CLIENT ALERT

Update on NAIC Actions on Structured Security Investments

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I. Overview

Last year, we reported on efforts by the National Association of Insurance Commissioners (the "NAIC") to review the regulatory oversight of private equity and complex assets in the insurance industry, particularly with respect to certain types of structured security investments by insurers: collateralized loan obligations ("CLOs"), collateralized fund obligations ("CFOs") and rated notes/feeder funds. Our previous report ("January 2023 Report") is available here.

This alert provides an updated look at the NAIC's activities regarding such investments since our January 2023 Report. Since then,

(i) the NAIC adopted amendments to statutory accounting reporting requirements to clarify that CFOs and rated notes may not automatically be reported as "bonds";

(ii) the Securities Valuation Office ("SVO") has continued to seek changes to address concerns about reliance on credit rating provider ("CRP") ratings in the credit quality assessment of securities owned by insurers;

(iii) the Valuation of Securities (E) Task Force ("VOSTF") adopted revisions to the Purposes & Procedures Manual of the NAIC Investment Analysis Office (the "P&P Manual") to give the SVO the responsibility of modeling CLO investments; and

(iv) the Risk-Based Capital Investment Risk and Evaluation (E) Working Group ("RBC IRE WG") adopted an interim 45% factor for residual tranches of structured securities for year-end 2024 filings and continues to work on a long-term solution for the appropriate risk-based capital ("RBC") charges for CLO tranches.

In addition, the NAIC Financial Condition (E) Committee (the "(E) Committee"), which oversees each of these areas of activity, has begun a high-level review of the regulatory framework for insurance company investments.

II. Specific Structures of Interest

Our January 2023 Report described three specific investment structures that had drawn attention from U.S. insurance regulators:

1. CFOs, i.e., securities that are backed by interests in funds, often private equity or hedge funds. A CFO can also be backed by other equity interests, such as limited partnership interests. CFOs can include both debt and equity components.
2. Rated notes or "feeder funds," i.e., structures where 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.
3. CLOs, i.e., structured finance securities collateralized by a pool of debt. CLO debt issued to investors consists of several tranches with different payment priorities and, in turn, differing credit quality and credit ratings.

Although this alert highlights these specific investment types, certain of the developments described herein are broadly applicable to insurance company investments generally.

III. Regulatory Activities Relevant to Structures

a. NAIC Action on CFOs and Rated Notes

i. *New Bond Definition*

As we highlighted in our January 2023 Report, the NAIC's "Bond Project," spearheaded by the Statutory Accounting Principles (E) Working Group ("SAPWG"), aimed to re-evaluate what investments should qualify as bonds for statutory accounting purposes. The Bond Project changes have now been adopted into the applicable Statements of Statutory Accounting Principles ("SSAPs") and will be effective January 1, 2025. In particular, a revised SSAP No. 26—*Bonds* sets forth a new "principles-based" bond definition:

> A bond shall be defined as any security representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation [("ICO")] or an asset-backed security [("ABS")] [as defined in SSAP No. 26].

ICOs generally reflect traditional bond investments (e.g., government-issued and corporate bonds).[1] Historically, CFOs and rated feeder structures qualified as bonds due to the debt feature of the investment. Under the revised guidance, such investments are not considered ICOs and will need to meet the definition of an ABS in order to receive bond treatment. In particular, to qualify as an ABS, an investment must have "a meaningful level of cash flows to service the debt" and the holder of such investment must be in a different economic position than if the holder owned the ABS issuer's assets directly (i.e., "substantive credit enhancement.").2 A revised SSAP No. 43—Asset-Backed Securities provides the accounting treatment for ABS.

The Bond Project work product will also include an Issue Paper to serve as a historical reference for the project's discussions and key decisions. On May 15, 2024, SAPWG exposed a revised version of the Issue Paper to reflect the final actions taken in connection with the Bond Project, and we anticipate that a final version will soon be adopted. The Issue Paper, while not authoritative like the SSAPs, emphasizes SAPWG's position that CFOs and feeder fund structures shall not automatically be assumed to qualify for bond treatment, and provides further guidance for evaluating the substance of such investments under the new bond definition.

