MAYER | BROWN

GLOBAL INSURANCE INDUSTRY
YEAR IN REVIEW 2020

EXCERPT

NAIC Investment-Related Initiatives

A fundamental element of US insurance regulation is monitoring the safety and soundness of insurers, and a big part of that task involves regulating the types of investments made by insurers. Like most aspects of US insurance regulation, the regulation of insurers' investments is a function of state law, although the NAIC has developed a framework for how insurer investments are treated for statutory accounting, financial reporting and risk-based capital ("**RBC**") purposes that the states generally follow.

The NAIC committee that addresses financial regulation is the Financial Condition (E) Committee (often called the **"E" Committee**). Like all NAIC committees, it is composed of state insurance commissioners or their designated staff members. The "E" committee currently has 38 subgroups that focus on different aspects of the financial regulatory landscape. In this article, we will discuss some 2020 initiatives of two of those subgroups—the Valuation of Securities (E) Task Force ("**VOS Task Force**") and the Statutory Accounting Principles (E) Working Group ("**SAP WG**")—that could significantly affect the regulatory treatment of certain insurance company investments.

"Principal Protected Securities" Lose Their Filing Exemption

The VOS Task Force oversees the NAIC's Securities Valuation Office ("**SVO**"), which is responsible for assessing the credit quality of securities owned by insurers. The SVO's operations are governed by the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the "***P&P Manual***"). One of the key elements of the *P&P Manual* is a procedure for insurers to file information about their bond and preferred stock investments with the SVO, so that the SVO can perform a credit quality assessment and assign a "designation" (essentially equivalent to a rating) between NAIC-1 and NAIC-6, with NAIC-1 indicating the lowest credit risk and NAIC-6 the highest credit risk. The RBC factors associated with these investments are highly sensitive to the NAIC designations. Currently, the pre-tax RBC factors for a life insurer are 40 basic points ("**bps**") for an NAIC-1 investment, 130 bps for an NAIC-2 investment, 460 bps for an NAIC-3 investment and 1,000 bps for an NAIC-4 investment.

In 2004, the *P&P Manual* was amended to include a filing exempt rule, granting an exemption from filing with the SVO for certain bonds and preferred stock that have been assigned a current, monitored rating by an NAIC-recognized credit rating provider ("**CRP**"). Under the filing exempt rule, the CRP rating is converted to the equivalent NAIC designation for statutory reporting and RBC purposes. The vast majority of fixed-income investments of insurers benefit from this filing exemption.

On May 14, 2020, the VOS Task Force adopted amendments to the *P&P Manual* that significantly changed the treatment of investments in "principal protected securities" ("**PPS**") for RBC purposes. As of January 1, 2021, insurers now need to file PPS investments with the SVO for review and assignment of an NAIC designation, rather than using the NAIC designation equivalent to the credit rating assigned by a CRP. Because the designations assigned by the SVO are expected to be lower than the designations based on CRP ratings, this will significantly increase the RBC charges associated with these securities.

The VOS Task Force took this action in response to a concern by the SVO that the CRP methodology was not accurately reflecting the risks of PPS investments from a regulatory, as distinct from a credit, perspective. The new requirement is designed to protect insurer solvency by ensuring that regulatory evaluations of those investments would accurately reflect the ability of insurers to use them to pay policyholders' claims.

The amendments to the *P&P Manual* define a PPS as "a type of 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:

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:
   a. 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
   b. 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.

The amendments provide three examples of transactions that fall within the PPS definition:

- A note issued by a special purpose vehicle ("**SPV**") that holds two underlying investments: (i) a Treasury zero-coupon bond purchased at a discount with a face value equal to the principal amount of the note at maturity; and (ii) a return linked to any positive performance of call options on the S&P 500 Index.
- A note issued by an SPV that holds multiple underlying components: (i) a corporate bond paying a fixed coupon with a stated maturity date; and (ii) additional undisclosed and unrated "performance assets."
- A repackaging of collateralized loan obligations ("**CLOs**") into a CLO combination note (often called a "**combo note**").

The amendments also include the following *exclusions* from the definition of PPS:

- Defeased or pre-refunded securities which have separate instructions in the *P&P Manual.*
- Broadly syndicated securitizations, such as CLOs (including middle-market CLOs) and asset backed securities ("**ABS**")—but *excluding* the examples listed above (e.g., CLO combo notes).
- CLO or ABS issuances held for purposes of risk retention as required by a governing law or regulation.

