July 15, 2022

VIA ELECTRONIC SUBMISSION

Ms. Carrie Mears, Chair
Mr. Doug Stolte, Vice Chair
Valuation of Securities Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Comments regarding the IAO Issue Paper on the Risk Assessment of Structured Securities - CLOs

Dear Ms. Mears and Mr. Stolte:

The American Investment Council ("AIC")[1] appreciates the opportunity to comment on the National Association of Insurance Commissioners ("NAIC") Valuation of Securities Task Force (the "Task Force") exposure, *IAO Issue Paper on the Risk Assessment of Structured Securities - CLOs* (the "Issue Paper"). As the advocacy, communications, and research organization for the world's leading private equity and private credit firms, which have substantial experience assisting insurers with their investment needs, we believe we are well-positioned to share an important perspective with the NAIC.

[1] The American Investment Council, based in Washington, D.C., is an advocacy, communications, and research organization established to advance access to capital, job creation, retirement security, innovation, and economic growth by promoting responsible long-term investment. In this effort, the AIC develops, analyzes, and distributes information about private equity and private credit industries and their contributions to the US and global economy. Established in 2007 and formerly known as the Private Equity Growth Capital Council, the AIC's members include the world's leading private equity and private credit firms which have experience with the investment needs of insurance companies. As such, our members are committed to growing and strengthening the companies in which, or on whose behalf, they invest, to helping secure the retirement of millions of pension holders and to helping ensure the protection of insurance policyholders by investing insurance company general accounts in appropriate, risk-adjusted investment strategies. For further information about the AIC and its members, please visit our website at http://www.investmentcouncil.org.

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We support the Task Force's mission of providing regulatory leadership and expertise to establish and maintain all aspects of the NAIC credit assessment process for insurer-owned securities. We also understand the need to review capital charges associated with collateralized loan obligations ("CLOs") – particularly in light of the growth in this market segment and the structural changes that have taken place since the 2008-2012 global financial crisis – and the need to understand the risk. To that end, we welcome the opportunity to serve as a resource to the Task Force as it considers the proposals (the "Proposals") submitted by the NAIC Investment Analysis Office ("IAO") to amend the NAIC *Purposes and Procedures Manual of the NAIC Investment Analysis Office* ("P&P Manual") to remove CLOs from Filing Exempt Status[2] and permit the NAIC Structured Securities Group to model the RBC Designation Categories for CLO investments.

If adopted, the Proposals would extend the current approach for RBC Designations of residential mortgage-backed securities ("RMBS") and commercial mortgage-backed securities ("CMBS") to RBC Designations for CLOs under the presumption that doing so would eliminate so-called "RBC arbitrage" that arises from holding a pool of loans versus holding individual tranches of a CLO, in which such loans have been securitized. Specifically, the Proposals suggest that the aggregate RBC factor for owning all tranches of a CLO should be the same as that required for holding each of the underlying loans. Therefore, the Proposals would be expected to result in certain CLO tranches carrying a higher capital charge than their NRSRO ratings currently assign. We do not believe that a higher capital charge is an appropriate outcome, nor would it appropriately characterize the actual risk associated with CLOs.

As explained in further detail below, the Proposals are a significant departure from the current framework and, if adopted, would have far-reaching and substantial consequences on the insurance industry and capital markets. The Proposals are unclear as to whether their underlying rationale– i.e., the implied presumption that CLOs or certain CLO tranches are inherently riskier than their current capital charges – takes into account the strong historical performance of CLOs (e.g., as described in more detail below, CLOs have substantially lower default rates than comparably rated corporates) or the structural benefits and investor protections that modern CLOs provide to investors.[3]

As the Task Force continues its review of the Proposals, we would encourage an open and transparent process. Given the potentially significant ramifications of the

[2] Filing Exempt Status generally permits insurers to utilize credit ratings of nationally recognized statistical rating organizations ("NRSROs") in certain instances for purposes of determining the proper NAIC designation category and the associated Risk-Based Capital ("RBC") factor.

[3] We also note that, if approved, the Proposals would appear to transfer certain modeling and rating responsibilities to the SSG, and we are concerned that the Issue Paper does not sufficiently address a number of issues – including modeling and rating governance and the opportunity for public comment – that should be resolved prior to taking such action.

Proposals, the Task Force's involving the relevant stakeholders in this process is critical, including as it relates to the opportunity to comment on the Issue Paper, the Proposals, and any future proposed RBC factor changes. Furthermore, we encourage the Task Force to engage an independent consultant with substantial capital markets experience to provide greater technical analysis (including an objective assessment of CLO risk profiles, insurers' investments in CLOs, and the potential impact proposals of this magnitude could have on the insurance industry and US businesses more broadly) prior to adopting the Proposals.

