February 17, 2023

VIA ELECTRONIC SUBMISSION

Ms. Carrie Mears, Chair
Ms. Lindsay Crawford, 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 Proposed Methodology for Modeling CLOs

Dear Ms. Mears and Ms. Crawford,

The American Investment Council ("AIC")[1] appreciates the opportunity to comment on the National Association of Insurance Commissioners ("NAIC") Valuation of Securities Task Force ("VOSTF") exposure regarding the *Proposed Methodology for Modelling CLOs* (the "Proposed Methodology") that was received by VOSTF on December 12, 2022. 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.

As noted in our July 15, 2022 letter ("July 15 Letter") to VOSTF regarding the NAIC Investment Analysis Office ("IAO") *Issue Paper on the Risk Assessment of Structured Securities – CLOs*, we support VOSTF'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 appreciate the need for the NAIC to analyze the risks associated with the various tranches of collateralized loan obligations ("CLOs") to determine appropriate capital charges in support of insurer solvency and policyholder protection.

[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.

Notwithstanding the above, we continue be concerned about the pace and cadence of the CLO workstream, and question whether subjecting CLOs to an NAIC Structured Securities Group ("SSG") financial modeling process is fit for purpose.

I. The NAIC has Not Demonstrated an Issue Exists with NRSRO CLO Ratings or CLO Performance

Fundamental questions remain unanswered regarding whether it is necessary or appropriate to subject CLOs to a financial modeling process. We recognize that the intention of the IAO's CLO modeling proposal is that insurers would no longer be able to utilize the ratings issued by Nationally Recognized Statistical Rating Organizations ("NRSRO") for purposes of the relevant regulatory capital charges. However, it remains unclear to us why VOSTF is questioning why the current practice of looking to NRSRO ratings is no longer appropriate for CLOs.

As you know, all NRSRO methodologies are published for public comment and scrutinized by public markets, and NRSROs use the same methodologies for private ratings as for public ratings. Further, following the Great Financial Crisis, NRSROs are subject to rigorous oversight and annual examination by the U.S. Securities and Exchange Commission ("SEC"). While we understand VOSTF is examining potential refinements to the use of NRSRO ratings, a broad examination of the use of NRSRO ratings should not translate into precipitously removing reliance on NRSRO ratings for a single asset. There has been very little CLO market volatility or systemic concern, or demonstrated problem with NRSRO CLO ratings, which would justify the NAIC generating its own proprietary internal modeling for CLOs. Removing reliance on NRSRO ratings for a single asset in the absence of a documented problem sends inappropriate market signals with respect to CLOs and CLO ratings.

VOSTF has also cited a need for transparency as a reason to move CLOs to non-filing exempt status and model the asset. The NAIC already has, however, access to the data required to analyze the content of NRSRO CLO ratings, because full rating reports for all insurers' filing exempt investments are now required to be provided. These reports include detailed explanations of how NRSRO CLO ratings were derived and typically include links to the public methodologies underpinning the ratings. To our knowledge, the IAO and VOSTF have neither processed the data available from these reports, nor identified substantive or quantitative problems with NRSRO CLO methodologies, ratings quality, or NAIC-required ratings reports. To the contrary, CLOs perform as well or better than equivalently rated corporate debt instruments. To the extent that VOSTF has identified specific concerns with NRSRO CLO methodologies, interested parties would benefit from the ability to understand and publicly comment on such concerns, as well as understand if or how the SSG will address any stated concerns in developing its own model.

II. Punitive Treatment of CLOs and ABS Have Significant Unintended Consequences

Rushing to implement a fundamental change to the CLO regulatory framework without first identifying a problem with reliance on NRSRO ratings and without proper vetting could inappropriately depress insurers' RBC and deprive insurers of a vital capital markets tool. In addition, punitive treatment of CLOs and other asset-backed securities can inappropriately hinder insurers from providing important life insurance and annuity products. The experience in Europe following the adoption of Solvency II provides important data regarding the consequences when regulators steer insurers away from high-quality investments that can back guaranteed life and annuity products.[2] The consequences would be even greater in the United States, where the life insurance and annuity industry provide significant financial protection to American families and retirees.