It is no surprise that the SVO has indicated that the designation it would assign to a PPS is lower than a designation based on a CRP rating. That is certainly the case for the three examples below:

- The PPS with the underlying Treasury zero-coupon bond and the S&P 500 Index-linked return would have a CRP rating of AAA/AA+ or an NAIC 1.A, based solely on the risk of the Treasury bond. 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.
- The PPS with the underlying corporate bond and the other "performance assets" would have a CRP rating of BBB or NAIC 2.B, based solely on the corporate bonds. In contrast, the WARF methodology would result in an NAIC 4.C when the exposure to all of the underlying investments is included.
- The combo note would have a BBB rating or NAIC 2.C on the notional based on payments from the underlying investment grade tranches. By contrast, the WARF methodology would result in an NAIC 4.B when the exposure to the below investment grade and unrated tranches is included.

To illustrate the impact on an insurer's RBC calculations: the pre-tax RBC factors for a life insurer are currently 40 bps for an NAIC-1 investment, 130 bps for an NAIC-2 investment and 1,000 bps for an NAIC4 investment. That means that receiving a designation of NAIC-4 instead of NAIC-1 (as in the first example above) will increase the RBC charge to 2500% of the current charge, and receiving a designation of NAIC4 instead of NAIC-2 (as in the other two examples) will increase the RBC charge to 769% of the current charge.

Prior to the May 14, 2020, adoption of the PPS amendments, industry representatives advocated that existing investments of insurers should be "grandfathered" and retain the NAIC designations corresponding to their CRP ratings. However, the SVO staff convinced the VOS Task Force not to allow "grandfathering," arguing that the risks they had identified needed to be addressed with respect to all insurer investments in PPS, regardless of when they were acquired. Accordingly, all PPS owned prior to January 1, 2021, need to be filed with the SVO by July 1, 2021, and all newly-acquired PPS need to be filed with the SVO within 120 days after acquisition. The goal is that *all* PPS included in an insurer's December 31, 2021, statutory financial statements will have been reviewed and assigned a designation by the SVO.

NAIC Takes Aim at "Bespoke Securities"

At its May 14, 2020, meeting, the VOS Task Force exposed for comment an issue paper written by the staff of the NAIC Investment Analysis Office ("**IAO**") (of which the SVO is a part). The IAO issue paper developed two concerns that had been expressed by the IAO to the VOS Task Force in a May 2019 educational session:

- A concern about "bespoke securities," defined as "financial instruments typically constructed by or for a small group of investors, which, due to their private nature, are not subject to or constrained by market forces and competition. As such, their visible characteristics may substantially underrepresent actual risks."
- A concern about what the IAO staff deem to be the NAIC's excessive reliance on CRP ratings to assess investment risk for regulatory purposes. The IAO staff does not believe that every CRP's methodology is appropriate for, or consistent with, the assessment of investment risk for statutory (i.e., regulatory) purposes.

The issue paper identifies six "red flags" that indicate the presence of a "bespoke security":

1. Rating from a single CRP;
2. Private letter rating;
3. Assets backing the security were primarily owned by the insurer or its affiliates before the transaction and were reported differently (i.e., regulatory arbitrage);
4. Assets backing the security do not generate bond-like cash flows (i.e., contractual requirements to pay periodic principal and interest);

5. The insurer or members of its affiliated group are the sole investors in the security; or
6. An affiliate of the insurer is the underwriter or sponsor of the security.

The treatment of "bespoke securities" proposed in the IAO issue paper was more nuanced than the treatment that PPS receive as of January 1, 2021. It included the following proposals:

- The SVO would get to review the legal agreements underlying "bespoke securities" and make a decision on whether the CRP's rating is acceptable for determining the NAIC designation or whether the security needs to be filed for an SVO-determined designation.
- The analysis supporting the assignment of any private letter rating would also need to be submitted to the SVO for review at least annually. The SVO would have the authority to determine if it would rely upon the private rating or require the security to be filed.
- At least two independent CRP ratings would be required for any NAIC designation to be derived from CRP ratings, and the lower of the ratings would be applied. In the absence of two CRP ratings, the security would need to be filed for analysis by the SVO.

With regard to CRPs, the IAO issue paper proposed that the SVO be tasked with monitoring CRP ratings and methodologies on a case-by-case basis and determining how they are used in the filing exemption process—with a goal of achieving "the greatest consistency and uniformity in the production of NAIC designations while maximizing the alignment between the assessment of investment risk to the NAIC's statutory objectives."