The NAIC reported that it is working to train regulators on the Bond Project changes, and anticipates receiving questions during the implementation phase of these changes regarding specific investment characteristics to assist in determining whether investments qualify as bonds.

ii. *SVO Challenging CRP Ratings*

Our January 2023 Report described an SVO proposal to define "Structured Equity and Fund" investments, which would have included CFOs and rated note/feeder funds and would have required that such investments be filed with the SVO for review and assignment of an NAIC Designation (i.e., an SVO rating), without reliance on CRP ratings for such investments. At the time, the SVO expressed that it did not want to wait for the Bond Project changes to take effect in order to address its concerns regarding these investments. VOSTF ultimately deferred action on this proposal in response to criticism from interested parties.

1 *See* SSAP No. 26, ¶7.

2 *See* SSAP No. 26, ¶8-10.

As an alternative, in spring 2023, VOSTF proposed a narrower process for the SVO to review a CRP rating for a specific filing-exempt investment, potentially challenging the CRP rating and resulting in the investment's removal from filing exemption. The goal of the proposal is to "grant the [SVO] some level of discretion over the [filing exempt] process to address the NAIC's current blind reliance on credit ratings." The process would entail identification by an SVO committee of a security that appears to be an unreasonable assessment of investment risk, followed by a request for information from insurers that hold the security. The SVO would then perform a full analysis of the security. If the filing-exempt NAIC Designation is three or more notches different than the SVO's opinion following its assessment, the SVO may convene a meeting with interested parties and regulators to determine whether the investment will be removed from the filing-exempt process.

The current proposal is available on VOSTF's website here, and has been exposed for a comment period ending July 26, 2024. We expect VOSTF to discuss comments at the NAIC's 2024 Summer National Meeting in August. The SVO has recommended adopting the proposal with a January 1, 2026 effective date to allow time for necessary system enhancements.

iii. *Updating Risk-Based Capital Treatment for Residual Tranches*

RBC IRE WG was formed in early 2022 in response to the perceived trend of insurers' shift away from corporate debt holdings toward structured securities and other asset-backed securities, and concerns from regulators that the existing RBC framework does not align with the risks of such investments. The Working Group is charged with performing "a comprehensive review of the RBC investment framework for all business types." As a priority project, the Working Group evaluated appropriate RBC treatment of residual tranches[3] of structured securities to find an "interim solution" until RBC treatment for structured securities as a whole can be studied more fully.

Following extensive discussions between the Working Group and interested parties, as we reported on here and here, in 2023 the NAIC adopted an interim RBC factor for structured security residual tranches of 30% for year-end 2023 RBC filings, which is scheduled to rise to 45% for year-end 2024 RBC filings.

b. NAIC Action on CLOs

i. *New SVO Authority to Model CLO Investments*

As with other types of structured securities, regulators have focused on CLOs and the need to assess whether the risks of such investments are adequately reflected in insurers' results. A key theme in these discussions has been the concept of eliminating RBC arbitrage—i.e., the idea that under RBC formulas, an insurer's ownership of every tranche of a CLO may

[3] The residual tranche refers to the "lowest" tranche of an asset-backed security that has equity-like characteristics, meaning it has the highest potential yield but also absorbs the first losses.

have a lower risk weighting than ownership of the underlying assets, even if the insurer is in the same economic position as direct ownership.

In February 2023, VOSTF adopted revisions to the P&P Manual requiring SVO modeling of all CLO investments to "evaluat[e] all tranche level losses across all debt and equity tranches under a series of calibrated and weighted collateral stress scenarios to assign NAIC Designations that create equivalency between securitization and direct holdings, thereby eliminating RBC arbitrage." Under these changes, CLO investments will no longer be broadly exempt from filing with the SVO based on CRP ratings.

