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March 23, 2023

Rachel Hemphill
Chair, NAIC Life Actuarial (A) Task Force (LATF)

Re: NAIC Valuation of Securities (E) Task Force (VOSTF) Referral to LATF – Structured Equity and Funds

Dear Ms. Hemphill:

The American Council of Life Insurers (ACLI) appreciates the opportunity to submit comments on the VOSTF referral to LATF regarding Structured Equity and Funds that was exposed for feedback on March 2, 2023.

ACLI believes that this informational referral does not warrant formal comment from LATF. ACLI is comfortable continuing the dialogue with VOSTF to address our main technical concerns with the proposal. For your reference, attached to this comment letter is a February 13, 2023, joint comment letter from ACLI, PPIA, and NASVA outlining those concerns.

Were LATF to formally comment, we would ask for an opportunity to present the main concerns described in the joint letter at a future LATF meeting before any such comments were sent to VOSTF.

Thank you once again for the consideration of our feedback and we are looking forward to any future discussions on this subject.

The American Council of Life Insurers (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

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cc: Scott O’Neal, NAIC

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February 13, 2023

Ms. Carrie Mears, Chair
Valuation of Securities Task Force
National Association of Insurance Commissioners
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Proposed Amendment to Define and Add Guidance for Structured Equity and Funds to the P&P Manual

Dear Ms. Mears,

The undersigned (ACLI, PPIA, and NASVA) appreciate the opportunity to comment on the exposure referred to above that was released for comment by the Valuation of Securities Task Force (VOSTF) on December 14th, 2022.

The Undersigned's Response to the Exposure – In Summary

The exposure has a variety of SVO concerns that are somewhat commingled. Our concerns, some of which are addressed in more detail following, are summarized below.

1. It appears some of the SVO's concerns include:

    a. Pure regulatory arbitrage, when comparing pre-and post-securitization, while holding the same economic risk,
    b. What constitutes a "bond" in concept, specifically for eligibility under SSAP No. 26R and SSAP No. 43R, and
    c. Lack of transparency on the structures and investments held by the underlying fund.

2. Industry is confused by the overlap with other initiatives and exposures, specifically the "Principles-based Bond Definition" initiative, the Risk-Based Capital Investment Risk and Evaluation (E) Working Group (Investment RBC WG) activities, and this Exposure. Projects and other initiatives address those concerns as follows:

    a. The Investment RBC WG agenda currently includes a project to determine the appropriate risk-based capital charge for residual tranches of structured investments, which will address the arbitrage concerns raised in this proposal,

b. SAPWG is currently near finalization of a project to define a bond, including determining eligibility for reporting on Schedule D. The SVO already has an avenue to raise concerns on investments that they do not believe meet the definition of a bond,
c. Private rating letters are now being filed. These letters are quite substantive and should include significant information about fund structures and their largest underlying investments.

3. The exposure name implies that the SVO is focused on feeder funds and structured equity investments. However, concerns associated with potential PIK interest, maturity extensions or other features that are common among securities appear to be commingled within the feeder fund example. To the extent a security has the potential to PIK or defer interest, where such interest is otherwise not capitalized or required to be accrued, or the potential to extend the maturity without paying interest for that extension, the Undersigned agree such a security has non-payment risk. Otherwise, the potential to PIK or defer interest, or the potential to extend the maturity, has real economic or business benefits, often mitigating risk, and should not be in the purview of the SVO for determining NAIC designations that are ultimately used for risk-based capital purposes.

   Presumably, the SVO has concerns related to liquidity risk, but this is not a factor in determining an NAIC designation, nor should it be, and the SVO is not in a position to assess liquidity risk for insurers. The SVO has been focused on securities with the potential to PIK or defer interest, as well as the potential to extend maturity, but we have yet to discern what that concern is other than liquidity risk.