III. The NAIC has Not Adequately Considered Foundational Issues Underpinning This Work

It is also notable that the fundamental issues of (a) whether the SSG is properly equipped to undertake such an endeavor and (b) whether other structured securities would be subject to similar modeling, have not been part of VOSTF's public process. Neither interested parties nor the NAIC's own members outside VOSTF have had the opportunity to weigh in on the fundamental considerations that serve as the basis for the Proposed Methodology. Proceeding with the Proposed Methodology without addressing these foundational issues could be viewed as an overhaul of the CLO RBC framework without members' prior approval.

IV. Modeling Should Not be Undertaken as an Indirect Means to Alter RBC Treatment of Insurer Investments

The SSG's proposal appears to also be rooted in a desire to eliminate perceived capital arbitrage in CLOs[3]. We disagree with this premise[4] and note that (a) data does not support this claim of arbitrage, especially considering significant revisions adopted to the Annual Statement reporting blank to distinguish CLOs from other types of investments, and (b) even if arbitrage existed, the proposal utilizes an unnecessarily broad and sweeping methodology to achieve the proposed intention. Further, we understand that capital charge changes are to be undertaken by

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[2] A 2018 Europe-wide survey of insurers indicated that Solvency II deterred long-term business. *See* Reinsurance News, *Solvency II beneficial but detering* [sic] *long-term business, survey shows*, July 5, 2018, *available at*: https://www.reinsurancene.ws/solvency-ii-beneficial-but-detering-long-term-business-survey-shows/. In its 2019 annual *Report on long-term guarantees measures and measures on equity risk*, required by Solvency II, the European Insurance and Pension Authority ("EIOPA") noted that approximately half of the jurisdictions in the European Union observed a reduction in the availability of traditional life insurance products with long-term guarantees, and a reduction in the size and duration of guarantees. While it is difficult to reduce this trend to a single cause, many observers draw a direct link between Solvency II's treatment of investments associated with market risk to the reduction in availability of long-term guaranteed products. The 2019 EIOPA Annual Report is *available at*: https://www.eiopa.europa.eu/sites/default/files/publications/reports/eiopa-ltg-report2019.pdf.

[3] *See* the May 15, 2022 memo from the SSG and SVO to VOSTF titled *Risk Assessment of Structured Securities – CLOs*, *available at*: https://content.naic.org/sites/default/files/inline-files/2022-004.01%20-%20Risk%20Assessment%20of%20Structured%20Securities%20-%20CLOs%20v3.pdf.

[4] *See e.g.,* our July 15 Letter.

the Risk Based Capital Investment Risk and Evaluation (E) Working Group ("RBCIREWG") and the Capital Adequacy Task Force ("CATF"), as discussed further below. This is a better vehicle for addressing changes to capital charges rather than having VOSTF or the IAO accomplish this indirectly through changes to non-exempt status and modeling.

To that end, we urge VOSTF to consider a comprehensive data-driven and collaborative approach to assessing insurer CLO investments, and reconsider its proposed modeling efforts unless and until the RBCIREWG and CATF determine it is necessary, especially given (a) the RBC methodology for evaluating CLOs has not been assessed by other NAIC working groups, and (b) VOSTF has not identified or quantified specific problems with CLO performance or NRSRO CLO ratings.[5] The RBCIREWG is working towards an applicable RBC analysis for CLOs, but its work is not complete. Based on the recent American Academy of Actuaries ("Academy") presentation on CLOs to the RBCIREWG, insurer CLO exposure is small and does not currently present a solvency risk to the industry. Accordingly, the RBCIREWG work can continue at the pace determined appropriate by that working group. Of note, the NAIC Capital Markets Bureau's *Special Report on CLOs*[6], issued last month, comes to the same conclusion regarding aggregate risk.

The Academy report also included the following conclusions:

- Corporate bonds, bank loans and CLOs have unique structures and risk profiles;
- Active management of CLOs changes the risk profile as compared to other modeled securities;
- It is inappropriate to use existing bond factors that force capital charge equivalence between CLOs and corporate bonds;
- The proposed interim RBC charges are not based on a quantitative analysis and the Academy has "zero confidence" that they are accurate.

