between securitization and direct holdings, thereby eliminating RBC arbitrage.” Comments on this proposal are due to VOSTF by February 13, 2023.

In anticipation of adding new NAIC Designation categories for CLOs based on the proposed modeling methodology, VOSTF has asked the RBCI WG to consider the appropriate RBC factors for such NAIC Designations. The RBCI WG has solicited comments on the RBC treatment of CLOs by January 27, 2023.

III. Takeaways

Following receipt of comments on the proposals outlined above between late January and mid-February 2023, we expect SAPWG, VOSTF and the RBCI WG to schedule public meetings to further discuss the proposals. These discussions may take place prior to or during the NAIC’s Spring National Meeting in Louisville, Kentucky from March 22 to 25, 2023. Insurance companies that invest in or are considering investing in these types of securities should monitor the comments and discussions to understand how any adopted changes will apply to the company’s current investment portfolio as well as any future investments. Similarly, investment managers that structure these types of investments for insurance companies should likewise carefully monitor these developments.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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