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NAIC's Proposed Bond Definition: Application to Rated-Debt Feeder Funds

November 28, 2022

The NAIC's multi-year process of modifying its accounting rules to confirm which debt instruments qualify as bonds for regulatory accounting purposes is of interest to insurance companies that use rated notes issued by feeder funds to facilitate their investments in private credit funds. This *Chapman Insights* article addresses the scope and current status of those modifications and the impact of those modifications on such rated notes.

Background

Our 2019 Action Item informed our readers that private credit funds were utilizing rated-debt feeder fund structures to attract capital from insurance companies that were simultaneously looking at private credit funds as a means to diversify their credit portfolios. Investing in a private credit fund through a rated-debt feeder fund provided insurance companies an opportunity to achieve their diversification goal without dramatically increasing their risk-based capital charges. Our 2021 Chapman Insights explained how an insurance company's investing in a private credit fund through a rated-debt feeder structure required thoughtful structuring and a close consideration of a number of legal issues to replicate the investment benefits that would otherwise accrue through a direct equity investment in the credit fund. Our January 2022 Chapman Insights discussed the scope of modifications being considered by the National Association of Insurance Commissioners (*"NAIC"*) of certain regulatory accounting rules designed to clarify which insurance company investments can be reported as bonds on an insurance company's Schedule D-1: Long Term Bonds (*"Schedule D-1"*). The NAIC's efforts to define what constitutes a "bond" has implications for the notes issued in a rated-debt feeder structure because an insurance company only receives the risk-based capital relief associated with rated-debt feeder notes if the notes are eligible for Schedule D-1 reporting.

The core principle behind the NAIC's modifications of its regulatory accounting rules is that the substance of the instrument, and not merely its legal form, must control its characterization. To implement that core principle, in 2019 the NAIC's Statutory Accounting Principles (E) Working Group (the *"SAPWG"*) proposed its first revisions of SSAP No. 43R, the accounting rule governing instruments eligible for listing on Schedule D-1, with the stated intent that only those securities that have "bond-like cash flows" be listed on Schedule D-1.

The modification process that started with those 2019 revisions of SSAP No. 43R culminated with the SAPWG's May 20, 2021, release of a proposed, principles-based bond definition (the *"Proposed Bond Definition"*). Since we released our January 2022 Chapman Insights that discussed the 2021 version of the Proposed Bond Definition, the NAIC has released two revisions of the Proposed Bond Definition and an extensive Issues Paper (the *"Issues Paper"*) that provide guidance as to the NAIC's proposed modifications to SSAP No. 26R and SSAP No. 43R (the *"Accounting Rules"*) that are necessary to implement the Proposed Bond Definition.[1] The comment period for the latest modifications to the Proposed Bond Definition and Issues Paper closed in October and comments received were discussed in a SAPWG meeting held on November 16, 2022 (the *"November SAPWG Meeting"*). Further refinements of the Issues Paper and modifications to the Accounting Rules were proposed in connection with the November SAPWG Meeting.

Implications for Rated-Debt Feeder Structures

The multiple drafts of the Proposed Bond Definition, the Issues Paper, and the proposed modifications to the Accounting Rules (collectively, the *"Proposed Rules"*) provide clarity on the characteristics that must be present for a note issued in a rated-debt feeder structure to be listed as debt on Schedule D-1. Those characteristics are discussed below.

Creditor Relationship

The Proposed Rules clarify that an instrument qualifies as debt for regulatory accounting purposes only if the instrument evidences a "creditor relationship" in substance (*i.e.,* the relationship must not reflect "equity-like characteristics").[2] If a note is backed by equity interests, there is a presumption that such note does not evidence a creditor relationship and might not qualify for bond treatment. The Proposed Rules, however, clarify that such presumption can be rebutted and confirm that a note backed by equity interests can represent a "creditor relationship" if "the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer."[3]

Because a note issued in a rated-debt feeder structure (a *"Rated Note"*) looks solely to the cash flows from the feeder fund, a Rated Note has the appearance of an instrument "backed by equity interests" and brings into question whether a Rated Note qualifies for debt treatment for regulatory accounting purposes. However, the Proposed Rules provide that an "assessment of equity backed securities should be looked at, not only in form, but also in substance" in order to determine if it evidences a creditor relationship.[4] Thus, despite being "backed by equity interests," a Rated Note can qualify for bond treatment if (i) in substance, such Rated Note evidences a creditor relationship, which can be demonstrated if the Rated Note is supported by *predictable cash flows*, and (ii) the feeder fund structure in which the Rated Note is issued includes *substantive credit enhancement*.