In practice, this amendment will not be effective until a modeling methodology for CLOs is also adopted and becomes effective. VOSTF has established an ad hoc group composed of regulators and industry representatives to develop the technical specifications for the modeling process, which has been meeting regularly since April 2023 to discuss the methodology and various test scenarios. On June 18, 2024, VOSTF adopted a proposal to postpone the effective date for CLO modeling to year-end 2025 to allow time to finalize the modeling methodology.

ii. *Review of RBC Charges for CLOs*

RBC IRE WG, in consultation with the American Academy of Actuaries, is currently working on a long-term solution for the appropriate RBC charges for CLO tranches. The project has included initiatives to consider how to model CLOs for RBC purposes without relying on prior approaches, and to create guiding principles surrounding RBC arbitrage to be used in developing a CLO methodology. The goal is to have an initial proposal and methodology ready for presentation at the NAIC's 2024 Fall National Meeting. The RBC IRE Working Group intends that the work being done on CLOs will provide a pathway for a long-term RBC approach for other types of structured securities.

c. Framework for Insurer Investment Regulation

In August 2023, the (E) Committee, in recognition of the various workstreams of its subcommittees and working groups described above, exposed for public comment a document titled "Framework for Regulation of Insurer Investments – A Holistic Review" (the "Investment Framework"). The document (available here) is still in an early stage of development but is generally intended to highlight areas where insurance regulation and the SVO can be enhanced to strengthen oversight of insurers' investments in complex assets. The proposed changes include:

- reducing/eliminating "blind" reliance on CRPs while continuing to utilize them by implementing a due diligence framework that oversees CRPs' effectiveness, with such system to be designed and implemented by an external consultant/resource;
- retaining the SVO's ability to perform individualized credit assessment as a "backstop" in the regulatory regime;

- bolstering the SVO's portfolio risk analysis and asset modeling capabilities;
- building out a policy advisory function at the SVO that can consider and recommend future policy changes to regulators;
- potentially establishing an NAIC investment working group to advise on investment processes such as reviewing bond reporting analysis under the principles-based bond definition and challenging individual designations provided by CRPs; and
- considering renaming the SVO and VOSTF to reflect the above changes.

The Investment Framework also includes "guidelines" to be considered with respect to the work of RBC IRE WG:

- Changes in RBC factors should consider market impacts (secondarily to solvency impact) and consistency across asset classes, with a goal of "equal capital for equal risk" to the highest degree possible.
- RBC IRE WG should address areas where inconsistencies across asset classes incentivize a particular legal form, and eliminate barriers that could prevent assets from receiving a capital charge commensurate with the underlying risk. For example, private credit funds, where the underlying assets should receive a fixed income capital charge but are instead assigned an equity factor, which requires insurers to securitize such investments in order to receive a fixed income charge, which may "overcorrect" and lead to capital arbitrage.

The Investment Framework is not intended to reach technical conclusions on NAIC initiatives or to pause any current workstreams such as those described above, but rather provide a "long-term strategic direction for investment regulation." Interested parties provided feedback in late 2023, including requests for transparency and the use of technology and outside expertise to support these initiatives.

The work related to the Investment Framework is expected to be a multi-year project. As a preliminary step, the NAIC will begin developing a request for proposal to hire a consultant to design and implement the project.

IV. Takeaways

With the Bond Project reporting changes taking effect on January 1, 2025, all insurers need to review their current investment portfolio under the new principles-based bond definition and corresponding SSAPs to confirm the statutory accounting treatment for each investment. Particular care will need to be taken in the assessment of structured securities such as rated notes and CFOs. Further, insurers should monitor the progress of the (E) Committee and its subgroups on matters related to CRP ratings, NAIC Designations and RBC charges for structured security investments, as well as any changes resulting from the Investment Framework project. Investment managers that structure these types of investments for insurance companies should likewise carefully monitor these developments.

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

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