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GLOBAL INSURANCE INDUSTRY

YEAR IN REVIEW

2019

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, financing 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 2019 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.

NAIC Bond Designations Becoming More Granular

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.

In 2004, the P&P Manual was amended to include a filing exempt ("**FE**") 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 FE 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.

Beginning with the statutory statements for 2020, the historical six NAIC designations will be replaced with a more granular system of 20 designation categories. For example, all FE bonds rated between Aaa and A3 are currently assigned a designation of NAIC-1 and accordingly receive

the same RBC charge. Under the new system, the NAIC-1 designation will be subdivided into seven categories ranging from 1.A (equivalent to Aaa) to 1.G (equivalent to A3). Although the more granular designation categories will be in effect for 2020 statutory reporting, the NAIC has not yet adopted a parallel set of granular RBC charges to go along with the designation categories.

Non-Principal Protected Structured Notes No Longer Have Admitted Status

The SAP WG has responsibility for the NAIC's *Accounting Practices and Procedures Manual*, which is the official codification of statements of statutory accounting principles ("**SSAPs**"). Statutory accounting is generally more conservative than GAAP accounting because it is not geared to helping investors assess an insurer's value or performance, but instead focuses on solvency – that is, an insurer's ability to keep its promises to policyholders. For example, assets that may have economic value but cannot be readily liquidated to fulfill obligations to policyholders are generally deemed "nonadmitted." Nonadmitted assets do not count toward an insurer's surplus, which is one of the key measures of an insurer's financial strength in statutory accounting.

On April 6, 2019, the SAP WG amended *SSAP No. 26R – Bonds* to define a "structured note" as "an investment that is structured to resemble a debt instrument, where the contractual amount of the instrument to be paid at maturity is at risk for other than the failure of the borrower to pay the contractual amount due." Due to those amendments, effective on December 31, 2019, such non-principal-protected structured notes are excluded from the scope of *SSAP No. 26R* and (unless they are "mortgage referenced securities"[1]) are also excluded from the scope of *SSAP No. 43R – Loan-Backed and Structured Securities*. That means they are no longer treated as bonds, but instead are within the scope of *SSAP No. 86 – Derivatives* and, moreover, are a type of derivative that is generally nonadmitted, unless a special exception is granted by the insurer's domiciliary state insurance department.

Principal Protected Notes May Lose Filing-Exempt Status

In July 2019, the SVO issued a memo to the VOS Task Force that proposed a new definition of "principal protected securities" that would be removed from the FE category and would need to be filed with the SVO for analysis and the assignment of a bespoke NAIC designation, rather than automatically receiving a designation based on a CRP rating. The assumption, of course, is that the NAIC designation that the SVO would assign to such filed securities as a result of its analysis would be lower than the CRP-equivalent designation the securities would have received under the FE system.

As described in the July 2019 SVO memo, principal protected securities are a type of structured security where a portion of the underlying assets are dedicated to ensure the repayment of principal at maturity or a third party may guarantee the repayment of principal at maturity. The remaining assets in the structure (the "**performance assets**") are intended to generate additional returns and may be of a type (e.g., derivatives, equities, commodities, non-rated debt, loans, funds, private equity, real estate, affiliated or undisclosed investments) that would not be eligible for reporting as bonds on Schedule D of an insurer's statutory financial statements if they were owned directly, but are indirectly included on Schedule D by being embedded within the note and benefit from the overall credit rating received by these notes.

In the ensuing months the VOS Task Force received considerable formal and informal comments on the proposal. At its October 31, 2019 meeting, the VOS Task Force directed NAIC staff to work with industry to refine the proposal, and following a series of meetings with industry representatives in November and December, the SVO released an updated proposal on January 27, 2020, which the VOS Task Force discussed on February 4, 2020 and exposed for a 30-day comment period ending March 5, 2020.

[1] *SSAP No. 43R* defines "mortgage referenced securities" as "credit risk transfer" securities issued by a government sponsored enterprise, where payments on the securities are linked to the credit and principal payment risk of a referenced pool of mortgages.

