INSURANCE COMPANY INVESTMENTS

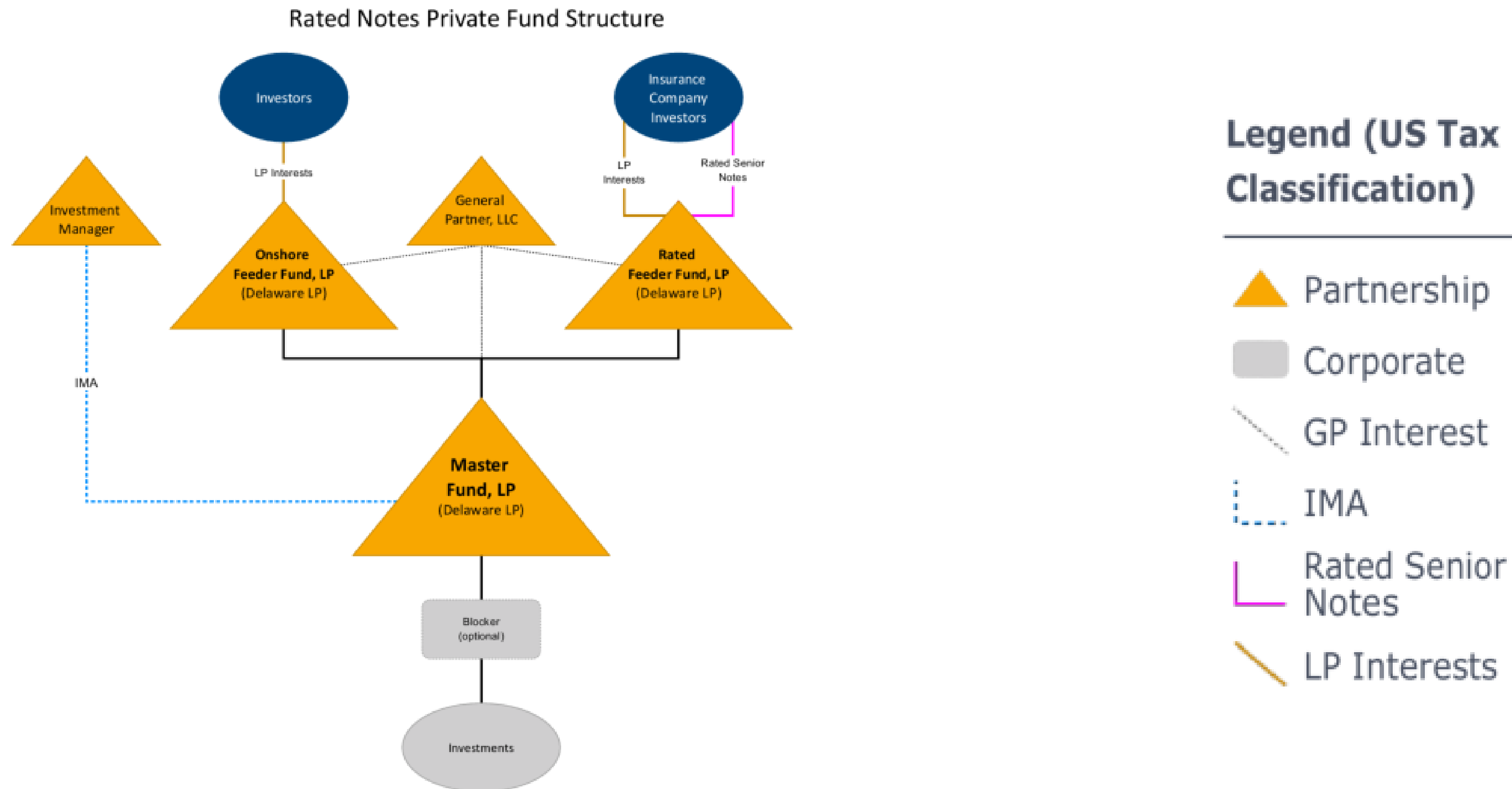
February 2025

Typical Rated Note Feeder Structures

TYPICAL RATED NOTE FEEDER STRUCTURE

- A feeder fund raises its capital by issuing debt and equity to investors and the proceeds of the offering are used by the feeder fund to acquire limited partnership interests in the master fund.
- The terms of the notes are customized to the strategy of the underlying master fund and investor considerations.
- The senior notes issued by the debt feeder fund are rated by a rating agency.
- The subordinated notes or feeder fund LP interests, as applicable, provide the subordination to support the ratings on the senior notes.
- Typically, the investment adviser of the master fund acts as manager for the rated note feeder issuer.