Predictable Cash Flows

The Proposed Rules presume that a debt instrument backed by equity interests does not to constitute debt for regulatory accounting purposes because in many circumstances the cash flows from the equity interests on which repayment of the debt instrument depends "are not contractually required to be made" and/or are "controlled by the issuer of the debt".[5] If, however, the underlying equity interests are projected to provide debt-like cash flows, that presumption can be rebutted. For instance, while a note backed by an equity interest in a private equity fund may lack predictable cash flows, a note backed by an equity interest in a private credit fund may have cash flows of sufficient predictability to rebut the presumption and support a conclusion that the requisite creditor relationship exists. The NAIC confirmed this difference in treatment between a debt instrument backed by a private equity fund and one backed by a private credit fund when it acknowledged that:

> *"… an arrangement where the debt is issued from a feeder fund, and the feeder fund has an equity interest in another fund, which only holds debt instruments and passes those fixed income cash flows through the structure to the ultimate debt holder, may have substance aligned with a debt investment rather than a single equity investment."* [6]

The Proposed Rules state that a note issued by a feeder fund to a private credit fund may have "substance aligned with a debt investment" if "the terms of the structure ensure that underlying fixed income cash flows [from the credit fund] are passed through."[7] As a result, Rated Notes need to be analyzed to determine if sufficient factors are present to support an expectation that the repayment of the instrument will be supported by predictable cash flows. The more certainty that exists as to the timing of the receipt of those underlying cash flows by a holder of a Rated Note and the amount of such cash flows, the more likely it is that a Rated Note will be treated as debt rather than equity. The NAIC lists a few factors that might undermine that certainty, namely:

(x) the extent of the fund manager's discretion to withhold distributions of the cash flows (as that could negatively impact the timing of the receipt of those cash flows) and (y) the projected sufficiency of the underlying cash flows to service the "regular cash interest" obligations of the feeder fund notes.[8] The NAIC is considering additional modifications to the Issues Paper that will clarify that certain features that exist in rated-debt feeder structures (*e.g.,* the authority of the manager to utilize cash flow to pay customary fund-level expenses and management fees, the obligation of the manager to make payments in accordance with a prescribed waterfall priority, and the use of PIK features to satisfy interest obligations under limited specified circumstances) will not negatively impact a conclusion that a note issued by a private credit fund's feeder fund is "aligned with a debt investment."

Credit Enhancement

Assuming sufficient factors exist to support a conclusion that a Rated Note has the "substance aligned with a debt investment", the Proposed Rules also require that such note benefit from "substantive credit enhancement."[9] Substantive credit enhancement exists if the enhancement places the holder of the Rated Note in a *different economic position* than if such holder directly owned the assets of the issuer of the note. That credit enhancement may be provided by, among other things, guarantees, subordination, or overcollateralization and must provide "a 'more than nominal' change to the risk and reward profile than if [the noteholder] had held the underlying investment directly."[10]

In many rated-debt feeder structures that requisite substantive credit enhancement derives from the feeder fund's issuance of an additional layer of debt that is subordinated to the Rated Note and/or the issuance of equity.[11] The larger the subordinated debt or equity tranche relative to the Rated Note, the more likely such credit enhancement will be determined to be "substantive". The Proposed Rules state that a Rated Note's "NAIC designation, obtained from either the NAIC Securities Valuation Office or from a Credit Rating Provider[,] does not constitute standalone evidence" of substantive credit enhancement, though "independent market validation may provide evidence supporting the substance of a credit enhancement."[12]

The Proposed Rules provide limited guidance on the substantive threshold required for credit enhancement other than that the credit enhancement has economic substance and is more than "merely nominal."[13] It is interesting to note that, after first proposing a requirement that the feeder fund structure reflect a level of credit enhancement to absorb losses that a reasonable investor would expect in other debt instruments of similar quality, the NAIC eliminated that requirement from the Proposed Rules. Ultimately, the NAIC determined that such a requirement implied a quantitative assessment of credit quality that was inappropriate for an accounting rule.[14]