The updated proposal defines Principal Protected Notes ("PPNs") 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," but for which two additional conditions are satisfied:

1. The insurer would obtain a more favorable RBC charge or regulatory treatment for the PPN 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 PPN is zero, below market or, in any case, equal to or below the comparable risk-free rate.

The updated proposal provides three illustrative examples of transactions that would fall within the definition of a PPN—one of which is a repackaging of collateralized loan obligations ("**CLOs**") into a CLO combination note (or "**combo note**").

The updated proposal also includes the following exclusions from the definition of PPN:

- 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 in the updated proposal (e.g., CLO combo notes); and
- CLO or ABS issuances held for purposes of risk retention as required by a governing law or regulation.

At the February 4, 2020 telephonic meeting of the VOS Task Force, NAIC staff expressed the view that the updated proposal had addressed the issues appropriately and arrived at the correct scope for the PPN definition. Some industry participants agreed with that view, though one participant expressed a desire for more input on the methodology that the SVO would use to analyze filed securities and suggested that a weighted average rating factor approach would be unduly punitive. In response, SVO staff stated that they could not be confined to a single prescribed methodology, but needed the discretion to tailor their methodology to the variety of structures and the nature of the risks. Another industry participant on the call suggested that the PPN treatment being recommended for CLO combo notes, was based on an inaccurate assessment of the risks of CLO investments (see further discussion on this topic below).

A topic that was not discussed on the February 4, 2020 call, but was discussed on the October 31, 2019 call is whether the new filing requirements for PPNs, if adopted, would be effective only for PPNs that insurers acquire after the effective date. The SVO staff has been consistent in its view that while it is appropriate to provide a transition period for insurers to adjust their portfolios, once the new requirements are in effect, they should apply to all portfolio investments, regardless of when they were acquired. The SVO is opposed to any "grandfathering" of already-owned securities because it believes it has identified a risk to insurers that needs to be addressed with respect to insurers' entire portfolios of these types of securities.

As noted above, the comment period for the current PPN proposal ends on March 5, 2020. The goal of the NAIC staff is to review the comments received and potentially have the current proposal, or a revised version of it, ready for adoption by the VOS Task Force at the NAIC Spring National Meeting on March 22, 2020.

Collateralized Fund Obligations May Lose Eligibility for Bond Treatment

SSAP No. 43R – Loan Backed and Structured Securities defines certain types of debt obligations as "loan backed and structured securities" ("**LBASS**"), which are treated similarly to bonds for statutory accounting purposes, are reported on Schedule D of an insurance company's statutory statements and receive bond-type RBC charges

based on their NAIC SVO designation (which is automatically assigned based on the CRP rating in the case of rated LBASS).

At the NAIC Summer National Meeting in August 2019, the SAP Working Group exposed for comment proposed revisions to SSAP No. 43R that, if adopted, would exclude collateralized fund obligations ("**CFOs**") from LBASS status, which means they would no longer be treated as bonds for statutory accounting, reporting or RBC purposes, even if they were rated by a CRP. The original proposal stated flatly that *SSAP No. 43R* is intended to capture investments with bond-like cash flows and "does not include equity instruments, investments with underlying assets that include equity instruments or any structures representing an equity interest (e.g., joint ventures, limited liability companies, partnerships) in which the cash flow payments (return of principle *[sic]* or interest) are partially or fully contingent on the equity performance of an underlying asset." The proposal added that the "scope of SSAP No. 43R shall not include any securitization of assets that were previously reported as standalone assets by the insurance reporting entity. In other words, an insurance reporting entity is not permitted to repackage existing assets as "securitizations" to move the reporting of the existing assets within scope of SSAP No. 43R." The NAIC staff initially classified the proposed change as "nonsubstantive" because in their view it was merely clarifying what they understood to be the original intent of SSAP No. 43R.