While we reserve the right to comment on any final Academy publication, we agree in principle with many of the Academy's central concerns. Indeed, our July 15 Letter expressed many of the same concerns in the context of the broader CLO RBC framework, while also providing evidence that:

- The RMBS/CMBS approach is not a suitable model for CLOs;
- CLOs have performed very well for decades (not just the 2011-2019 economic expansion); and

[5] We note in particular that VOSTF is charged with "coordinating with other NAIC working groups and task forces…to formulate recommendations…to ensure expertise relative to investments, or the purpose and objective of guidance in the P&P Manual, is reflective of the guidance of such other groups and the expertise of such other NAIC regulatory groups…."

[6] *See* NAIC Capital Markets, Special Report, *Collateralized Loan Obligation Stress Testing U.S. Insurers' Year End 2021 Exposure*, January 5, 2023, *available at*: https://content.naic.org/sites/default/files/capital-markets-special-reports-clo-stressed-analysis-ye2021.pdf.

- The 2020 CLO Stress Test, which we understand is the basis for the Proposed Methodology, may not be fit for purpose.

We believe there is a reasonable basis to address the issues that are foundational to the entire CLO workstream first, including the RBCIREWG developing the more fundamental concepts underlying the CLO RBC framework, before determining a modeling methodology that supplants established NRSRO ratings. At a minimum, we think there is value in a more collaborative and transparent process involving VOSTF, the RBCIREWG, and interested parties that does not result in VOSTF indirectly changing the capital framework for CLOs before the RBCIREWG has completed its analysis and capital charge work.

V. <u>CLO Modeling Methodology</u>

The Proposed Methodology appears to suggest that the IAO will build a cash flow testing model with key assumptions to be exposed for comment at a later date. While we understand that VOSTF's next step will be the exposure of a modeling proposal that will include probabilities and scenarios, it is difficult to provide meaningful feedback without having the benefit of other critical information. For example, no information is provided regarding the most important features of the model (e.g., what default rates are assumed by rating, what recovery rates are assumed by loan seniority, and interest rate stresses). Similarly, the Proposed Methodology includes no discussion of correlation/diversification – a key feature of any CLO model – which the SSG seemingly intends to ignore without any identified rationale. The SSG also fails to describe how the model will be calibrated to real-world historical CLO investment performance data, which is critically important to ensure the CLO model produces high-quality results. The below comments are therefore limited to the portions of the methodology where limited details have been provided.

- *Scope*
  - The Proposed Methodology references limitations with respect to specific CLOs "*via our third party software vendor*". Does the SSG anticipate disclosing its third party software provider, material contractual obligations and restrictions, and limitations with respect to the SSG's ability to assess CLOs as a result of the limitations of that provider?

- *Givens*
  - <u>Assumption that the inputs are periodic "partial" default rates for each loan based on the current rating</u>
    - The methodology assumes that default rates for each loan should be based solely on a loan's current rating. This raises the following question: why use NRSRO ratings for the underlying asset default probabilities, but not the CLO ratings? Has the SSG considered other indicators of default rate? We would be happy to discuss other factors that should be considered based on historical data.

- <u>Assumption that each loan has a recovery rate, based on its seniority, for that period</u>
  - It is crucial to consider the current price of a loan when attempting to ascertain its expected recovery. While seniority, specifically first or second lien, is often a helpful factor in modeling expected recovery, the large variation in documentation/covenants and industry (credit cycle dependent) can lead to large variations in ultimate recovery.

- *Assigning Ratings to Underlying Assets*
  - The methodology appears to rely on public ratings for underlying loans, but not for CLOs themselves. It seems illogical to conclude that NRSRO ratings can be relied on with respect to underlying collateral, but not for the CLO rating, unless the SSG has identified a perceived flaw in NRSROs' CLO methodologies. If a flaw has been identified, those flaws should be explained by the SSG and exposed for public comment so that interested parties – including the NRSROs – have the opportunity to comment.