We believe the following information is paramount for the analysis and evaluation of the Proposals and appreciate you taking it into consideration.

I. Modern CLOs Have Numerous Structural Benefits and Investor Protections

Under the current system, NRSROs evaluate transactions in a consistent manner based on detailed criteria that is publicly available and regulated by the United States Securities and Exchange Commission ("SEC")[4]. Among other things, that evaluation accounts for numerous CLO features (detailed below) in determining the rating of CLO tranches. Each CLO tranche is rated and receives an RBC charge that corresponds to the underlying credit and structural risk on such tranche, with the equity (first loss) residual having the same charge as an investment in common equity and other equity interests generally. Recent reports and studies also conclude that other equity investments have similar risk profiles to, if not more adverse than, the risk profile of CLO equity.[5] Therefore, it is wholly appropriate for CLO equity to be treated the same as other forms of equity.

Nevertheless, the stress modeling approach outlined by the Issue Paper would require CLO equity RBC factors to increase materially, with some recent models (conducted in response to the Issue Paper) indicating that the RBC factor for CLO equity would need to increase to 75%-100% to achieve the Proposal's objective.[6] Such an outcome is significantly misaligned with the actual performance of CLO equity. For example, the median equity internal rate of return for redeemed CLO equity deals that were issued during the global financial crisis between 2005 and 2007 were higher than 20%, and for deals issued in 2020 were higher than 40%.[7]

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[4] NRSROs are registered with and subject to the oversight and supervision by the SEC.

[5] *See, e.g.*, Bank of America Securities CLO Weekly, 8 July 2022 *available at*: https://rsch.baml.com/access?q=iFp-!Um2FVU52HHJ2iTm6w.

[6] *See*, Citi, US Insurers' CLO Investments May Face a Spike in Capital Charge, July 2022.

[7] *See,* Bank of America Securities CLO Weekly, 8 July 2022. We also note that the aforementioned RBC factor change in respect of CLO equity would be in addition to RBC factor changes that would be necessary to the BB and/or BBB tranches of CLOs in order to achieve the Proposal's objective.

In addition, the Issue Paper suggests that the aggregate RBC factor for owning all tranches of a CLO should be identical to that which is required for holding each of the underlying loans. Such a methodology does not accurately account for the numerous benefits of securitization that have led to CLO tranches – including below-investment grade tranches – experiencing lower impairments than equivalently rated corporates.[8] There are important factors that need to be assessed on a tranche-by-tranche basis: (i) diversification within the collateral pool, (ii) excess spread[9] payable to CLO debt and equity holders; (iii) active management; (iv) collateral quality tests; and (v) overcollateralization; and (vi) priority of payments waterfalls. It is important to note, for example, that the risk profile and economic outcomes of the individual tranches of a CLO will be different than if, for example, an investor solely held single-B rated loans, as assumed in the Issue Paper's proposed modeling approach. These factors are described in greater detail below.

- Diversification. CLOs impose and enforce diversification within the structure. The diversification requirement is crucial to understanding the riskiness of the product, because the probability of losses in holding a CLO tranche of a certain rating level is significantly reduced in comparison to holding a single loan of the same rating level.[10] The collateral pool itself is comprised of loans in uncorrelated industries – this further reduces credit risks because the exposure in the CLO tranches is uncorrelated, and as a result this further helps protect an investor as compared to investing in a single loan of comparable rating.[11] NAIC RBC C1o currently accounts for diversification for publicly traded corporate debt through the portfolio adjustment factors process. At a minimum, a similar diversification adjustment factor should be applied to the collateral pools in a

[8] *See* Analysis of Historical NRSRO Ratings Data (Morgan Stanley, February 2022), *available at:*https://mcusercontent.com/65ee38c99561aeba4a1f82919/files/ff9650b4-dfa7-2815-f41afa7a60d85fbf/Final_Morgan_Stanley_Report_18_.pdf; *see also* Moody's Annual Default Study (February 2022); Moody's Semi-Annual Performance Statistics Update (August 2021); S&P Annual Global Structured Finance Default and Rating Transition Study (May 2021); Moody's Impairment and Loss Rates of Global CLOs (June 2021).

[9] "Excess spread" is the surplus difference between the interest received by a CLO issuer from the underlying loans and the interest paid to the CLO debt holders.

[10] This has been demonstrated through objective data analysis. *See* The US CLO Market (LSTA, April 2022), *available at*: https://www.lsta.org/content/the-u-s-clo-market-white-paper/.

