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Rated-Debt Feeder Structure: NAIC Regulatory Accounting Treatment

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As originally discussed in our 2019 Action Item, the continuing, low interest rate environment has caused many insurance companies to turn to private credit funds to diversify their credit portfolios and increase their returns. Private credit funds that offer insurance companies the opportunity to participate in their funds indirectly through a rated-debt feeder fund structure provide insurance companies an opportunity to lower their risk-based capital requirements when compared with investing directly in such credit funds. As discussed in our 2021 Chapman Insights, investing in private credit funds through a rated-debt feeder structure is not without legal complexities, but many insurance companies have found those complexities to be worth the regulatory capital relief that may be available by investing through a rated-debt feeder structure.

Since private credit funds typically raise capital by having investors purchase limited partnership interests in their fund, structuring an insurance company's investment in a private credit fund as a purchase of debt issued by a feeder fund has caused insurance companies, fund sponsors, and placement agents to consider the regulatory accounting treatment that might be afforded those debt instruments. This article discusses how the National Association of Insurance Commissioners ("*NAIC*") is modifying its regulatory accounting rules to address various debt instruments purchased by insurance companies, particularly those purchased as part of securitizations involving private funds and equity interests, and whether those modifications might relate to the debt issued by rated-debt feeders.

NAIC: CFOs and the Revisions to SSAP No. 43R

The NAIC recently acknowledged that the introduction of complex investment structures has created a challenge in determining whether certain debt securities issued to insurance companies in such structures constitute "bonds" for insurance regulatory accounting purposes. For some time, the NAIC has been concerned with debt securities issued as part of a collateralized fund obligation (a *"CFO"*), a securitization where the cash flow from one or more private equity funds supports the repayment of the debt issued in the CFO. The NAIC views as problematic certain CFOs where the underlying equity interests are not expected to provide a "meaningful level of cash flow" for the repayment of the CFO debt. In addition, the NAIC has raised regulatory accounting concerns with CFOs designed to "transfer" an insurance company's private equity fund investments from Schedule BA (where equity investments are reported) to Schedule D-1 (where the debt portion of a CFO might be reported), substantially reducing an insurance company's risk-based capital requirements with respect to such investments.

The NAIC has stated that the determination of whether a particular instrument can be characterized as a bond eligible for listing on Schedule D-1 must be based on the substance of the instrument, rather than its legal form. To reflect that premise, in 2019 the Statutory Accounting Principles (E) Working Group of the NAIC (the *"SAPWG"*) proposed revisions of SSAP No. 43R which governs the accounting treatment of loan-backed and structured securities that can be listed on Schedule D-1. The proposed revisions seek to clarify that the intent of SSAP No. 43R is to capture only those securities that have "bond-like cash flows" and to confirm that investments that might previously have been reported as equity investments on the books of an insurance company cannot be converted into investments reported as bonds merely by holding those investments through a CFO structure, as that provides an insurance company with unwarranted risk-based capital relief.

Proposed Bond Definition

Since being introduced in 2019, the proposed revisions to SSAP No. 43 have highlighted a need for the development of a "principles-based approach" to defining a bond for regulatory accounting purposes. On May 20, 2021, the

SAPWG released a proposed, principles-based bond definition (the *"Proposed Bond Definition"*) for consideration by the insurance industry. The Proposed Bond Definition introduces characteristics of an instrument to be classified as debt, a glossary of terms, and examples of the characteristics set forth in the definition.

Appendix I of the Proposed Bond Definition includes three examples of debt instruments which, despite their legal form as debt, may not represent a creditor relationship in substance and thus may not qualify as a bond eligible for listing on Schedule D-1. Each of the three examples in Appendix I references a debt instrument that relies on the value or cash flow generated by private equity funds or equity interests as the source of the debt instrument's repayment. Each example is distinguishable from the debt typically issued in a rated-debt feeder structure where pools of loans (rather than private equity funds or other equity interests) serve as the source of the rated debt's repayment.

Even though Appendix I provides three examples of debt instruments that may not qualify as bonds for regulatory accounting purposes, Appendix I acknowledges that, in certain circumstances, a debt obligation that relies on equity interests for repayment may qualify as a bond and goes on to state that "significant judgment and analysis" are required to determine whether a debt obligation that relies on equity interests for repayment represents a creditor relationship in substance (making it eligible for listing as a bond on Schedule D-1).

