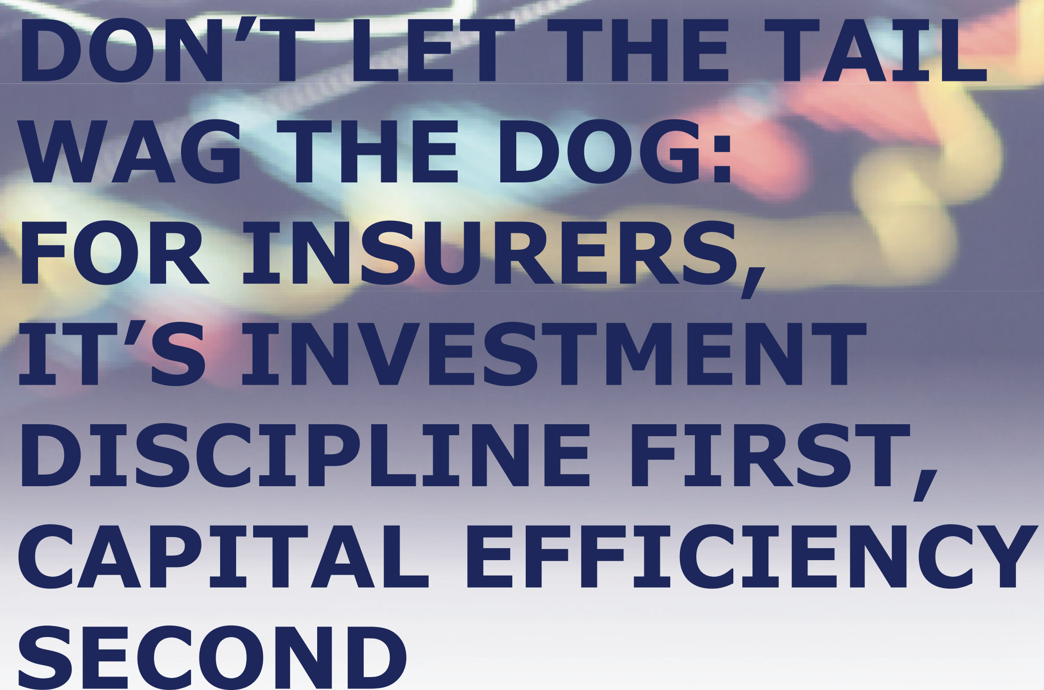

DON'T LET THE TAIL WAG THE DOG: FOR INSURERS, IT'S INVESTMENT DISCIPLINE FIRST, CAPITAL EFFICIENCY SECOND

Insurance Investment Practice Group

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This year was the year of the dog, according to the Chinese zodiac. For NEPC's Insurance Investment Practice, 2018 was the year of rated-private-debt funds. As the search for yield has insurers looking to more complex and less liquid investments in private markets, we have fielded a significant number of requests from asset managers to review their capital-advantaged strategy.

Referred to as "rated" or "capital-optimized", these funds are usually private (credit and infrastructure) debt vehicles structured to avoid the typical risk-based capital charges of similarly pooled private investments. As the National Association of Insurance Commissioners (NAIC) considers changes to the accounting treatment of these vehicles, we would like to remind insurers that their due diligence process should stay the same. Only once the strategy is cleared and approved for investment, should the implementation vehicle be considered. A fund that is made up of non-investment-grade securities has that level of ultimate risk, regardless of the pooled rating.

HOW DOES THE FUND ACHIEVE CAPITAL RELIEF?

There are multiple mechanisms for an insurer to invest in a private markets strategy. The most common is a separately-managed account or a traditional limited partnership (or LLC) structure. While the two structures have advantages and disadvantages in terms of, for instance, size, accounting complexity and reporting, the capital charges are well defined.

Although there are a host of unique structures available, capital-optimized solutions usually fall into two broad categories:

Structure Type	Methodology
Rated Fund	**Typically, this is a limited partnership vehicle. The fund is rated by a NRSRO. The public rating is equated to an NAIC-equivalent bond rating.**
Debt-Equity	**The investment portfolio is housed in a structured product. Like a collateralized loan obligation (CLO), the portfolio is split into tranches comprising rated notes and an equity tranche. The distribution mechanism can vary by structure.**

RATED FUNDS

Currently, the rated fund only benefits life insurers, but the NAIC is also reviewing

them for health and property and casualty insurers. The rated fund is similar to the traditional limited partnership structure, and is still a single-line item held on schedule BA. The fund has risk-based capital relief because it is rated by the Securities Valuations Office (SVO) or has an equivalent rating (the filing-exempt process) from a Nationally Recognized Statistical Rating Organization (NRSRO), often in the form of a private side letter.