[11] This diversification is generally governed by indenture rules around individual issuer and sector concentration limits. Specifically, rating agencies and investors require every CLO to maintain a high level of corporate sector diversity within its portfolio. CLOs include formal "single name limits," that limit any single borrower exposure (e.g., 1-2% max per obligor) and "industry limits" that prevent one industry from representing too great a concentration (e.g., 10-12%, sometimes with exceptions up to 15%) of underlying assets.

CLO. If applied to the 200 or more loan issuers in each CLO's collateral, the portfolio adjustment factors ("PAF") formula[12] would reduce the RBC charge by 15% to 20%.

- Active Management. Unlike a static pool of loans, CLOs are actively managed by professional asset managers with teams of portfolio managers, credit analysts, risk managers, and operations personnel. A CLO manager may purchase new assets with proceeds received from the prepayment or scheduled amortization of loans in the existing portfolio, which are subject to strict eligibility criteria and collateral quality tests. This helps to maintain and/or improve the credit quality of the portfolio. CLO managers may also engage in a certain amount of discretionary trading and trade "credit risk" or "credit improved" loans to optimize portfolio quality in real time.[13] In addition, CLO managers have the ability and are incentivized to sell loans out of the structure before default or a material price deterioration. As explained recently by the Loan Syndications and Trading Association, active management thus allows CLO investors to avoid the defaults it might otherwise experience if it passively held the underlying loans directly.[14] Specifically, CLO historical average defaults (<0.1%) were much lower than bank loan historical defaults of 1%-2%.[15]

- Overcollateralization. This important feature ensures the value of the underling pool of collateral exceeds the principal value of the CLO debt tranches. The overcollateralization requirement of CLOs provides protection to CLO debt holders if ratings migration of the underlying pool of loans deteriorates in excess of the applicable threshold amount, which typically limits the amount of "CCC" rated underlying loans to 7.5%.

[12] Life insurers must apply to all their holdings the adopted MA base RBC C1 bond factors and PAF derived solely from public corporate holdings. They multiply their portfolio weights for each NAIC designation by the associated bond factor to develop a pre-tax capital charge for that designation. A post-tax capital charge is then derived from the pre-tax factor. Finally, all post-tax capital charges are summed. A PAF is derived based on the number of issuers in the insurer's holdings and that PAF is multiplied by the post-tax capital charges to create the C1o for use in the NAIC RBC formula.

[13] Managers are able to achieve alpha and, importantly, avoid losses (thus reducing risk), as compared to a passive pool of loans by (a) selling potential defaults before their loan prices decline significantly and (b) buying distressed loans at discounts when market conditions become challenging, effectively building subordination to support the liabilities.

[14] *See* CLOs: NAIC-scent challenges (LSTA, June 2022), *available at*: https://www.lsta.org/news-resources/clos-naic-scent-challenges/. *See also* Bank of America Securities CLO Weekly, 24 June 2022 ("an actively managed vehicle drives lower implied defaults/losses in CLO portfolios vs historical defaults in the loan market.").

[15] *Id*.

- Waterfalls. If cash flow on the underlying pool of loans deteriorates, under the terms of a CLO, it can result in a failure of the CLO's overcollateralization ratio test, whereby the CLO structure will retain (or "trap") cash (as opposed to distributing it through the waterfall to subordinate tranches), and use this cash to de-lever the senior CLO tranches.[16]

II. RMBS/CMBS Approach Is Not a Suitable Model for CLOs

The factors described above are unique to CLOs and are distinguishable from the structures for RMBS/CMBS. Furthermore, the different historical context for the RMBS/CMBS approach should be accounted for when considering whether to apply the same approach to CLOs. Importantly, in 2009, SVO modeling for RMBS/CMBS was driven by negative credit ratings migration experienced by RMBS/CMBS during the 2009 housing crisis that caused a potential solvency crisis for the insurance industry. At that time, insurance regulators and the industry understood that insurance companies often held higher tranches of these investments. As a result of the housing crisis and the overall financial crisis, many of the RMBS assets were downgraded by NRSROs. The downgrading actions in the lower tranches impacted the NRSROs' approach to rating all tranches of these investments, including higher tranches, which also experienced substantial downgrades. As a result, insurers' RBC plummeted.[17] These circumstances appropriately caused regulators to seek to change the way RMBS and ultimately, CMBS, were evaluated for statutory accounting purposes.