4. The proposed definitional change to the P&P Manual would potentially capture a whole host of more traditional fixed income securities that industry does not believe were intended to be in scope and may be difficult for the SVO to evaluate. The following fixed income securities are explicitly not feeder funds, nor share the same risk profile. Industry notes the following examples potentially captured by the exposure (including but not limited to):

   - Senior secured debt issued by a comingled fund, private or public (SEC 40 Act regulated funds, mutual funds etc.)
   - Senior secured debt issued by SPVs that own or invest in debt instrument(s), whether directly or through tax or jurisdictionally required blockers
   - Senior debt issued by REITs
   - Senior debt issued by BDCs
   - Senior debt issued by entities owning stakes in one active corporate subsidiary, or multiple related active corporate subsidiaries (“holding companies”),
   - Senior debt issued by Collateralized Fund Obligations (“CFOs”) through a trust securitization offering
   - Senior debt issued as NAV Loans generally with very low LTVs

   In addition to the cost associated with reviewing these additional transactions, the question arises as to whether the SVO can better assess risk than rating agencies. Some of these structures (such as CFOs) are non-homogenous and require substantial modelling resources to evaluate. Certain rating agencies have developed a niche in assessing these risks. We also note these securities often have significant credit enhancement retained by the issuer that are not

part of the securitization (e.g., CFOs) as well as significant overcollateralization (e.g., NAV Loans, often with LTVs at 10%).

5. The exposure mentions that the SVO could use any methodology that it deems appropriate to designate such funds. There is concern about the lack of transparency of SVO methodologies, and related consistency in designations for similar risk. We believe transparency in methodology, as is happening with CLOs, is important and SVO methodologies should be fully transparent. This would accomplish two objectives – 1) Ensure the SVO is applying methodologies consistently and 2) Provide transparency to the market and industry.

6. A 2021 NAIC Capital Markets Bureau Special Report stated, "On average, designations were 2.375 notches higher, with designations 2.4 notches higher at small CRPs and 1.9 notches higher at large CRPs" than SVO's designations". This statement implies that SVO designations are conservative, even when compared with larger rating agencies. We believe that conservative designations for their own sake should not be the objective of the SVO. Rather, the pursuit of consistent, accurate, and transparent investment risk assessments should be the joint objective of the NAIC, VOSTF, SVO, and Industry. Excess conservatism and lack of transparency for critical processes within the SVO's designation methodology have the potential to create a disconnect between the appropriate risk-based capital charges set by the NAIC's Capital Adequacy's Task Force and SVO designations. Risk-based capital charges are based upon public rating agency experience and is the foundation upon which the capital charges are ultimately based.

   While acknowledging the SVO's designation process generally works well for most traditional corporate bonds that are filed with the SVO, although not without examples of unsubstantiated deviations, the potential for inconsistency in appropriate risk assessment becomes even greater as structural complexity increases. Additionally, having concentrated critical processes under the SVO's sole discretionary purview, including choice of rating methodology to apply, application of that methodology, and the lack of a robust and independent appeals process for industry, does not offer appropriate checks and balances. Currently, industry struggles to understand how the SVO might view securities with new, unusual, or outlier risks and what type of designation the SVO might assign to such securities. The potential for inconsistency in appropriate risk assessment becomes even greater as structural complexity increases. If an SVO designation methodology exists for all asset classes, industry does not understand why they cannot be made both public and transparent. If an SVO designation methodology does not exist for all asset classes, that would be concerning as the SVO looks to expand its role for designating even more complex securities.

   There is also concern that a lack of transparency and applied consistency with the SVO's undisclosed designation methodologies will lead to material capital uncertainties and inconsistent designations. Capital certainty may not officially be a component of an NAIC designation, but we believe all should agree that consistent application of, and transparency of, designation methodology is important to all stakeholders, including the SVO and state regulators. Further, capital certainty and timeliness of designations are very important to insurance companies to manage risk-appetites for risk-based capital in a meaningful way, and to ensure that return on investments covers not only expected losses but also an acceptable return on capital.

7. The undersigned believe the proposed amendment should focus on what we consider should be mutual areas of agreement in principle.

   The SVO should make their methodologies public to help ensure they are applied consistently, the SVO's powers have appropriate checks and balances, and/or they are not overly conservative when compared to rating agencies' ratings and upon which risk-based capital charges are based.

