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NAIC Proposal on Credit Ratings Causing Market Disruption

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Developments at the nation's premier forum of state insurance regulators are roiling capital markets, with potentially meaningful consequences for companies raising funds as well as the insurance industry.

By way of background, insurance companies invest premium dollars in investment assets such as mortgages, bonds and stocks. Insurers are among the most active institutional participants in capital markets, particularly private placements. Like many investors, insurers want to be diversified and hold a variety of asset classes. State insurance laws also require that insurers observe concentration limits and similar criteria in their investment portfolios (*see, e.g.,* New York Insurance Law Art. 14).

One of the ways in which state insurance regulators police insurance company strength is through the "risk-based capital" (RBC) framework, published by the National Association of Insurance Commissioners (NAIC) and incorporated in each state's insurance laws. The NAIC is a non-governmental body comprising the state insurance regulators and its own professional staff.

The RBC framework requires that each insurer maintain an amount of capital appropriate to its specific circumstances; as part of this approach,

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it mandates that an insurer hold additional capital against each investment it holds, as a hedge against the risk that the investment fails. The RBC system assigns each kind of investment a "charge" specifying the amount of capital that must be held against it. The riskier the asset, the greater the RBC charge.

In general, equity securities carry a much higher RBC charge than debt. This is because equity securities, such as corporate stock and limited partnership interests, are considered inherently riskier than debt as a result of their location in the capital structure.

One of the key inputs for the RBC system is the "NAIC designation" of a particular investment. An NAIC designation from the NAIC's Securities Valuation Office (SVO) constitutes the SVO's assessment of credit risk associated with that

security, where "credit risk" means the "relative financial capability of an obligor to make the payments contractually promised to a lender." (*Purposes and Procedures Manual of the NAIC Investment Analysis Office* ("*P&P Manual*"), Part One, ¶ 37.)

The scale of the SVO's designation categories ranges from 1.A (denoting the most creditworthy securities) to 6 (least creditworthy). The designations are relevant for compliance with state insurance laws on investment criteria. (*See*, *e.g.*, New York Insurance Law § 1404(a)(2)(A)(iv), which provides a safe harbor for certain insurers to invest in obligations that "have been given the highest quality designation" by the SVO.) They are also relevant to establishing the RBC charge associated with the relevant security, with higher-designated securities entitled to a lesser charge and hence more attractive to insurers.

Filing a security with the SVO to obtain a designation requires a comprehensive submission of the security in question so that the SVO can assess the credit risk. However, where a security is already rated by a rating agency such as Fitch or Moody's, the security need not be filed with the SVO—that is, the NAIC considers it "filing exempt" (or "FE"). Consequently, it automatically obtains a designation that maps to the rating agency's rating scheme, as set forth in NAIC guidance.

For instance, a Fitch rating of "AAA" maps to an NAIC designation of 1.A, a Fitch rating of "AA+" maps to an NAIC designation of 1.B, and so on, down to Fitch's "CC" through "D" ratings, all of which map to NAIC 6. Similar mapping is provided for other rating agencies including Standard & Poor, Moody's and Kroll.

Where a rating of a particular security is not public, and issued in a private letter between the rating agency and the sponsor, the insurer must report the private rating to the SVO in order to achieve the mapped designation (a so-called "private letter rating" filing).

In a Nov. 28, 2022, memorandum to members of the NAIC's Valuation of Securities Task Force (VOSTF), which oversees it, the SVO wrote that it had "processed several private letter rating (PLR) filings for investments in . . . a special purpose vehicle, trust, limited liability company, limited partnership or other legal entity that operates as a feeder fund which itself invests, directly or indirectly, in one or more funds or more equity investments."

In the memorandum, the SVO illustrated its concerns with a hypothetical example of a feeder fund structure. In the example, an investor in a fund, instead of holding an LP interest in the fund (which would be treated as an equity interest and would draw the higher RBC charge), holds an interest in a second fund that is itself an LP of the main fund. Where that interest is classified as a debt security, regulatory guidance may have been circumvented insofar as what is functionally an LP interest has been "routed" into a debt form, entitled to the lower capital charge. The SVO recommended that such investments be excluded from FE status.

One of the benefits of feeder funds is that they allow insurers to invest in a diversified portfolio of credits without needing to invest individually in them, which would be administratively onerous. After considering (generally negative) input from interested parties on the proposal to revoke FE status from feeder funds, in May 2023, the SVO unveiled a more elaborate procedure for contesting an NAIC designation generated by the automatic mapping available to FE securities. (*See* Attachment 6 to VOSTF meeting materials, Aug. 14, 2023.) However, the new proposal would apply not only to feeder funds but theoretically to any FE-eligible security.

Under this proposal, the NAIC's Investment Analysis Office (the IAO, which comprises the SVO and a companion body, the Structured Securities Group) may determine sua sponte that an

NAIC designation is "not a reasonable assessment of risk of [a] security for regulatory purposes." The process may also be initiated by a state insurance regulator (such as the New York Superintendent of Financial Services). The IAO would notify insurers that hold the security (as well as state insurance regulators) of this step.

Under the proposed procedure, the IAO may elect to put a security under such analytical review only if it determines, based upon its review, that the rating agency rating is three or more notches different from the IAO's own assessment (*e.g.*, NAIC designation category 1.G versus 2.C).

As part of its review, the IAO may consider factors such as "(i) a comparison to peers rated by different [rating agencies], (ii) consistency of the security's yield at issuance or current market yield to securities with equivalently calculated NAIC Designations rated by different [rating agencies], (iii) the IAO's assessment of the security applying available methodologies, and (iv) any other factors it deems relevant."

No later than 120 days after a security is marked as under review for FE status or following the conclusion of any outstanding appeal, whichever is later, the IAO would be required to make a final determination on FE eligibility of such security. If the IAO determines that the NAIC designation category assigned pursuant to the mapping process should remain unchanged, the security would remain eligible for FE.

If the IAO determines to revoke FE eligibility, the IAO would so indicate on NAIC systems, with a notice to insurers that the security is not FE eligible. An insurer with concerns over the process by which FE status was revoked could appeal to VOSTF.

At its Aug. 14, 2023 meeting as part of the NAIC 2023 Summer National Meeting, VOSTF considered feedback from interested parties. Among the objections to the SVO proposal were the following: (1) it would create uncertainty among insurers and disruption in the capital markets; (2) the ratings methodology and appeals process lack transparency; (3) it would unduly expand SVO's role beyond that of regulator, thus creating a conflict of interest; and (4) existing safeguards are adequate inasmuch as credit rating agencies are regulated by the U.S. Securities and Exchange Commission.

In addition to objectors from the private sector, eight members of the U.S. House of Representatives wrote the NAIC complaining that the discretion claimed by IAO, "which appears to lack any formal methodology, if enacted, would deviate significantly from the NAIC's proper role within insurance regulation."

As of this writing, any SVO framework for revoking FE status, and triggering an independent SVO review of a security's creditworthiness, hangs in the balance as VOSTF considers interested party feedback to the May 2023 proposal. VOSTF's parent body, the NAIC's Financial Condition (E) Committee, recently included VOSTF's efforts on ratings in the E Committee's overarching "Framework for Regulation of Insurer Investments – A Holistic Review".

The uncertainty associated with VOSTF's deliberations is causing disruption in capital markets; it has been reported that some issuers are holding off on private placements of securities pending more clarity from the NAIC. These developments also have the potential to deprive insurers of unique opportunities to diversify their portfolios with feeder funds.

The impact on insurer financial strength remains to be seen.

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