NEPC's understanding is that the equivalency mechanism will likely be made unavailable to insurers after January 1, 2019:

> *b. Condition to Eligibility – The "fixed-income–like" regulatory treatment accorded under this Section 8 only applies to funds that the SVO has verified meet eligibility criteria established by the VOS/TF and been assigned NAIC Designations or reviewed under the verification procedures and added to an NAIC List or other NAIC compilation process as hereafter discussed in this Section 8. The use of NAIC CRP credit ratings under the filing exempt process discussed in Part Three, Section 1 (b) of this Manual shall not be an acceptable basis to apply for and receive the regulatory treatment specified in this Section 8. A private fund reported on Schedule BA, acquired prior to January 1, 2019 and reported with an NAIC Designation produced under filing exemption, can continue to be reported on the basis of a credit rating until sold or disposed of, provided the insurer also reports the investment on the Fund GI (General Interrogatory). Funds that do not qualify for the exceptions identified in this Section 8 would continue to be reported as common stock on Schedule D-2-2 or as other invested assets on Schedule BA without NAIC Designations. Note: In all cases where it is necessary for the reader to understand statutory accounting guidance or concepts, please refer to the NAIC Accounting Practices and Procedures Manual.*
> *Source: NAIC Memorandum, "Proposal to Add Comprehensive Instructions for Fund Investments to the P&P Manual", January 31, 2018*

DEBT-EQUITY

The debt-equity methodology creates a structure made up of fixed-income tranches, for instance, senior and junior, and an equity tranche. The differentiated fixed-income pools are rated and held on Schedule D, like any similar security, and the equity tranche is held on Schedule BA as a traditional alternative asset. The level of subordination, that is, the percentage of equity, can vary significantly.

SHOULD INSURERS INVEST IN RATED AND/OR CAPITAL-OPTIMIZED STRATEGIES?

At NEPC, we prefer well-researched, credit-intensive private debt strategies over public assets that are rated below investment grade. While the insurance ratings overlay creates an additional level of risk that should be analyzed, it should not impact the investment process from a traditional due diligence perspective other than to potentially constrain the guidelines.

As with all private markets research, the insurer should evaluate the investment team, firm resources, opportunity set, investment thesis, track record, and back-office capabilities. Once the strategy has passed all investment due diligence tests and has been approved for investment, then the implementation vehicle should be considered.

Under the current regulatory and ratings environment, it is understandable that insurers want to take advantage of the potential capital relief for private markets

investment. It is important that insurers keep in mind that these are long-term investments and that the future regulatory environment may change. To this end, we suggest insurers consider the following questions:

- Will a change in regulatory or rating agency methodology cause investors to exit the rated vehicle?
- If so, will the structure survive a "run on the bank"? This is a dual threat: The run on the bank could generate a forced sale if the lock-up clauses don't hold, but if the lock-up clauses do hold, capital can be tied up in a suboptimal vehicle.
- What responsibility does the General Partner/Investment Manager have if the structure breaks?
- Do we understand the inputs and factors employed by the different NRSROs? While the NAIC "has no discretion to ignore an NRSRO credit rating" (NAIC Valuation of Securities (E) Task Force, September 2018), an insurer can evaluate and differentiate between agencies.
- If there is a change in the standing of an NRSRO, would there be a willing replacement for any annual review process?
    - If yes, what would a potential rating change look like? This highlights the additional level of downgrade risk. The strategy is subject to downgrade risk from the selected NRSRO, but should an NRSRO fail, the replacement may apply a downgrade.

Thorough due diligence should determine the viability of any private markets investment. An insurer should evaluate each opportunity agnostic to the implementation vehicle, and capital optimization should be a distant secondary consideration. History has not looked kindly on strategies that have been engineered to overcome regulatory challenges.

ADDENDUM

The objective of this article was to focus on private markets and the regulation and accounting treatment for structures that exist in that universe. We deliberately avoided the discussion of how AM Best, another NRSRO, would incorporate these structures into its BCAR calculation (another key solvency model for US insurers). We are of the understanding that AM Best has constructed an investment working group that will assist with the evaluation of pooled investment vehicles. We strongly recommend that insurers discuss private markets allocations and the capital impact with their designated analyst.

DISCLAIMERS AND DISCLOSURES

- Past performance is no guarantee of future results

- All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

- The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.

- The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.

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