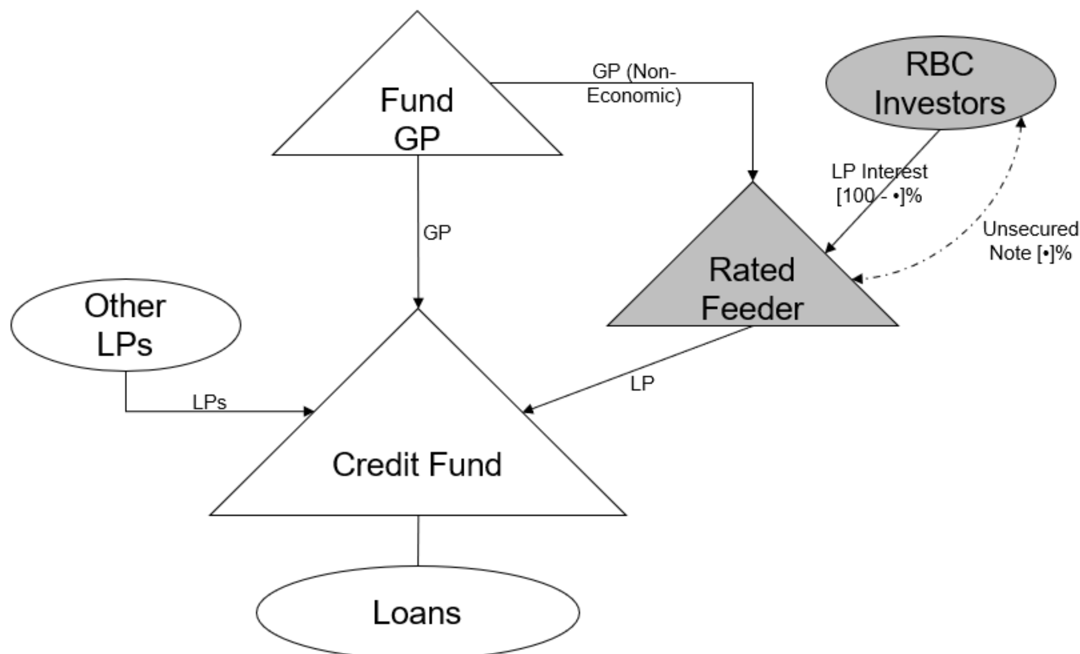
   Even the large rating agencies, who have extensive resources (including sizable staff with dedicated teams for specific asset classes with unique characteristics, trained economists, the latest technology, access to tailored seminars/training for specific asset classes, and access to management), are not experts in all areas.

   As a result, both large and smaller rating agencies have developed particular niche expertise, and no one rating agency rates every type of debt asset class.

The undersigned would like to work together with the SVO and NAIC to better understand their concerns so approaches more tailored toward those specific concerns can be more efficiently addressed. We look forward to having dialogue with you on these issues and stand ready to help.

Feeder Fund Structures

The remaining part of our letter focuses on the feeder fund structure and the examples included within the exposure. A visual depiction of a feeder fund can be shown as follows:



This type of structure, as well as other structures such as CFOs, were subject to significant discussion during the principles-based bond definition project. Early in the project, complex and unworkable rules were being developed in an attempt to address risk-based capital concerns of structures (i.e., allowing for potential risk-based capital arbitrage without a substantial change in economic risk). It was ultimately decided by SAPWG that such concerns were best addressed by revising the definition of a bond in combination with the Investment RBC WG addressing the

appropriate risk-based capital charges for residual tranches. All residual tranches have subsequently moved to Schedule BA and are in scope for potentially higher risk-based capital charges.

During the bond project, industry also shared with regulators that these feeder fund structures provide valuable benefits to the insurance industry, as well for those outside the insurance industry. Feeder funds allow companies to obtain diverse exposure to mezzanine debt (or junior debt, 1st lien debt, etc.) which investors would otherwise not be able do individually due to materiality, individual underwriting expertise, lack of diversification, etc.

The feeder fund structure was initially developed, at least in part, for anti-arbitrage reasons and to allow insurance companies to access funds with a capital charge that puts insurance company investors on a level playing field with pension funds, banks, and other non-insurance investors. The key is that some investors cannot commit sufficiently large capital to do a separately managed account directly, and thus must choose between either foregoing attractive credit risk exposure or taking an overstated risk-based capital charge to access a diversified portfolio of ultimately debt instruments via a fund investment. A pension fund, for example, can invest in the limited partnership directly without similar risk-based capital consequences. But for an insurance company, the risk-based capital charge is 30%. Meanwhile, as noted in the SVO example, the real risk-based capital risk on a look-through basis is lower – in the example only 9.5% – resulting in anti-arbitrage.