TYPICAL RATED NOTE FEEDER STRUCTURE



Legend (US Tax Classification)

- Partnership
- Corporate
- GP Interest
- IMA
- Rated Senior Notes
- LP Interests

NAIC Considerations for Rated Feeder Structures

NAIC CONSIDERATIONS

- **Insurers want their fixed income investments to be treated as bonds** – reported on **Schedule D** and receiving a risk-based capital (**RBC**) charge based on their NAIC designation
- **Insurers also want their fixed income investments to be filing exempt** (**FE**) – so that they automatically receive the NAIC designation associated with their rating by a NRSRO (referred to by the NAIC as a Credit Rating Provider or CRP) rather than having to be filed with and analyzed by the NAIC's Securities Valuation Office (**SVO**)
- Recent NAIC initiatives will make it more challenging for insurers to achieve these goals:
  - A new principles based bond definition (**PPBD**) became effective on January 1, 2025
  - Starting on January 1, 2026, the SVO will have the authority to challenge and potentially override NAIC designations derived from CRP ratings on a security-by-security basis

RBC FACTORS FOR LIFE INSURERS (PRE-TAX)

NAIC Designation	NRSRO Equivalents	Life RBC Factor (%)		NAIC Designation	NRSRO Equivalents	Life RBC Factor (%)
1.A	Aaa/AAA	0.158		3.A	Ba1/BB+	3.151
1.B	Aa1/AA+	0.271		3.B	Ba2/BB	4.537
1.C	Aa2/AA	0.419		3.C	Ba3/BB-	6.017
1.D	Aa3/AA-	0.523		4.A	B1/B+	7.386
1.E	A1/A+	0.657		4.B	B2/B	9.535
1.F	A2/A	0.816		4.C	B3/B-	12.428
1.G	A3/A-	1.016		5.A	Caa1/CCC+	16.942
2.A	Baa1/BBB+	1.261		5.B	Caa2/CCC	23.798
2.B	Baa2/BBB	1.523		5.C	Caa3/CCC-	30.000
2.C	Baa3/BBB-	2.168		6	All Lower	30.000

ALL DEBT SECURITIES MUST SATISFY THE PPBD TO QUALIFY AS BONDS

- The new *SSAP No. 26* defines a "bond" as:
  - a security
  - representing a creditor relationship
  - whereby there is a schedule for one or more future payments and
  - which qualifies as either:
    - an issuer credit obligation (**ICO**) or
    - an asset-backed security (**ABS**)
- There is no "grandfathering" of existing investments – all portfolio investments must satisfy the new definition effective on 1/1/2025

DEFINITION OF "SECURITY" FOR STATUTORY ACCOUNTING PURPOSES (SAME AS GAAP)

- Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:
  a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer
  b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment
  c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests or obligations

- An **ICO** is a bond, the repayment of which is supported primarily by the general creditworthiness of an operating entity or entities
- Issuers can be either operating companies or holding companies that have the ability to access the cash flows of operating company subsidiaries through their ownership rights
- The ICO definition includes:
  - US Treasury and US government agency securities
  - municipal bonds
  - corporate bonds
  - project finance bonds
  - securities for which repayment is “fully supported by an underlying contractual obligation of a single operating entity” (discussed on next slide)
  - bonds issued by REITs
  - bonds issued by funds that represent “operating entities” (discussed below)
  - convertible bonds (including mandatory convertible bonds)

TWO CONDITIONS ABS MUST SATISFY TO BE A BOND (DETERMINED AS OF THE DATE OF ORIGINATION)