The comment period for the "bespoke securities" issue paper ended in August 2020. Comment letters were received from both life and property-casualty insurance trade associations. In September 2020, the parent "E" committee sent a letter to the VOS Task Force, publicly disagreeing with one of the comment letters and declaring that the SVO should have the ability to decide on a deal-by-deal basis whether to recognize a CRP rating for purposes of the filing exemption. The advance materials for the Task Force's November 2020 meeting included a copy of the 2010 report and recommendations of an NAIC Rating Agency (E) Working Group that was formed in 2009 (in response to the financial crisis) to evaluate the insurance regulatory use of rating agencies. Everything seemed to point to the VOS Task Force taking another major step to narrow the use of the filing exemption.

When the VOS Task Force met on November 18, 2020, the SVO asked for two things:

1. First, the SVO recommended that, beginning on January 1, 2022, when private letter rating securities are filed with the SVO, the related private rating letter rationale report must also be filed to provide more in-depth analysis of the transaction, the methodology used to arrive at the private rating and discussion of the transaction's credit, legal and operational risks and mitigants.
2. Second, the SVO recommended that it be given full discretion, based on its reasonable review of the private rating letter and the supporting rationale report, to:
   - Assign an NAIC designation equivalent to the private letter rating;
   - Require the security to be filed for review; or
   - Decline to assign any NAIC designation, on the basis that the security cannot be reported as a bond or a loan-backed or structured security on Schedule D of the insurer's statutory financial statements.

After a vigorous debate, the VOS Task Force voted to expose part (1) of the SVO's proposal for a 60-day comment period (ending February 5, 2021) – but not part (2). The consensus of the Task Force was to first enhance the transparency of private letter ratings and see what patterns emerge from the SVO's review of the supporting rationale reports before changing the treatment of private letter rated securities and giving the SVO the power to overrule the private letter rating. It was clear, however, that if the SVO is able to point to specific problematic issues with private letter ratings after it has an opportunity to review the rating agencies' rationales and methodologies, then part (2) of the SVO's request could well be revisited by the Task Force. In addition, the SVO staff stated that it would be scheduling a "regulator only" call in early 2021 to review with the Task Force examples of private letter rating transactions that the SVO believes should be ineligible for filing exemption, ineligible for Schedule D reporting and/or where there is a material difference in opinion as to the risk.

The version of the proposal that was actually exposed for comment included one of the features of the SVO's "ask" that many observers did not expect to be included. It provided that when a private letter and private letter rationale report are filed for a security, the SVO would also evaluate whether the privately-rated security is eligible to receive an NAIC designation with a CRP credit rating. In other words, the SVO would evaluate (i) whether the security is a fixed-income security eligible for reporting on Schedule D, and (ii) if so, whether it is eligible for a filing exemption. The proposal would not change the standards for answering those two questions, but it would establish a checkpoint whereby each private letter rated security would actually be examined by an SVO analyst to determine whether it satisfies those two criteria.

Representatives of the American Council of Life Insurers ("**ACLI**"), Private Placement Investors Association ("**PPIA**") and North American Securities Valuation Association ("**NASVA**") submitted a comment letter on February 5, 2021, and also spoke at the February 18, 2021, meeting of the VOS Task Force regarding their proposed modifications to the proposal:

1. Industry requested a transition period, such that for securities issued in the period from and after January 1, 2018, and prior to January 1, 2022, the requirement to furnish rating rationale reports be on a best efforts basis, rather than a firm requirement, and that it only become a firm requirement for securities issued on January 2, 2022, or later. The SVO agreed to make this change.
2. Industry requested that only the rating rationale report be required to be filed only at the time of initial issuance of a private letter rating, and not for subsequent changes to the rating. The SVO did not agree to make this change. The PPIA representative suggested as a compromise position that if a subsequent rating rationale report was issued, then it would be required to be filed, but that there would be no requirement to file a subsequent report if one was not required to be issued under the issuer's contract with the credit rating provider. This will likely be discussed further between the SVO and the industry representatives.
3. Industry requested that language be added to the *P&P Manual* defining the basis on which the SVO could determine that a privately-rated security is ineligible to receive an NAIC designation with an NAIC CRP credit rating, and requiring the SVO to provide the reasons for rejection, so that the filer could challenge the SVO's determination. The SVO did not agree to make this change, giving as its reasons that the eligibility criteria and appeal processes are already contained elsewhere in the *P&P Manual*. There was debate on the call as to whether the existing SVO practices would provide transparency to filers as to the reasons why the analyst determined a security to be ineligible, and the ACLI representative stated that the commenters would like to discuss this further with the SVO offline. The NASVA representative suggested that when an SVO analyst rejects a security as ineligible, that determination should be posted for all to become aware of, and not just made known to the company whose filing was rejected.