The Investment RBC WG agenda currently has a project to determine the appropriate risk-based capital charge for residual tranches commensurate with the levered risk of the residual tranche. An interim solution is anticipated in time for concurrent adoption with the principles-based bond project. In the SVO's example, if the residual tranche risk-based capital charge was set at 65% (i.e., half-way between 30% and 100%) the aggregate risk-based capital charge of owning both the debt and equity tranche would be 7.635% versus 9.535%, essentially eliminating the "arbitrage" as laid out in the feeder fund exposure example. However, the SVO's example only has a 10% equity tranche which is substantially lower than a typical equity tranche. A more representative equity tranche of 25% with a 30% risk-based capital charge would yield an aggregate risk-based capital charge of 8.446% essentially eliminating any arbitrage. A risk-based capital charge of 65% on the residual tranche would yield an aggregate RBC charge of 17.196% which would still be significantly anti-arbitrage.

Further, securities issued by feeder funds are often issued as tranches with associated waterfall structures. These more complicated structures allow apportionment of risk potentially between different entities and/or segments to further allocate risk. Often the investment teams at insurance companies that manage fixed income versus equity portfolios are separate entities. To the extent a debt-oriented fund must be evaluated by an equity portfolio team, the fund will generally not gain traction being a "lower returning opportunity" compared to equity asset classes. This can make the access to this attractive asset class effectively fall through the cracks at many insurance companies. Feeder vehicles can assist these companies to shift the evaluation from their equity portfolio teams to their debt-oriented teams.

Not all feeder fund investors are primarily motivated by risk-based capital treatment; some of them are very focused on having the "reliable and predictable income" that debt tranches from a feeder fund would provide. The complex structuring and apportionment of senior/subordinate risk between tranches is both experience and technology intensive. CRPs have invested materially for years in their capabilities to assess credit risk in these tranched waterfall-based securitizations, and their published methodologies are transparent and consistently applied. We question whether the SVO

could evaluate such structures, for all different types of asset classes, in a more efficient, transparent and/or consistent manner than already performed by the CRPs.

The SVO's WARF methodology can work well where it is currently applied such as when there is direct ownership in an LP interest with no debt, but it becomes problematic when there is debt or when multiple tranches exist with a waterfall structure. Absent this already being addressed by the Investment RBC WG, it might be reasonable to have the SVO apply the WARF methodology and utilize that charge, if the SVO would apply the aggregate 9.535% charge they note is appropriate in the exposure. However, this comes with several practical problems:

1) The SVO exposure suggests any methodology for a designation could be used by the SVO, in their sole discretion without transparency as to considerations given or to ensure consistency of application. A lack of transparency as to methodology has long been a significant challenge industry has raised regarding the SVO, as designations received from the SVO can sometimes seem variable and inconsistent. This can lead to industry uncertainty regarding assessment of risk. While acknowledging the SVO's designation process generally works well with traditional corporate bonds that are filed with the SVO, although not without examples of unsubstantiated deviations, the potential for inconsistency in appropriate risk assessment becomes even greater as structural complexity increases. Trying to gain an understanding of potential outlier risk assessment is generally not achievable with today's SVO structure.

2) The cost of filing such securities with the SVO, which is significant given the proposed scope, could be prohibitively expensive and time consuming given the potential for limited incremental benefits, if any, compared to the status quo. For example, if the underlying debt itself is not rated by a CRP, our understanding is the designation for that underlying bond is automatically deemed a 5B, which is inappropriate, or each individual underlying instruments needs to be filed with an RTAS. The hard cost of filing each security, and each RTAS, combined with the requisite filing requirement for each underlying security (if all such information is even available in the form required), is prohibitive. Rating agencies have devoted significant cost and staff to analyze such securities. For example, industry understands that rating agencies stress each individual CUSIP within the securitization under different scenarios. Many rating agencies also have niche expertise in certain variations of asset backed securities, with different underlying collateral.

3) The SVO's exposure questions both the PIKing or deferral and accruing of interest and circumstances where the weighted average life of the underlying junior debt differs from the term of the note. However, there are valid economic reasons for why these structural features exist, and we think it is an oversimplification to assume that such features are inherently risky.

   For example, while acknowledging significant variations exist (one example cannot cover all contingencies), it is common that the underlying investments in the portfolios of these funds are not typically traded. While the fund manager has the authority to actively manage the fund, in large part the average fund ends up pursuing a "buy and hold" strategy. During the investment period of the underlying fund, investments are originated and purchased by the fund. After the end of the investment period, the fund goes into a "run-off" mode and no further investments are purchased by the fund. As cash is generated from the underlying investments in the fund is distributed to investors in the fund on a pro-rata basis per their respective commitment to the fund. To the extent the investor has come into the fund via a feeder vehicle, then the waterfall provisions of that vehicle will dictate how the cash is distributed to the tranches of securities

that were issued by the feeder vehicle. The portfolio manager has no discretion to redirect these cash flows, and again they are contractually directed per the waterfall.