Notably, however, and importantly, this dynamic does not exist today *vis-à-vis* CLOs. No such market volatility related to CLOs exists which would justify the proposed RBC change for CLOs. As explained below, the structure and performance of CLOs bears no relation to that of RMBS and CMBS, and should not be treated the same

[16] We recognize that this may be to the economic disadvantage of residual tranches of CLOs. However, we respectfully note that: (i) as discussed in Section I above, it is appropriate for CLO equity to be treated the same as other forms of equity; and (ii) the Issue Paper seems to imply unrealistic outcomes for mezzanine and other CLO tranches. As Bank of America notes, "The impact of the proposal will likely primarily be felt in BBB and below rated bonds. This may result in a significant disconnect wherein higher rated CLO bonds which have historically displayed little to no losses, are faced with an RBC factor similar to corporates that are rated at least 3-5 notches lower. *See* Bank of America Securities CLO Weekly, 24 June 2022.

[17] According to the NAIC, continued reliance on NRSRO ratings for year-end 2009 designations would have resulted in a nearly six-fold increase in life insurers' RBC for mortgage-backed securitizations, and RBC charges would have increased from about $2 billion to more than $14 billion. *See*, Financing Home Ownership: Origins and Evolution of Mortgage Securitization Public Policy, Financial Innovations and Crises (NAIC and The Center for Insurance Policy and Research, August 2012), *available at*: https://content.naic.org/sites/default/files/inline-files/cipr_120812_white_paper_financing_home_ownership.pdf

way. Moreover, unlike the case with RMBS/CMBS, the Proposal could be expected to have a negative impact on insurers' capital and surplus (especially given there is no grandfathering contemplated by the Proposal), which is at odds with the purpose of the RMBS/CMBS model initiative. Further consideration and analysis should be given before concluding that an actual fundamental modeling of the underlying loans (and not simply adjusting the structure based on underlying assets) is the proper course of action with respect to CLOs.[18]

III. CLOs Have Performed Very Well for Decades

Unlike RMBS and CMBS during the financial crisis, CLOs have historically – and continue – to perform well. Along with the performance of CLOs, it is significant to note that studies conclude that CLO default rates are substantially lower than default rates for corporates with equivalent ratings[19]. In fact, studies indicate that the number of cumulative losses that would have had to occur in respect of the loans underlying CLOs for CLOs to have suffered significant defaults during the 2008-2012 financial crisis is significantly higher than what actually occurred during such time (assuming a reasonable recovery rate), thus demonstrating the durability of, and differentiated outcomes related to, CLOs.[20] Even single B tranches of CLOs have out-performed their equivalently rated corporates during this period (single B CLOs have experienced 0.66% impairments in the past decade versus 1.28% for equivalently rated corporates).[21] CLOs have also historically recovered after economic downturns. For example, a recent study indicates that, as an asset class, CLOs had a strong rating and price recovery following the 2008-2018 global financial crisis.[22]

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[18] Furthermore, in 2009, insurance companies were not only supporting the reform in respect of RMBS (due to the RBC impact in the absence thereof), but the idea behind reform originated from the insurance industry and, in particular, the American Council of Life Insurers ("ACLI"), which approached the NAIC with proposals, and requested implementation of such change by year-end 2009. Here, there is no consensus around the need for a change to the RBC charge methodology related to CLOs, much less that the SSG is the appropriate body to design such a methodology.

[19] *See e.g.,* Analysis of Historical NRSRO Ratings Data (Morgan Stanley, February 2022).

[20] *See* Moody's Impairment and Loss Rates of Global CLOs (June 2021) at pp. 14-19 (Appendix I: List of CLO material impairments worldwide).

[21] *See* Moody's Investors Service, Impairment and Loss Rates of Global CLOs: 1993-2020 (June 3, 2021) in Excel Supplement Ex. 9 (annual average of 1-year CLO default rates); Moody's Investor Service, Annual Default Study (Feb. 8, 2022) at p. 36 Ex. 37 (annual average of 1-year corporate default rates).

[22] In particular, 95% of the downgraded AAA debt returned to AAA ratings and 88% of the previously investment grade rated debt returned to investment grade debt. *See*, Citi, US Insurers' CLO Investments May Face a Spike in Capital Charge, July 2022.

Notwithstanding its strong track record, the CLO market has also evolved since the financial crisis: post-crisis CLOs (generally referred to as "CLO 2.0") now include enhanced investor protections, and more robust NRSRO rating processes and requirements. Such protections and processes include: increased tranche subordination (i.e., higher rated tranches comprise a lower percentage of the overall structure, compared to pre-financial crisis CLOs), greater credit enhancement at each ratings level, shorter reinvestment periods, no call periods and maturity periods, and the ability to refinance CLO tranches. Modern CLOs are also less complex than prior products: Specifically, newly originated collateral pools are now limited to corporate loans and, to a lesser degree, bonds and structured finance products are no longer permitted in CLO portfolios.