During the comment period, which ended on October 11, 2019, there was a strong reaction from the insurance industry, with commenters asserting that the proposal was too "broad brush," would impact billions of dollars of industry assets and could have major unintended consequences. In response, the SAP Working Group deferred action on the proposals until 2020, in order to give the staff time to analyze the comment letters. Doubtless as a result of the comments, the materials released by the NAIC staff in advance of the January 8, 2020 telephonic meeting of the SAP Working Group took a more measured approach. The staff now recommended that the Working Group classify the project as "substantive," meaning that staff would prepare an issue paper on the subject, in consultation with industry representatives, and would make their revised proposal for changes to SSAP No. 43R in the context of that issue paper. As a preview of the direction in which they were leaning, the NAIC staff suggested the following:

- The guidance should distinguish between investments that satisfy the SEC definition of ABS and those that do not.
- Different treatment might be warranted for CLO combo notes and for ABS that are not broadly syndicated.
- Investments where the amount of principal or interest is calculated solely with reference to an external market index should be excluded from the scope of SSAP No. 43R.
- Detailed guidance is needed to clearly identify and assess "insurer-sponsored securitizations."
- Separate treatment was needed for equipment trust certificates, credit tenant loans and lease-backed securities that is tailored to those securities.

Industry participants in the January 8, 2020 meeting of the SAP Working Group suggested that the staff working on the new SSAP No. 43R issue paper should coordinate their efforts with the SVO staff working on the PPN definition. Other participants expressed concerns about using the SEC definition of ABS as a controlling criterion and about what the consequences would be for ABS not meeting that definition. At the conclusion of the meeting, the SAP Working Group approved the staff's recommendation for the preparation of an issue paper. With respect to timing, the staff stated at the meeting that its goal was to have the issue paper available in time to be exposed for comment at the Spring National Meeting on March 21, 2020.

Differing Views of CLO Risks and Investment Risks

A point of disagreement that was briefly discussed at the February 4, 2020 meeting of the VOS Task Force was how to assess the risks of CLO investments for insurers. On December 6, 2019, the NAIC Capital Markets Bureau released a report entitled "Collateralized Loan Obligations – Stress Testing US Insurers' Year-End 2018

Exposure." That report described stress-testing that the NAIC staff had performed to assess the impact on CLO investments of a potential market downturn. The results of the stress tests showed that (a) losses on "normal" CLO tranches (i.e., CLOs with regular promises of principal and interest) only reached BBB-rated tranches, even under the worst-case scenario and (b) for "atypical" CLO tranches (i.e., CLOs that have unusual payment promises, such as equity tranches and combo notes), losses reached AA-rated securities. On the February 4, 2020 VOS Task Force call, one of the industry representatives expressed concerns about the methodology of the NAIC CLO report, suggesting that default assumptions were too high (among other things, by failing to take account of structural changes in loan documentation following the financial crisis) and that stressed recovery rate assumptions were too low. That individual urged the VOS Task Force to engage an independent expert to advise the Task Force on this issue. In response, a representative of the NAIC Capital Markets Bureau stated that he disagreed with the criticisms of the NAIC report and was planning to respond to them with a written rebuttal.

This debate is important, because it is likely that the NAIC staff's view of the risks associated with CLO combo notes has influenced the inclusion of CLO combo notes in the PPN definition that is currently under consideration by the VOS Task Force. Having said that, the debate may actually reflect a fundamental difference in orientation between the investment world and the regulatory world. Insurance regulators, with their focus on protection of policyholders above all else, generally have a more risk-averse orientation than investment analysts do. An investment structure that offers statistically attractive returns may be problematic in the eyes of regulators if they perceive that it has the capacity to cause even one insurance company to become insolvent. And the recent experience of a group of life insurers that are now in delinquency proceedings after having invested heavily in PPNs that involved underlying affiliate investments has led many regulators to conclude that the PPN structure is facilitating RBC arbitrage that undermines the integrity of the RBC system—although the proposed PPN definition goes far beyond just targeting affiliate underlying investments. Yet another perspective to consider is that for many years prior to the financial crisis, life insurers made long-term promises to policyholders based on assumptions of higher returns than they can now obtain from traditional classes of fixed-income investments – meaning that newer structures by which life insurers can obtain higher returns in a capital-efficient manner may be one ingredient in enabling them to fulfill their promises to their policyholders. Accordingly, it is important that the views and concerns of insurance companies continue to be heard as the NAIC deliberates on these potentially consequential initiatives.

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