Generally speaking, feeder vehicles are structured such that once an underlying fund portfolio has "ramped-up", given the inherent overcollateralization of these structures from the viewpoint of the rated notes, ample cash flow is generated from the fund's assets to pay the contractual cash coupons on the rated notes issued by the feeder vehicle. After paying administrative expenses, all cash received during each period is first available to pay the interest due on the Senior Notes of the feeder vehicle, followed by interest due on any Subordinated Note tranches. During the investment period, it is typical that any remaining cash be distributed to the residual or equity tranche of the feeder vehicle, while after the investment period this cash would otherwise be used to pay down principal of the Senior Notes (until fully repaid) and then any Subordinated Notes, prior to being applied to the residual tranche.

Given the structure of a typical feeder vehicle and the waterfall priorities, it is highly unlikely that interest due to the Senior Notes issued by a vehicle would not be paid in cash. For any Subordinated Notes, to the extent there is not sufficient cash flow received on a current basis in a particular period of time to pay the interest due on those notes, then that interest is PIKed or otherwise accrued for the current period. Per the priority structure of the waterfall, that interest will then have to be paid in cash from cash received from the underlying fund investments in subsequent periods. This amount due will remain outstanding and retain its priority in the waterfall until fully repaid.

For an underlying fund that primarily holds private debt investments in its portfolio, these investments may typically have legal maturities of 7-10 years. Given that these investments can generally be prepaid by their issuing companies several years before the legal final maturities, and with the normal life cycle of private equity ownerships of companies generally, it is very common that these investments will only be held by the underlying fund for ~3-4 years.

With a typical structure for a feeder vehicle, the note tranches issued by the vehicle will generally have debt maturities longer than the maturities of the investments in the underlying fund (and practically speaking much longer than the actual hold period for most investments in those funds). Since all cash received from the underlying investments is directed by the feeder vehicle waterfall structure to pay down interest and then principal of the notes issued by the feeder vehicle, this potential mismatch is not problematic. In fact, this is a credit enhancement for the notes issued by the feeder vehicle that ensures there is no need for distributions in kind.

As noted in our previous letter on Subscript S and non-payment risk, there are valid reasons for potential PIK interest (or deferral of interest) as well as for potential maturity extension features, and if structured appropriately, they do not represent non-payment risk. A US Treasury security can be a PIK security, for example. The SVO's exposure says the interest "could" be deferred without capitalization. It is unclear in the example cited, whether this is the case or "could" is used more generally. However, if the debt interest can be deferred without capitalization or otherwise being accrued, as stated in the deal documents, we agree that is non-payment risk and have no disagreement that it should be filed with the SVO as a non-filing exempt security. Although we are generally not aware of such securities being utilized, we agree that, to extent such securities exist, we are comfortable filing them. However, we do not think the presence of a PIK interest feature that capitalizes interest when used, is problematic.

4) The exposure's second example doesn't appear to have an equity tranche, and therefore the analysis presented in the exposure would not be practically appropriate. In any instance, we do not believe the math is correct in the SVO's analysis. To arrive at the SVOs risk-based capital charges, both debt tranches would have to be 50 and 50, not 55 and 55. The "BB Debt" would not be debt and would have an equity charge of 30% resulting in an aggregate RBC charge of 17.6925% in this instance. Should it be 65% the aggregate risk-based capital charge would be 37%. That is greater than the risk-based capital charge of the underlying equity.

Industry believes that feeder fund structures should be left, as originally planned by SAPWG, to be addressed by the Investment RBC WG. Additionally, industry does not deem the presence of PIK interest and principal extension features in securities to automatically translate to higher risks that would necessitate a filing with the SVO. The SVO was recently granted the authority to review private rating letter rationales (which are in-depth reports) and report suspected non-bonds to regulators, and regulators can react accordingly. It is unnecessary to make a large swath of any given asset class non-filing exempt in order to identify instances of potential abuse.

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We stand ready to work collaboratively with the Task Force and SVO on this and other matters in the future

Sincerely,

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey
Tracey Lindsey
NASVA

John Petchler
John Petchler
on behalf of PPiA
Board of Director