

CLIENT ALERT

Private Credit Investments May Be Impacted by NAIC’s “Deactivation” Direction

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For the last several years, an increasing number of investment managers have been offering “rated feeder fund” interests as a way to attract insurance company capital to invest in private credit strategies. The interest in the industry has been driven by the confluence of a challenged fundraising environment for traditional private capital managers as well as increased appetite from insurance companies to better match the regulatory capital treatment of investments in these funds with the regulatory capital treatment of the funds’ underlying credit investments. In these structures, the insurance company investor obtains a debt commitment in or purchases notes from a feeder vehicle. In order for the insurance company investor to obtain favorable NAIC Designation treatment, the investment manager facilitates these notes by obtaining a private letter credit rating, which letter would typically include a rationale report (a “Rationale Report”), from nationally recognized statistical rating organizations (“Rating Agencies”). When a private letter credit rating is obtained, the notes are considered “privately rated securities” for insurance regulatory capital purposes.

At a meeting on November 17, 2024, the Valuation of Securities (E) Task Force (the “Task Force”) of the National Association of Insurance Commissioners (the “NAIC”) directed the NAIC’s Securities Valuation Office (the “SVO”) to begin to “deactivate” privately rated securities issued after January 1, 2022 that do not have a Rationale Report on file with the SVO. Such investments will no longer be eligible for “filing exempt” status, and insurers that hold them will need to submit a filing to the SVO for analysis and assignment of an NAIC Designation, or “self-file,” which will likely result in a less favorable NAIC Designation and higher capital charge for the investment.

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The impact of this “deactivation” process, and the possibility of future “deactivations,” may be secondary to whether, come January 1, 2025, these privately rated securities identified as missing a Rationale Report meet the principles-based bond definition and remain filing-exempt after that initial hurdle. If these privately rated securities are “bonds,” then insurers will have the burden of submitting a complete package of the private letter credit rating inclusive of the Rationale Report for approximately 1,700 privately rated securities issued during the period from 2022 to 2024 that have been identified by the SVO for “deactivation.” While not subject to the current deactivation, another approximately 2,000 privately rated securities issued during the period from 2018 to 2021 have been identified. A significant portion of these privately rated securities are likely private credit rated feeder fund notes or notes issued by collateralized fund obligations (CFOs) because these private credit investments are what have driven the growth in the usage of private letter credit ratings versus public ratings.

I. Background

State insurance laws have limits on U.S. insurance companies’ investments in securities based on “NAIC Designations” of those securities. An NAIC Designation is obtained by filing the security with the SVO for analysis in accordance with the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the “P&P Manual”).¹ NAIC Designations are produced for insurance regulators to assess the quality of a security in the context of the state’s insurance investment laws and they also translate into risk-based capital charges assigned to investments. NAIC Designations fall within number categories 1 (highest quality) through 6 (lowest quality). Riskier investments with a higher NAIC Designation number receive a higher risk-based capital charge. Certain investments are exempt from filing with the SVO when rated by a Rating Agency. Where such Rating Agency ratings are not public, but are made by private letter rating, such investments are described in the P&P Manual as “PL securities” (referred to herein as “Privately Rated Investments”).

With an amendment to the P&P Manual that became effective on January 1, 2018, the Task Force required insurance companies to submit the private rating letter issued by the Rating Agency for each Privately Rated Investment to the SVO. A subsequent amendment that became effective January 1, 2022 requires a Rationale Report issued by the Rating Agency to also be filed with the SVO in order for Privately Rated Investments issued on or after January 1, 2018 to be filing-exempt. When adopting this amendment, the Task Force indicated that the Rationale Report should be comparable to the reports published by Rating Agencies for publicly rated securities, providing “a more in-depth analysis of the transaction structure, the methodology used to arrive at the private rating, and, as appropriate, a discussion of the transaction’s credit, legal and operational risks and mitigants.” With both the private rating letter and the Rationale Report on file, the SVO would “be able to better understand the security.”²

¹ The P&P Manual defines an “investment security” subject to the SVO filing procedures as “an instrument that documents a lending transaction between an insurance company as lender and a non-affiliated borrower, where the borrower’s sole motivation is to borrow money and the insurance company’s sole motivation is to make a profit on the loan.”

² 2021-4 NAIC Proc. 1006.

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The above amendments resulted in three categories of Privately Rated Investments: (i) those issued prior to 2018, which are not subject to the private rating letter or Rationale Report requirements; (ii) those issued between 2018 and 2021 and originally subject to the private rating letter requirement but not the Rationale Report requirement (but which subsequently became subject to the Rationale Report requirement when it became effective in 2022); and (iii) those issued on or after January 1, 2022 after the Rationale Report policy became effective.

The amendments also contemplated that the NAIC would create systems to identify an insurer-owned Privately Rated Investment, verify its Rating Agency rating, review the Rationale Report, and either translate the Rating Agency rating into its equivalent NAIC Designation or notify the insurer that the security is not eligible for filing exemption. At the November 17 meeting, the SVO reported to the Task Force that it has completed its work on building out these systems and is now in a position to enforce the filing requirements with respect to Privately Rated Investments issued on or after January 1, 2022 in accordance with the P&P Manual, which provides that if a Rationale Report is not on file with the SVO within 120 days of the insurer’s purchase of the security, it must treat the security as not filing-exempt. This is accomplished by “deactivating” an unsupported Rating Agency rating in the SVO’s systems.

II. Next Steps for Impacted Securities

The Task Force directed the SVO to proceed with deactivating Privately Rated Investments issued on or after January 1, 2022 that do not have a Rationale Report on file. If a Privately Rated Investment is deactivated, the insurer that owns it must either (i) file the security with the necessary documentation for the SVO to analytically determine the NAIC Designation; or (ii) “self-assign” an NAIC Designation of 5.B GI to the security (used for a security where documentation necessary to permit a full credit analysis of a security by the SVO does not exist or a Rating Agency rating is not available).

The SVO indicated that it has published information in its VISION and AVS+ databases to inform insurers of the filing status of Privately Rated Investments, and has provided the National Association of Securities Valuation Analysts (“NASVA”) with a list of approximately 1,700 Privately Rated Investments for which no Rationale Report has been filed. NASVA will review the list and report whether there are indications of any “material system defect” with the SVO’s databases, in which case the SVO will pause deactivation until the defect is remediated and seek to deactivate sometime before March 2025. Further, after discussions with NASVA and insurers, the Task Force agreed to permit a 30-day grace period for Rationale Reports to be filed following renewal for Privately Rated Investments that renew at year-end 2024.

Insurers that hold Privately Rated Investments issued on or after January 1, 2022 should review whether the required private rating letter and Rationale Reports are on file with the SVO in order to avoid incurring additional SVO filing requirements or an impact to the NAIC Designation and capital charge of such investments. In addition, the SVO noted that it will defer for an additional year enforcing the filing requirements applicable to the category of Privately Rated Investments issued between 2018 and 2021 (approximately 2,000 securities), given a current lack of clarity on filing procedures within SVO

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systems for that population of securities. Insurers holding those securities should be aware of the potential for similar deactivation procedures in the future.

To the extent investment managers with a private credit strategy issued Privately Rated Investments on or after January 1, 2022, but did not obtain a Rationale Report as part of the private letter rating for these Privately Rated Investments, then investment managers should discuss with their insurer investors whether to contact the applicable Rating Agency to obtain a compliant Rationale Report.

If you have any questions regarding this alert please contact the following attorneys or the Willkie attorney with whom you regularly work.

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