- Condition #1: The assets owned by the ABS issuer must be either:
  - financial assets, or
  - cash-generating non-financial assets
    - defined as assets that are expected to generate a "**meaningful**" level of cash flows toward repayment of the bond through use, licensing, leasing, servicing or management fees, or other similar cash flow generation (and not just through the sale or refinancing of the assets)
    - "meaningful" criterion is deemed met if payment of 100% of the interest and at least 50% of the original principal relies on sources of cash other than sale or refinancing—but can also be met in other ways

- Condition #2: The holder of a debt instrument issued by an ABS issuer must be:
  - in a different economic position than if the holder owned the ABS issuer's assets directly
  - as a result of "**substantive**" credit enhancement through:
    - guarantees (or other similar forms of recourse),
    - subordination and/or
    - overcollateralization
- This means that the "first loss" tranche in an ABS structure is not a bond
  - Instead, it is classified as a "**residual interest**"

DEFINITION OF "FINANCIAL ASSETS"

- *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* defines a financial asset as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right (a) to receive cash or another financial instrument from a second entity or (b) to exchange other financial instruments on potentially favorable terms with the second entity
- Financial assets do not include assets for which the realization of the benefits conveyed by the above rights depends on the completion of a performance obligation (e.g., leases, mortgage servicing rights, royalty rights, etc.). These assets represent non-financial assets, or a means through which non-financial assets produce cash flows, until the performance obligation has been satisfied

SPECIAL RULES APPLY WHEN ABS ARE BACKED BY EQUITY INTERESTS

- There is a **rebuttable presumption** that debt instruments collateralized by equity interests do not qualify as bonds because they do not reflect a creditor relationship in substance.
- Notwithstanding this rebuttable presumption, it is **possible** for such a debt instrument to represent a creditor relationship if:
  (1) the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and
  (2) the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer.
- A **documented analysis** supporting the predictability of cash flows must be completed *at the time the investment is acquired* to overcome the rebuttable presumption.
- A debt instrument that has been successfully marketed to unrelated investors may provide enhanced market validation in contrast to one held by a single insurer or group of affiliated insurers.

NON-EXHAUSTIVE LIST OF FACTORS TO BE CONSIDERED IN OVERCOMING THE REBUTTABLE PRESUMPTION

- Number and diversification of the underlying equity interests
- Characteristics of the equity interests (vintage, asset-types, etc.)
- Liquidity facilities
- Overcollateralization
- Waiting period for the distributions/pay-downs to begin
- Capitalization of interest
- Covenants (e.g., loan-to-value trigger provisions)
- Reliance on ongoing sponsor commitments
- Source(s) of expected cash flows to service the debt (*i.e.*, dividend distributions from the underlying collateral vs. sale of the underlying collateral)

HOW ARE RATED FEEDER NOTES AND CFOS TREATED UNDER THE PPBD?

- They neither automatically qualify for, nor are automatically disqualified from, bond treatment
- It is necessary to look through the structure and evaluate the underlying portfolio of assets that generate the cash flows for repayment
- Consider the regularity and certainty of the cash flows
  - In particular, whether the assets are debt instruments that generate periodic, scheduled payments of principal and interest
  - The expectation is that rated feeders and CFOs for private credit funds, direct lending funds and similar strategies will qualify for bond treatment
  - If cash flows vary or are irregular (e.g., due to discretion of an underlying fund manager or the need to sell underlying investments, such as private equity portfolio assets), it will be harder to qualify the structure for bond treatment

WHAT HAPPENS IF A DEBT SECURITY FAILS TO SATISFY THE PPBD?

- A debt security that fails the bond definition is a "non-bond debt security" (**NBDS**) governed by *SSAP No. 21—Other Admitted Assets*
- NBDS are admitted assets only if the underlying collateral primarily qualify as admitted assets. (Examples of what would not qualify: student loans, consumer loans, railcar leases)
- NBDS are reported on **Schedule BA**, initially at cost and subsequently at the lower of amortized cost or fair value
- NBDS are segregated on Schedule BA based on the PPBD characteristic they lacked (creditor relationship, substantive credit enhancement or meaningful cash flows)
- NBDS need to be filed with the SVO to receive an NAIC designation, i.e., they are not eligible for the filing exemption under which a CRP rating is used to determine the NAIC designation