The next meeting of the VOS Task Force is scheduled for March 22, 2021, where it is likely that a revised form of the SVO proposal will be adopted. It is hoped that any proposal that is adopted will give insurers sufficient and timely insight into how their investments will be treated for statutory reporting and RBC purposes to enable them to make appropriate investment decisions. Too much uncertainty as to capital treatment could have the unfortunate effect of deterring insurers from pursuing the attractive yields and credit outcomes available in the private credit market.

Changes to the Rules on Structured Securities Are Coming Soon

On March 18, 2020, the SAP WG exposed for comment a preliminary (and partial) draft of an issue paper on potential substantive changes to *Statement of Statutory Accounting Principles (SSAP) No. 43R – Loan-Backed and Structured Securities.* The draft issue paper suggested that whether certain types of structured securities that do not meet the SEC definition of ABS—with collateralized fund obligations ("**CFOs**") being top of mind—should no longer be classified within the scope of *SSAP No. 43R* and should not be eligible for reporting on Schedule D as fixed-income securities. 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.

The draft issue paper proposed that structured securities that do not meet the SEC definition of ABS could still be considered for eligibility to remain in scope of *SSAP No. 43R* if they satisfy four principles:

1. Securitization and issuance of debt securities are from a trust/SPV that is separate and distinct as well as bankruptcy remote from the sponsoring organization;
2. Assets held in the trust/SPV predominantly represent contractual obligations to make payments ("**bond-like cash flows**");
3. The contractual obligations to make payments (assets held in trust/SPV) are owed by many diverse payers; and
4. Each securitization distributes periodic performance reports to investors that provide information about the underlying collateral composition, credit quality of obligors and payment performance.

At the SAP WG meeting on October 13, 2020, which was called to discuss the comments on the draft issue paper, the focus shifted to a new proposal from the Iowa Insurance Division that was exposed for a comment period ending December 4, 2020, and that many believe charts a path forward. The Iowa proposal offers a principles-based definition for assets to qualify for reporting on Schedule D (i.e., fixed-income treatment). Bonds would be defined as any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualify as either issuer obligations or ABS under the following definitions:

- Issuer obligations represent the debt of operating entities, which have a purpose other than the pass-through of investment proceeds. Examples of issuer obligations include (among others):
  - Treasury securities
  - US government agency securities
  - Municipal securities
  - Corporate bonds, including Yankee bonds and zero-coupon bonds
  - Convertible bonds, including mandatory convertible bonds
  - Bank loans issued directly by a reporting entity or acquired through a participation, syndication or assignment

- ABS represent debt issued through the securitization of financial assets. There are two defining characteristics that must be present in order for a security to meet the definition of an ABS:
  - The financial 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 financial assets collateralizing the debt issuance redistributes the credit risk of the underlying 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 lack of a trust or SPV would not be a definitive criterion for determining that a security meets the definition of an ABS.

The key to the Iowa proposal's definition of a bond—whether represented by an issuer obligation or ABS—is the notion of subordination: that the holder 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 "more than insignificant" subordinated interest must be present.

Another way of putting it is that an ABS redistributes the risk of the underlying collateral, such that the investor is in a different position than if the underlying collateral were held directly. On that principle, the Iowa proposal suggests that an entity that simply passes through the proceeds of the underlying collateral has done nothing to alter the nature of the investment, has no economic substance and should therefore be looked through to determine the appropriate accounting.

The Iowa proposal would define ABS as debt issued through the securitization of financial assets, but it does not define the key term "financial assets." From speaking with one of the authors of the Iowa proposal, it seems that the omission of a definition of "financial assets" was intended to leave this point open for further discussion. Significantly, the Iowa proposal does not say that securitized "financial assets" must have "bond-like cash flows" (which was the formulation in the draft issue paper that aroused such concern). Assuming that the Iowa proposal becomes the template for eventual action by the SAP WG, how "financial assets" are ultimately defined will be quite important.

The emergence of the Iowa proposal as an alternative to the more draconian approach proposed in the draft issue paper was a welcome development in 2020, and shows that the members of the SAP WG respond thoughtfully to feedback from industry. There is great anticipation for the SAP WG's next meeting on March 15, 2021, when it is expected that the Iowa proposal will be further hammered out.

Conclusion

All of the developments discussed above will have a significant impact on the investments of US insurers—particularly life insurers who have made long-term commitments in anticipation of achieving a certain level of investment returns. And coming in the midst of the COVID-19 pandemic, these developments will certainly add to the unprecedented challenges that insurers are already facing.

Authors

Lawrence Hamilton
Partner
lhamilton@mayerbrown.com
Chicago
+1 312 701 7055

Sanjiv Tata
Associate
stata@mayerbrown.com
New York
+1 212 506 2205

View the full Global Insurance Industry 2020 Year in Review.