  - The Proposed Methodology states: "*if the Securities Valuation Office [("SVO")] has assigned an NAIC Designation Category to the Issue, that NAIC Designation Category will be used, unadjusted*." Is this intended to be a catch-all clause that would apply even where an Issue Rating is available from an NRSRO? Is the answer the same if the NRSRO rating is not available within the NAIC's third party software?

  - The references to "Issuer Rating" and "Issue Rating" in the Proposed Methodology seem to be derived from Moody's existing CLO methodology, versus other rating agencies' CLO methodologies. Is it expected that the Moody's methodology and loan ratings be given priority in the model over other NRSRO's ratings and methodology? If so, on what basis? How will the model treat underlying loans with different ratings from different rating agencies?

  - If current NRSRO ratings are to be used in the model, does the SSG expect to assess and potentially update its analysis periodically to reflect downgrades or portfolio rotation?

  - NRSROs have access to CLO portfolio managers, and their assessment of CLO managers is taken into account in the ratings process. Does the SSG expect to take a similar approach that will include an assessment of CLO portfolio managers in addition to quantitative modeling factors?

  - As we have indicated previously, active management of CLO investments are among the key reasons that CLO equity demonstrates higher returns after experiencing a financial crisis than after a bull market, and one of the key differentiators between a CLO and its underlying assets. Does the SSG expect to account for active management in its modeling?

- *Recovery Rate*
  - The NAIC Capital Markets Bureau and SSG *CLO Stress Test Methodology*[7], published in November 2022, provides the following:

    > *"Our Stress Thesis envisions that underlying leveraged loans will perform like unsecured assets during the next downturn. Furthermore, we assumed that the other assets in the CLO would perform similarly to their next worst category."*

    Does the SSG expect to quantitatively justify its stress thesis?

- *Cash Flow Assumptions*
  - <u>Interest Rates / Proceeds</u>
    - The Proposed Methodology states that "*interest proceeds for each period are based on the weighted average current portfolio spread plus the applicable base rate times the non-defaulting principal*." This appears to be inconsistent with the statement in the *Event Timing* section, which states that "*periodic payments on identified collateral [are] as per loan terms*." Interest proceeds should be modeled at the collateral level, not by using a weighted average of the current portfolio, and such modeling should include differences between 1 and 3 month paying collateral, the applicable base rates, and actual payment dates per loan terms.
  - <u>Maturities and Prepayments</u>
    - The model assumes loans repay at maturity. However, many loans have amortization and are not full bullet maturities. The effect is more significant if the model assumes no prepayments (as is the case here).
    - The model assumes no prepayments, which does not accurately reflect how the loan market operates and fails to reflect an important driver of CLO outcomes. Such an assumption would grossly distort outputs as it does not reflect the reality of how CLOs actually function. To the contrary, prepayments and reinvestments are among the key reasons that CLO equity demonstrates higher returns after experiencing a financial crisis than after a bull market, and have occurred in every economic environment since the inception of the leveraged loan index. We believe a prepayments assumption should be included in line with historical experience.

[7] *See* NAIC Capital Markets Analysis *NAIC Collateralized Loan Obligation (CLO) Stress Tests Methodology*, November 2022, *available at*: https://content.naic.org/sites/default/files/capital-markets-clo-stress-tests-methodology.pdf.