RBC FOR NON-BOND DEBT SECURITIES

- NBDS are not filing-exempt, meaning that they no longer derive an NAIC designation from a CRP rating
- For life insurers:
  - If an NBDS has a designation assigned by the SVO, that will flow through the AVR and will determine the RBC, using the bond RBC factors
  - If an NBDS does not currently have an SVO-assigned designation, it needs to obtain one
- For P&C and health insurers:
  - An NBDS is classified under "Other Invested Assets" with an RBC factor of 20%
  - It is possible that the NAIC may decide in the future to allow an SVO-assigned designation to determine the RBC for P&C and health insurers as well, but that is not currently the case

"RESIDUAL INTERESTS" – DEFINED BASED ON THE SUBSTANCE RATHER THAN THE FORM OF AN INVESTMENT

- The definition of "residual interest" was adopted on 9/21/2023 and became effective on 12/31/2023
- A residual interest or a residual security tranche exists in investment structures that are backed—directly, or indirectly through a feeder fund—by a discrete pool of collateral assets
- These collateral assets generate cash flows that provide interest and principal payments to debt holders, and once those contractual requirements are met, the resulting excess funds generated by (or with the sale of) the collateral assets are provided to the holder of the residual interest
- The residual interest holder thus absorbs losses resulting from assets in the collateral pool not performing as expected, before any losses are borne by the debt holders
- Consequently, the residual interest holder may ultimately receive nothing, a reduced amount from original projections, or large returns, based on how the underlying collateral assets perform

RBC AND ACCOUNTING TREATMENT OF RESIDUAL INTERESTS

- Effective with the 2024 RBC calculation, residual interests receive an RBC charge of 45% (increased from 30%) for life insurers and 20% for P&C and health insurers (no change)
- Additional criteria apply in determining whether a residual interest qualifies as an "admitted asset" (an asset that counts toward the insurer's surplus)
  - If the senior debt in the structure consists of one or more bonds, then the underlying collateral does not need to consist of admitted assets in order for the residual interest to be an admitted asset
  - If the senior debt in the structure consists of NBDS, then the underlying collateral must be admitted assets in order for the residual interest to be an admitted asset

EFFECTIVE 1/1/2026, THE SVO WILL BE ABLE TO CHALLENGE DESIGNATIONS ON FILING-EXEMPT SECURITIES

- The SVO will be able to challenge the NAIC designation assigned through the FE process if it believes the CRP rating "may not be a reasonable assessment of investment risk of the security for regulatory purposes" and its own assessment differs by three or more notches
- The challenge process will require the insurer to file information with the SVO that is comparable to what is required for non-FE securities
- The insurer may submit any other information it wishes to support the CRP rating, including inviting the CRP to participate in the process
- Both sides will present their case to a subgroup of the NAIC Valuation of Securities (E) Task Force consisting of state insurance regulators
- That group of regulators will decide whether or not to substitute the SVO's assessment for the designation assigned through the FE process