In addition, Appendix I contrasts a debt obligation that relies on equity interests as a source of repayment with a "debt instrument collateralized by assets with contractual flows" (*e.g.,* the notes issued by a feeder fund in a rated-debt feeder structure that rely on pools of loans for repayment) because, in the latter situation, cash flow distributions are required to be made and the issuer of the debt controls whether those distributions are made. Based on those statements, one could conclude that debt instruments typically issued in rated-debt feeder structures do not raise the same regulatory accounting concerns as those that arise in the context of CFOs and other debt obligations that rely on equity interests for repayment.

Certain "interested parties" sought confirmation of that conclusion in their comment letter to the SAPWG, stating that they do not believe that Example III of Appendix I of the Proposed Bond Definition is intended to exclude from debt characterization notes issued by a feeder fund which in turn invests in a fund that invests directly in debt securities.[1] The Interested Parties Comment Letter urges clarification in this regard since such arrangements (*i.e.,* debt issued to insurance companies by feeder funds of private credit funds) might otherwise "be construed to be debt backed by equity interests", rather than debt backed by other debt instruments. The statements in Appendix I, taken together with the Interested Parties Comment Letter, support a conclusion that the treatment of a debt instrument issued in a private credit fund's rated-debt feeder structure is distinguishable from the debt issued in a CFO, even though a rated-debt feeder structure shares some characteristics with a CFO.

Status of the Proposed Bond Definition

At its August 26, 2021 meeting, the SAPWG authorized further study of the Proposed Bond Definition with a stated goal of incorporating a "principles-based approach" into the NAIC's accounting procedures for the purpose of clarifying which debt instruments are eligible to be considered a bond and reported on an insurance company's Schedule D-1 and, thus, eligible for a reduced risk-based capital requirement (in comparison with debt instruments that may require listing on Schedule BA). Kevin Clark, Vice Chair of the SAPWG, acknowledged that many debt instruments will qualify for listing on Schedule D-1, stating that "the development of a principles-based approach will accommodate a vast array of investment structures".[2]

Final modifications of regulatory accounting principles, including final adoption of a principles-based definition of a "bond", are not expected to be ready for approval until May 2023. Julie Gann, Assistant Director, Solvency Policy at the NAIC, stated that "due to the significance of the changes expected, the earliest application of the new standard would likely be Jan. 1, 2024".[3] She also stated that "until revised guidance is adopted and effective, reporting entities can continue reporting as they have been for items currently in scope of SSAP No. 26R or SSAP No. 43R".[4] Ms. Gann indicated that she did not expect that the NAIC would provide "pure grandfathering of existing structures"; however, it is expected that the development of "transition guidance" would be part of the on-going discussions of the regulatory changes.[5]

While there will be much for the SAPWG to discuss as it considers the scope of the Proposed Bond Definition and receives further industry comments about the regulatory accounting treatment of various instruments that may fall within or outside the proposed definition,[6] the examples and statements included in the May 20, 2021 Proposed Bond Definition and the current industry comments regarding the same suggest that the rule-making will focus on debt instruments that rely on equity interests for repayment, as opposed to debt instruments that rely on underlying pools of loans for repayment (the structure utilized by rated-debt feeder funds). We will continue to follow the refinement of the Proposed Bond Definition and its incorporation into SSAP No. 43R during calendar year 2022.

For More Information

If you would like further information concerning the matters discussed in this article, please contact Van Holkeboer or the Chapman attorney with whom you regularly work:

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1 *See,* Comment Letter dated July 15, 2021 of The Travelers Companies, Inc. and Equitable on behalf of "interested parties" (the *"Interested Parties Comment Letter"*).

2 *See*, the minutes of the SAPWG August 21, 2021 meeting.

3 *See*, the minutes of the SAPWG August 21, 2021 meeting. *Also see*, the Hearing Agenda for the August 21, 2021 meeting which indicated that "[a]n earlier effective date (of Jan. 1, 2023) … is not viewed to be realistic due to the extent of revisions needed and discussions expected to occur".

4 *See*, the minutes of the SAPWG August 21, 2021 meeting.

5 *See*, the minutes of the SAPWG August 21, 2021 meeting.

6 It is our understanding that the "43R study group" organized by the SAPWG continues to meet regularly to address the myriad issues raised by the Proposed Bond Definition, including whether the "stapling" of a debt instrument and an equity instrument as part of an insurance company's investment might negatively impact the classification of the debt instrument as "debt" for regulatory accounting principles (which arises in part from Example 1 of Appendix I of the Proposed Bond Definition and was the subject of the Pinnacol Assurance Comment Letter to the Proposed Bond Definition). Per Vice Chair Clark, the implications of "stapling" will be reviewed as part of the project.