- Reinvestment
  - The model assumes no post-reinvestment period reinvestment, which does not accurately reflect how CLOs operate in reality. Most CLO documents permit limited reinvestment post-reinvestment period.
  - The model assumes that reinvestments are at par which, specifically during times of credit stress, is a very conservative assumption. During higher default and downgrade environments, and periods of preceding or subsequent volatility, higher quality collateral is accessible at prices below par, and even new issue collateral can often be sourced with material original issue discounts. We urge VOSTF to reconsider this position.
  - The model assumes that "*reinvestment occurs before payment date – i.e., there are no principal proceeds in the waterfall that can be used to pay interest or satisfy overcollateralization ("O/C") tests*." While principal proceeds are generally reinvested expeditiously, the application of proceeds on a given payment or determination date can vary, often leading to differing results for O/C tests. These differences can lead to varied de-levering of more senior tranches of debt.
  - The model states that "*reinvestment is assumed to have a rating equal to the transaction's weighted average rating factor ("WARF"). If the WARF is not reported, then it is assumed to be 4.C (B3) and is defaulted as stated above*." This, too, is not reflective of realized manager activity: Reinvestments predominantly occur into higher quality collateral. Additionally, anchoring reinvestment assumptions to a given transaction's WARF may not be universally applicable, since not all deals report WARF. Finally, the SSG should consider the treatment of cash, which is not discussed in the Proposed Methodology.
  - To provide more fulsome substantive feedback, it is also important to understand the assumed reinvestment spread, recoveries, tenor, and coupon applied to reinvestments, and whether the tenor will be limited to factor in a CLO's weighted average life, or WAL, test.
- Event Timing
  - The model states that "*periodic payment on reinvested collateral [will be paid] quarterly*" Depending on the underlying collateral characteristics, the SSG should also consider reinvestment into collateral that pays monthly.
  - It is important to understand whether the SSG CLO methodology will feature a probability of a loss, or expected loss (as is the case with NRSRO CLO methodologies), or refer to other framework assumptions regarding the bottom-performing percentile over a specific time horizon. Relatedly, CLO equity does not involve a promise to pay as does debt, so

to evaluate the SSG's CLO model, one will need to understand the basis of evaluation of CLO equity performance.

- *Additional Procedural Comments and Questions*
  - Does the SSG or VOSTF expect to publish for public exposure a fulsome explanation of the proposed methodologies? We note that NRSROs are required by federal law to publish comprehensive explanations of proposed methodologies for public comment, which ultimately leads to better methodologies and outcomes for the capital markets, insurers and all interested parties. Accordingly, we encourage VOSTF (or other committee of jurisdiction) to expose the full methodology details for public exposure.
  - Does the SSG or VOSTF expect to conduct an impact analysis to understand the aggregate effect of CLO modeling and what the cost will be to insurers, both on an individual review basis and in the aggregate? Notably, the market will still require insurer-purchased CLOs to have NRSRO ratings, so any fees paid to the NAIC as a result of a SSG financial modeling process will increase costs of these investments.
  - Do state insurance regulators (including VOSTF members) expect to address the conflict of interest created by the SSG recommending that CLOs (and seemingly other investment classes) should no longer receive filing exempt status and, instead, that they should be subjected to a financial modeling process that is developed and conducted by the SSG?
  - How does the SSG intend to ensure that the CLO methodology will be reasonable and consistent in comparison to capital charges for other asset classes?

VI. Conclusion

We welcome the opportunity to serve as a resource to VOSTF – or any broader NAIC collaborative group or forum – as state insurance regulators consider a CLO regulatory framework, and would be pleased to present or otherwise provide insight into our members' perspective on these issues. In particular, we welcome the opportunity to support VOSTF and the SSG by providing real world market data in support of the foregoing positions (including with respect to historical CLO vs. corporate credit performance, data regarding default and recovery rates, inter-period interest, prepayments, reinvestments, and active management).

To the extent the technical work continues as planned, we expect to provide additional comments regarding the CLO modeling scenarios and probabilities (including default and recovery rates) once those items are exposed for public comment, with an eye towards ensuring that any changes align regulatory treatment with actual risk and preserve the ability of insurers to offer life and annuity products with long-term guarantees. We share your desire to protect insurer solvency and policyholders, while avoiding Solvency II-like treatment of high-quality investments that are well-suited to match insurer liabilities.

Thank you for the opportunity to comment. We look forward to continuing to work with you on these important issues.

Sincerely,

/s/ Rebekah Goshorn Jurata
General Counsel
American Investment Council

cc: Mr. Charles Therriault
Director, Securities Valuation Office
National Association of Insurance Commissioners (via email)

Ms. Denise Genao-Rosado Senior Administrative Assistant
National Association of Insurance Commissioners (via email)