The NAIC also eliminated from the Proposed Rules an example of a debt instrument that qualified as a creditor relationship but failed to qualify for bond treatment because it was "stapled" to an equity interest of the note issuer. That example was eliminated because the Proposed Rules ultimately conclude that "tranches that separately qualify as bonds should be reported as bonds even if other tranches from a structure that do not qualify as bonds are also held by the reporting entity". The Proposed Rules recognize that, by holding both a Rated Note and the equity tranche, insurance companies "would be subordinate to themselves as they would recognize a loss on the equity tranche to safeguard payment under the debt tranche" and that such arrangement did not create an issue for regulatory accounting purposes.[15]

Consistent with this elimination of the stapling rule, the Proposed Rules confirm that the determination of whether or not there is substantive credit enhancement does not turn on who holds or provides the credit enhancement, rather, the assessment focuses on the substance of the credit enhancement and whether it has the effect of placing the holder of the debt instrument in a different position than it would be if it owned the underlying collateral directly.[16]

Current Status of the Accounting Rules

The final modifications of the Accounting Rules will incorporate the final version of the Proposed Bond Definition and much of the commentary included in the Issues Paper. The modifications proposed at the November SAPWG Meeting will be "exposed" at the fall meetings of the NAIC in December of 2022. The revisions to the Accounting Rules indicate that, once finalized, the revised Accounting Rules will have an effective date of January 1, 2025.[17]

Conclusion

While the Proposed Rules remain subject to further industry comment and modification prior to being finalized, the most recent modifications lend clarity to a conclusion that a note issued in a rated-debt feeder fund structure that (i) evidences a creditor relationship, (ii) is supported by sufficient predictable cash flows, and (iii) includes substantive credit enhancement should be eligible for listing as a bond on Schedule D-1.

For More Information

If you would like further information concerning the matters discussed in this article, please contact Van Holkeboer or the Chapman attorney with whom you regularly work:

Rated-Debt Feeder Fund Team

Van E. Holkeboer
312.845.3401
holkeboer@chapman.com

Kimberly R. Bischoff
980.495.7305
bischoff@chapman.com

Kelley M. Bender
312.845.3439
bender@chapman.com

Corporate Finance Partners

Anthony D. Yager
312.845.3731
yager@chapman.com

James R. Nelson
312.845.3498
jnelson@chapman.com

Edward J. Pelican
312.845.3861
epelican@chapman.com

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1 Those updates and revisions and the Issues Paper were dated March 2, 2022, and August 10, 2022.

2 Issues Paper, Paragraph 10(b).

3 Issues Paper, Paragraph 24. *See also*, the revised draft of SSAP No. 26R, Scope of Statement (as included in the Hearing Agenda for the SAPWG November Meeting (the "*Revised SSAP No. 26R*")), Paragraph 6(a).

4 Issues Paper, Paragraph 27. The Proposed Rules also state that any instrument that relies for its repayment on underlying equity assets is one that "inherently requires significant judgment and analysis." *See*, Issues Paper, Paragraph 25. *See also*, the Revised SSAP No. 26R, Paragraph 6(a).

5 Issues Paper, Paragraph 25. *See also*, the Revised SSAP No. 26R, Paragraph 6(a).

6 Issues Paper, Paragraph 27.

7 Issues Paper, Paragraph 27.

8 Issues Paper, Paragraph 27.

9 Issues Paper, Paragraph 38.

10 Issues Paper, Paragraph 41.

11 Although credit enhancement could also be provided by a sponsor guarantee of a portion of the cash flow or by overcollateralization resulting from predictable declines in the loan to value ratio of the Rated Note.

12 Issues Paper, Paragraph 44. Note that Paragraph 44 reiterates that an NRSRO is not an "automatic validation that the substantive threshold has been met".

13 Issues Paper, Paragraph 43. *See also*, Revised SSAP No. 26R, Paragraph 10(a).

14 Issues Paper, Paragraph 43.

15 Issues Paper, Paragraphs 66 and 67(a). The Issues Paper reiterates that permitting the reporting entity to hold both the debt and equity tranche is not an accounting issue to be addressed by the SAPWG but may be a “risk charge” issue for consideration by the NAIC’s Financial Condition (E) Committee and/or the RBC Investment Risk and Evaluation (E) Working Group.

16 Issues Paper, Paragraph 45(d).

17 Revised SSAP No. 26R, Paragraphs 43, 45, 47, and 49. This was also confirmed orally by NAIC staff during the November SAPWG Meeting.

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