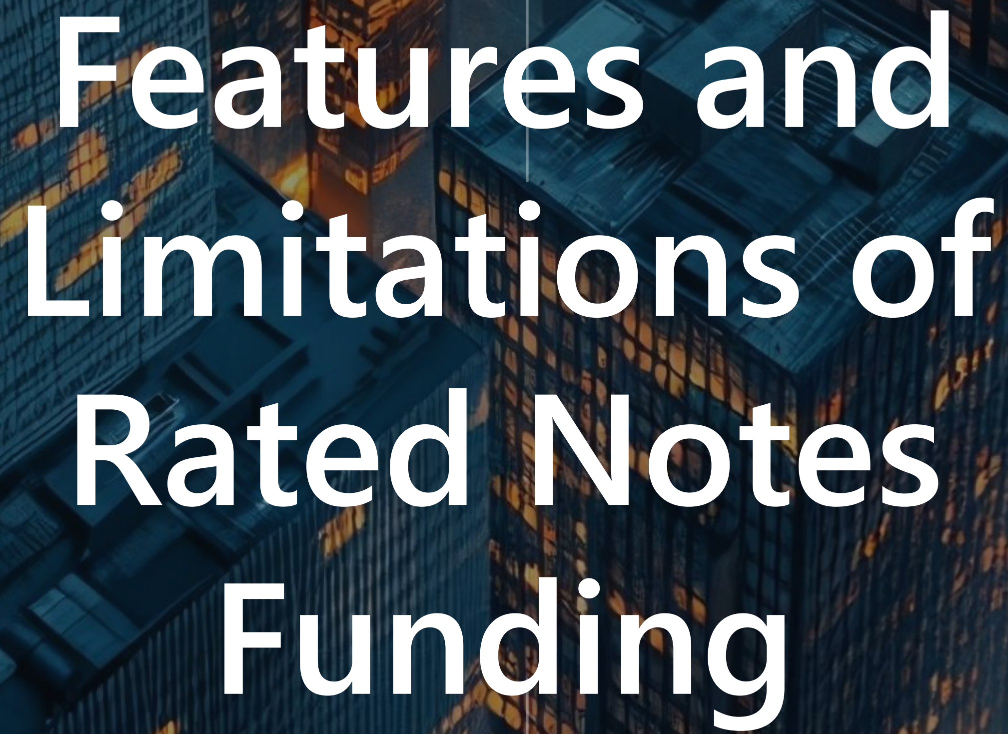
NAIC PPBD IMPACT TO RATED FUND STRUCTURES

- Avoid applying traditional equity features to notes
  - Senior noteholder giveback for indemnities is problematic
  - Avoid discretionary distributions by the sponsor
  - Use standard noteholder draw-down conditions
    - No excuse or exclusion provisions
    - Draw-downs after the end of the investment period need to be limited
- Add additional debt features to bolster bond treatment
  - Appointment of a third-party trustee or paying agent
  - Use of an independent director to establish bankruptcy remoteness of note issuer
  - Grant of security interest

NAIC PPBD IMPACT TO RATED FUND STRUCTURES CONT'D

- Increased equity to satisfy the "substantive credit enhancement" requirement
  - Credit enhancement must result in a holder of the debt security being in a "different economic position" than if investing directly in the underlying portfolio
  - Credit enhancement cannot be nominal or lack economic substance. It must function as true, substantive first loss.
  - The amount of credit enhancement required will be specific to each transaction or structure
- Stapling interests (debt and equity) is still possible
  - Tranches must be separate securities (not a single investment unit)
  - Separate CUSIPs are preferable
  - Bond tranches will be reported on Schedule D
  - Residual tranches will be reported on Schedule BA

Features and Limitations of Rated Notes Funding



TYPICAL PASS-THROUGH FEATURES OF FEEDER FUND STRUCTURES

- **Interaction with Master Fund.** A rated note feeder, like other feeder vehicles, does not typically affect terms of master fund.
- **Investment Restrictions.** A rated note feeder will be limited to making an investment in the master fund. Need to look at investments and investment restrictions of master fund to support rating of notes.
- **Capital Commitments.** Investors make capital commitments to the fund, which are drawn down over the life of the fund on an investor-by-investor basis (e.g. fund expenses, management fees, investments, etc).
- **Rebalancing.** The entire fund complex can admit subsequent closing investors. Subsequent closing investors pay their portion of previously drawn-down contributions, plus an interest payment, which can be waived by sponsor.

TYPICAL PASS-THROUGH FEATURES OF FEEDER FUND STRUCTURES CONT'D.

- **Varying Fees.** Investors may be subject to varying management fees and carried interest. Fees and carried interest may be borne by the rated note feeder at the master fund level – therefore need to structure economics on an investor-by-investor basis or otherwise build in mechanisms to fund documents to true up investors.
- **Giveback Obligations.** Investors are subject distribution giveback obligations in the event of a loss/indemnification event of the Fund.
- **Recycling Obligations.** Investors are subject to recycling obligations, i.e., their capital commitments may increase to the extent they receive a distribution.
- **Excuse / Exclusion Rights.** Investors generally have a right to be excused from making an investment and the sponsors generally have the right to exclude an investor.
- **Side Letters.** So long as the specific deal term does not affect other investors, investors and the sponsor have free reign to negotiate specific fund terms through side letter arrangements.

