NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

TO: Thomas Botsko, Chair, Capital Adequacy (E) Task Force
Members of the Capital Adequacy (E) Task Force
Phillip Barlow, Chair, Risk-based Capital Investment Risk and Evaluation (E) Working Group
Members of the Risk-based Capital Investment Risk and Evaluation (E) Working Group

FROM: Carrie Mears, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau
Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

RE: Referral on the Risk Assessment of Structured Securities - CLOs

DATE: August 30, 2022

Summary – The Investment Analysis Office (IAO) staff have recommended to the Valuation of Securities (E) Task Force to direct the modeling of collateralized loan obligations (CLO) to the Structured Securities Group (SSG). SSG is already responsible for the modeling of residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS). Included in their recommendation was a request to refer to the Capital Adequacy (E) Task Force and Risk-based Capital Investment Risk and Evaluation (E) Working Group a request that your groups consider creating or breaking out risk-based capital factors for three new NAIC 6 designation categories; i.e. 6.A, 6.B, and 6.C.

Rationale - A collateralized loan obligation (CLO) is type of structured security backed by a pool of debt, typically corporate loans with low credit ratings. Each tranche of a CLO differs based on the order in which the investors will be paid when the underlying loan payments are made. As a result, they also differ with respect to the risk associated with the investment since investors who are paid last have a higher risk of default from the underlying loans. The aggregate risk of owning all the underlying corporate loans held by a CLO structure should be the same as owning all of the CLOs tranches. Therefore, the RBC impact of both should be equivalent if it is free from any risk-based capital (RBC) arbitrage.

Regulatory Issue – As the attached memorandum reflects, there is currently the potential to materially (and artificially) reduce C1 capital requirements just by securitizing a pool of assets into a CLO. SSG can model CLO investments and evaluate all tranche level losses across all debt and equity tranches under a

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series of calibrated and weighted collateral stress scenarios to assign NAIC Designations that eliminate this RBC arbitrage.

Recommendation – The Valuation of Securities (E) Task Force has requested NAIC staff to draft an amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* permitting SSG to model CLO investments for the assignment of NAIC Designations. The Task Force also requests that the Capital Adequacy (E) Task Force and its Risk-Based Capital Investment Risk and Evaluation (E) Working Group contemporaneously consider NAIC staff's recommendation to add new RBC factors to account for the tail risk in any structured finance security. Staff suggests adding new NAIC Designation Categories (e.g. 6.A, 6.B and 6.C) with recommended RBC factors of 30%, 75% and 100%, respectively. The Task Force understands that the recommended new RBC factors may only be an interim step until structured finance securities can be studied more fully by your groups, but the Task Force believes there is a pressing regulatory need to take timely action to eliminate this RBC arbitrage and potential financial solvency risk.

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