IV. <u>The 2020 Stress Test May Not Be Fit for Purpose</u>

As you are aware, in 2020 the NAIC performed five stress tests on broadly syndicated loan CLOs held by US insurance companies at year-end 2019. In light of the pandemic, these stress tests included two extreme scenarios: one intended to replicate the conditions of the 2008-2012 global financial crisis, and one intended to replicate an even more severe recession (note that the NAIC did not view these two extreme scenarios as sufficiently likely to include in its most recent stress testing, which considers just three scenarios). Those extreme stress test scenarios adopted certain unrealistically negative assumptions, including that those periods of volatility cause prepayments to stop completely for the life of the loans, which is not borne out by market experience. In addition, the stress tests assumed a reinvestment price of par, which is extremely unlikely during a period of high volatility.

These conservative assumptions were unrealistic because CLO managers can use prepayment proceeds to reinvest in new loans at discounts, improving credit support to the CLO debt tranches. Nevertheless, even under these and other highly conservative assumptions, the NAIC's own stress tests found virtually no principal impairment of CLO tranches rated at or above the "A" level. We believe this further demonstrates that CLOs provide a risk-appropriate asset class that performs to the benefit of policyholders.

V. <u>CLOs Benefit Insurers and Finance US SMEs</u>

As of 2020, insurers own approximately $200 billion[23] of CLO securities, a vital source of capital to US small and medium sized businesses. Specifically, CLOs represent over 60% of the financing for syndicated leveraged loans, a $1.4 trillion market that

[23] *See* Capital Markets Special Report (NAIC, 2021), available at https://content.naic.org/sites/default/files/capital-markets-clo-special-reports-ye-2020.pdf.

provides financing to thousands of US companies.[24] By design, any downgrade in the RBC treatment of CLO tranches, including the lower tranches, would disincentivize insurance companies to invest in those securities. This is notable – and troubling – for a number of reasons.

First, per the NAIC's data, the majority of US insurer CLO investments were held by large life companies – i.e., those with at least $10 billion in assets under management.[25] Specifically, the top 10 US insurance groups accounted for 45% of the US insurance industry's total CLO exposure, and at least five of the top 10 insurance groups have CLO management subsidiaries.[26] If one or more CLO tranches attract higher RBC charges as a result of the Proposals, this could impact the ability of insurers to continue to operate those subsidiaries which, according to a recent NAIC report, benefit insurer affiliates by providing internal CLO infrastructure and insurer-specific knowledge.[27] Such CLO management subsidiaries may also be more cost-effective for certain insurers and, therefore, of benefit to policyholders. As such, any loss of this internal management function (and the corresponding loss of the ability to provide internal access to an asset class that provides attractive, risk-adjusted returns), would be disadvantageous to insurers and their policyholders.

In addition, as noted above, insurers are among the largest investors in CLO securities. CLOs, in turn, have a significant role in the capital markets generally. However, if RBC charges on CLO tranches were increased as contemplated by the Proposal and, as a result, insurers make fewer CLO investments, the overall volume of CLOs can be expected to decrease significantly, thus taking away an important liquidity tool for the capital markets. The absence of this liquidity tool could have a chilling effect on lenders' willingness to make certain loans (as they would lose a mechanism for achieving liquidity through securitization) and reduce the sources of capital for the large number of corporate borrowers who rely on such loans.

VI. Conclusion

We appreciate the Task Force requesting comments from relevant stakeholders as it engages in the important evaluation of the Proposals. We endeavored to explain why what is contemplated in the Proposals is unwarranted and could have adverse ramifications to policyholders. To that end, we encourage an open and transparent process and to engage an independent consultant with substantial capital markets

[24] *See* PitchBook LCD's Quarterly Leveraged Lending Review: 2Q 2022, p. 98 (Primary Investor Market: Institutional Market by Type – LTM 6/22).

[25] *See* Capital Markets Special Report (NAIC, 2021).

[26] *Id*.

[27] *Id.*

experience to provide greater technical analysis (including an objective assessment of CLO risk profiles, insurers' investments in CLOs, and the potential impact proposals of this magnitude could have on the insurance industry and US businesses more broadly) prior to advancing, much less adopting, the Proposals. However, we do fully support the necessary requirement for regulators to understand the risks that their regulated entities are appropriately taking and we welcome the opportunity to serve as a resource to the Task Force as it considers the Proposals.

Thank you for the opportunity to comment. AIC looks forward to working with the NAIC on this project.

Sincerely,

Rebekah Goshorn Jurata

Rebekah Goshorn Jurata
General Counsel
American Investment Council

cc: Mr. Charles Therriault
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