TYPICAL RATED NOTE CHARACTERISTICS

- **Advances**
  - Align timing with Master Fund capital commitments
  - Usually Delayed Draw-down or Recycling Mechanics
- **Interest Payments**
  - Fixed or Floating Interest Rate is possible
  - Interest usually Deferred automatically if not paid (avoid PIK Interest terminology)
  - Rating agencies require interest to accrue on unpaid interest
- **Distributions**
  - Rated Feeder proceeds (net of Mater Fund expenses and fees) distributed on a quarterly payment date
  - Separate investment period and amortization period waterfalls
- **Limited Events of Default**

STRUCTURAL GAPS TO ADDRESS

Fund Feature	Typical LP Interest	Rated Notes	Structural Gaps to Address
Capital Commitments Drawdowns	Investor-by-Investor	Pro Rata and Pari Passu	Limits the ability to call capital on a non-pro rata basis
Distributions	Investor-by-Investor	Pro Rata and Pari Passu	Distributions are limited which may impact investor performance The subordinate interest is effectively levered, though subordinate to the rated notes
Rebalancing	Allowed	Limited Rebalancing	Subordinate interest responsible for (i) interest payment on behalf of notes and (ii) its own interest payment
Fee Arrangements	Investor-by Investor	Partial	Subordinate interest becomes recipient of fee discounts
Giveback / Recycling Obligations	Allowed	Not Allowed	Subordinate interest responsible for giveback and recycling obligations
Excuse / Exclusion	Allowed	Not Allowed	Effectively limited

Subscription Line Financing Considerations

SUBSCRIPTION CREDIT FACILITY CONCERNS WITH DEBT COMMITMENTS

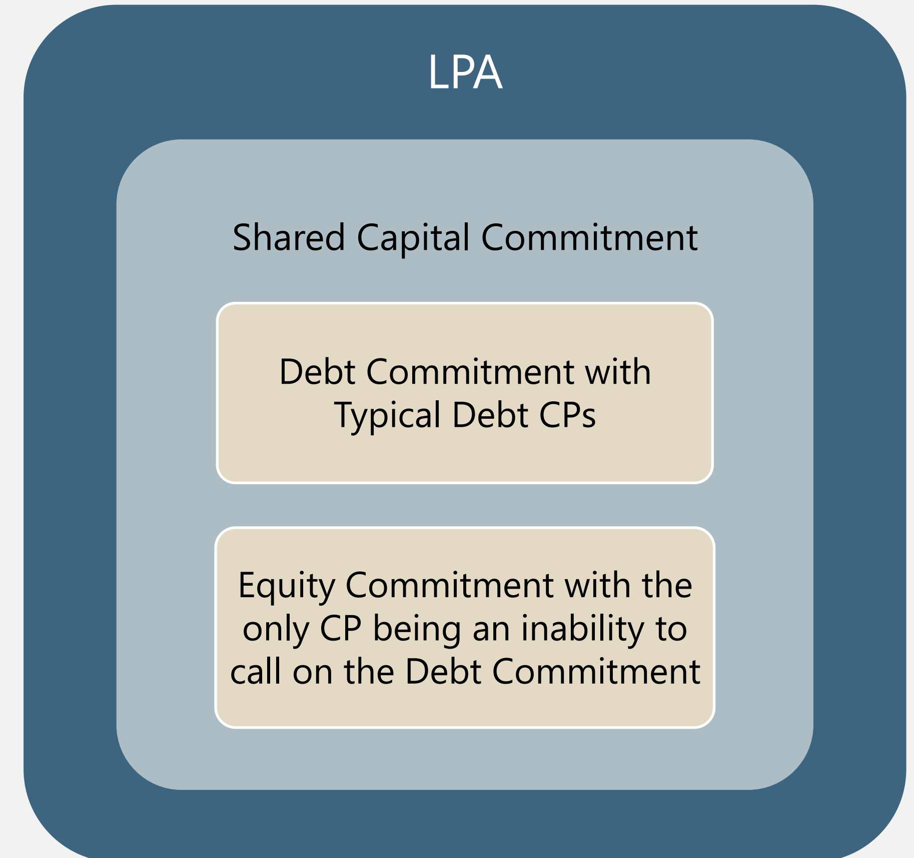
- **Bankruptcy Risk:** A debt capital commitment is problematic under a subscription credit facility if there is an insolvency of the rated note feeder fund, or it is consolidated into an insolvency proceeding of the related main fund
  - Debt capital commitments have historically been classified as ineligible for borrowing base inclusion
    - Uncertainty of whether such debt capital commitments will be considered an "executory contract" and thus may not be enforceable under Section 365(c)(2) of the US Bankruptcy Code if the applicable fund was ever subject to a bankruptcy proceeding
  - Some sponsors have used a hybrid debt/equity capital commitment that begins as a debt capital commitment but "converts" to an equity capital commitment upon the occurrence of an event of default or similar triggering event under the subscription facility (such as a bankruptcy or insolvency of the fund)
    - Market has moved away from this approach in light of 365(e) of the US Bankruptcy Code, which provides that a contractual agreement which terminates or modifies an executory contract conditioned or triggered by the occurrence of an insolvency, the commencement of a bankruptcy case or a similar event is not enforceable in a bankruptcy proceeding (this concept is often referred to as an "Ipso Facto Prohibition")

