CADWALADER

FUND FINANCE FRIDAY

Insurance Companies in NAV, CLOs and Rated Feeders: Where Are We Now

June 14, 2024

By Angie Batterson
Partner | Fund Finance

If you are confused about the current state of play of insurance companies investing in CLOs, rated feeder structures and other NAV based loans, we are here to help. Let's start with the basics: the National Association of Insurance Commissioners (the "NAIC"), the entity that regulates insurance companies in the U.S., is responsible for categorizing fixed income structures and the impact that such structures may have on insurance companies' critical risk-based capital ("RBC") ratios. RBC is important to insurance companies, as it serves as a measurable risk metric across the industry. Insurance companies are required to maintain a minimum level of RBC to equity (or surplus for mutual insurers) to ensure their policy holders will have access to policy payouts when they become due. RBC ratios are based on (i) the insurance company's equity or surplus and (ii) the inherent riskiness of its financial assets and operations, as defined by the NAIC's policy and procedures manual (P&P Manual).[1] In the simplest of terms, the riskier the investment (AAA rated debt is most favorable, equity or unrated debt is least favorable), the more capital needs to be reserved. How, you may ask, does the NAIC decide what investments get which RBC treatment? Well, the past five years have yielded the most changes to how RBC's are calculated since before the 2008 crisis.

If the investment is deemed to be a "bond", which the NAIC defines as a security where there is a fixed schedule of payments, it automatically qualifies to get a rating from a Nationally Recognized Statistical Ratings Organization (an "NRSRO") so long as it doesn't trip a separate specific asset test. Based on the rating, the NAIC assigns the applicable RBC; the better the rating the better the RBC. While that sounds simple enough, the devil is in the details. So, just what determines if the investment is a bond you ask?

In August of 2023, the NAIC issued a statement setting forth certain rules of the road for determining what is a bond, which rules will become effective in January of 2025. There are two sets of rules: one for "issuer credit obligations" (i.e. loans or bonds where an operating company is the borrower) and one for "asset backed securities" (our focus today). Asset backed loans are structures created for the purpose of raising capital where the direct obligor is not an operating company and the cash flows are derived from a pool of underlying non-operating company assets. The noise in the media in the last few years has centered around some rather extreme asset-backed securities and their respective treatment for RBC purposes. To be considered a bond and have the ability to get a rating from an NRSRO, the NAIC requires that these structures must have a meaningful level of cash flow generated by the underlying assets to repay the investment other than through the sale or refinancing of the underlying assets. The NAIC has created a safe harbor that allows these structures to meet the bond test even if they contain a mix of underlying assets: so long as more than 50% of the underlying assets are cash flow generating and debt service is not reliant on the sale of assets or refinancing.

So how is this framework applied to fund finance loans? Let's look at two examples of potential deal structures and give some thought to the outcome to the key question - is it a bond or not a bond?

In our first structure, an SPV is set up to hold the limited partnership interests in a private credit fund whose sole function is to make loans to underlying operating companies (the "Loan Structure"). The second structure is an SPV set up to hold limited partnership interests in private equity funds (the "Equity Structure"). In the Loan Structure, if the underlying loan assets will generate enough cash flow from regularly scheduled payments of principal and interest to service the debt, and if sized correctly, an investment in the Loan Structure should get bond treatment. In the Equity Structure, where there may be no regular payments of principal and interest and repayments will instead come from future, unscheduled distributions on the equity positions, the cash flows generated to service the debt need to be analyzed to determine if an investment in the Equity Structure meets the criteria to be a bond. To determine whether the Equity Structure should receive bond treatment, the NAIC will look to numerous factors including:

- Diversification of the underlying collateral pool;
- Characterization of the assets - is the fund in its initial stage of its life cycle where distributions are unlikely or is it a mature fund that is spinning off cash distributions regularly and with enough certainty to service the debt;
- Existence of other sources of repayment - liquidity facilities, guaranties, cash collateral, sponsor equity commitments etc.;
- Whether interest is payable currently or can be deferred; and
- The existence of meaningful loan to value covenants.

Starting in 2025, insurance companies will need to submit reporting to the NAIC at year end, which are called the "blanks" for each asset justifying the insurer's reasoning for the structure to be considered a bond. Filling in the "blanks" will give the NAIC more visibility into the actual loan structure than just the title on the cover page of the loan agreement. They will be looking under the hood to see if the investment really looks like a creditor/debtor relationship and is not just disguised equity.

The NAIC has separately engaged in a review of all collateralized loan obligations ("CLO"), as they are assessing whether the ratings assigned to various CLO tranches are appropriate for the associated RBC charge. While CLO debt clearly meets the newly approved definition of what a “bond” is, the NAIC now requires that these structures be subject to a modeling method conducted by the NAIC’s Securities Valuation Office (“SVO”) that has been historically time consuming and uncertain for the insurer, as each debt tranche is reviewed by the SVO under rating methodologies that are not public or standardized (unlike the NRSROs, who are required by their regulator, the SEC, to publish their ratings methodology and are audited quarterly as to their adherence).

To complicate matters even further, the NAIC is considering allowing its SVO the ability to question any bond’s NRSRO rating and conduct its own internal rating instead. While this veto right has not yet been decided upon (and industry has vehemently pushed back on this requested authority), if approved it will allow structures that in the past have been characterized as a bond to become subject to the SVO’s current opaque rating process, which presently appear to have no set published methodology nor the staff or technology to efficiently and effectively administer risk ratings.

As we see insurance companies presently dipping their toes back in the CLO and financing markets, we should soon learn more about how the NAIC framework will be implemented. Stay tuned!

[1] NAIC Risk-Based Capital reported dated January 1, 2024