STRUCTURAL PROTECTIONS: BANKRUPTCY REMOTE

- Bankruptcy-Remote Rated Feeder Funds: This approach focuses on minimizing the risk that the feeder fund will be subject to a bankruptcy in the first place by structuring the feeder fund as a bankruptcy-remote special purpose vehicle (an "SPV")
  - An SPV structure does not seek to address the legal bankruptcy-related risks associated with debt capital commitments, but instead is intended to diminish the likelihood of the occurrence of a bankruptcy proceeding of the feeder fund that could impact the debt capital commitments of the investors
  - The feeder fund organizational documents will include customary bankruptcy-remote covenants intended to insulate the SPV from an insolvency proceeding, including a requirement that an independent director or independent manager of the feeder fund explicitly approve any bankruptcy filing on the part of the feeder fund or other material actions that could give rise to an insolvency proceeding
  - The SCF market has not embraced this as the preferred protection, however as the Fund Finance and Structured Finance markets grow closer together, we expect more lenders to become comfortable with this approach

STRUCTURAL PROTECTIONS: DAY–1 EQUITY

- **Day-One Equity Commitment:** Intended to establish an obligation of an investor to contribute 100% of its capital commitment in equity on "day-one" of closing its investment with the understanding that the investor can contribute capital in the form of debt until an event of default under the subscription credit facility occurs
  - Following an event of default under the subscription facility, equity capital contributions are required to be made by the investor
  - The day-one equity capital commitment approach is not likely to raise the same level of potential Ipso Facto Prohibition concerns as the conversion approach because it is not triggered by an insolvency of the fund, but rather an event of default under the subscription credit facility and is largely accepted by lenders and lawyers across the market
  - SCF Market has fully embraced this solution



STRUCTURAL PROTECTIONS: ECL

- **Practical issues with the Day-1 Equity Approach:**
  - Many existing Funds don't have the "shared" commitment concept included in their organizational documents
  - Some investors would like to structure their entire capital commitment as debt, and thus there would be no existing "LPA" to modify to include a shared Day-1 Equity Commitment
  - Funds and investors might not want to complicate their core documentation to simply address SCF concerns (especially investors that have concerns over the fund using the SCF instead of putting their money to work)
- **The Equity Commitment Letter Structure**
  - Can be used to establish a shared day-one equity commitment in legacy funds that don't include the concept, in new funds where there is sensitivity by the investment manager to including the concept in the fund documents, or where no equity commitment otherwise exists
  - SCF market is generally comfortable using the equity commitment letter approach (similar to using an investor letter used to address deficiencies in a fund LPA with respect to subscription credit facility provisions)
  - Investors that don't sign an ECL are excluded from the borrowing base (much like an "investor letter" deal where investors that do not sign an investor letter are excluded)

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