STRUCTURED FINANCE ASSOCIATION

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February 17, 2023

Carrie Mears
Chair, Valuation of Securities (E) Task Force
National Association of Insurance Commissioners

Re: Proposed Methodology for Modeling CLOs

Dear Ms. Mears,

SFA appreciates the opportunity to provide feedback to the Valuation of Securities (VOS) (E) Task Force (VOS TF) on the exposure draft for the Proposed Methodology for Modeling CLOs ("Proposed Methodology"). In gathering feedback to respond to the Proposed Methodology, SFA engaged with various market participants, including insurance companies, asset managers, CLO managers, rating agencies, law firms, and others. While all SFA members who participate in the CLO market were invited to participate in building a membership consensus, we will highlight the views of only our insurance company members that are the economic stakeholders that would most directly be impacted by the Proposed Methodology and the move away from the filing exemption towards internal modeling by the NAIC Structured Securities Group (SSG).

Additionally, per SFA's governance, we seek to arrive at consensus on policy positions. However, in instances where there is not consensus, we will instead inform policymakers of the differing views from market participants. Our response will focus first on feedback and market participant views on the proposed removal of the filing exemption to permit staff's discretion over the assignment of NAIC designations including through internal modeling by the SSG. We will then share specific feedback on the assumptions provided in the Proposed Methodology.

1. ***Views on Proposed Removal of Filing Exemption & Internal Modeling of CLOs and Role of Rating Agencies in Determining Risk Based Capital***

As a threshold matter, we note that the exposure of the Proposed Methodology takes place within parallel processes involving various groups working simultaneously and in coordination with each other. As part of that process, SFA shared our views with VOS TF on July 15, 2022, and we appreciate that views were noted in the NAIC Annual Summer meeting on August 11, 2022. We also appreciate the degree to which matters SFA raised—including procedural questions, the need for transparency, and providing ample opportunity for market participants to share their views—have been incorporated into the NAIC's process.

Against that backdrop, and as the NAIC process has advanced through various committees and task forces, our membership is split on its views around the proposed removal of the filing exemption for CLOs and the proposed move towards internal modeling of CLOs. While some members see the proposed change as a reasonable continuation of the work started with RMBS and CMBS in the aftermath of the Great Financial Crisis to better capture the unique risks embedded in structured securities, others have expressed concern about the appropriateness and timing of the change as it relates to CLOs, and point to reservations expressed by the American Academy of Actuaries on December 14, 2022 as evidence.

Given this strong split in member views, SFA surveyed our members seeking a deeper understanding of their positions surrounding the removal of the filing exemption and the move towards internal modeling. What follows next is a summary of the survey responses, including insights into the rationale behind those views.

a. Views on Timing of NAIC Actions Relative to Removal of Filing Exemption and Move Towards Internal Modeling of CLOs

There was consensus among our membership in terms of the important actions that the NAIC should undertake in relation to any move towards internal modeling for CLOs. Such actions include:

- Making SVO modeling methodology and all related assumptions available concurrently for review;
- Detailing the process and frequency of NAIC's modeling designations for CLOs and the required NAIC resources;
- Coordinating with other ongoing efforts, particularly the RBCIRE WG in their evaluation of capital requirements; and
- Examining proposed changes to CLOs, and comparing them to other structured securities, fixed income assets, and equity investments.

While there was consensus about the actions that NAIC should undertake, there was a divide among our members in terms of the timing of such actions relative to a move towards internal modeling for CLOs. Approximately 40% of the insurance companies who responded believe that such actions should be undertaken pursuant to an enumerated goal of having the NAIC move towards internal modeling for CLOs. In other words, these insurance companies believe that these actions should be undertaken with a view to inform *how* the NAIC moves towards internal modeling for CLOs.

On the other hand, 60% of the insurance companies we surveyed believe that such actions are necessary preconditions that must be met prior to the NAIC implementing any procedural changes. In this view, the rationale necessary to justify removing the filing exemption and moving towards internal modeling must first be established by completing these steps including seeking public comment. In other words, these insurance companies believe that these actions should be undertaken with a view to inform *whether* the NAIC moves towards internal modeling for CLOs. Either way, SFA members agree that if the filing exemption is removed and NAIC adopts a modeling approach, then all assets in the CLO should be modeled and the NAIC designation should be determined using a similarly rigorous methodology and assumptions put out for public comment.

b. Views on Role of Rating Agencies in Determining CLO Risk Based Capital Requirements

Next, SFA surveyed our members for their views on the role of utilizing credit ratings as a basis for risk-based capital calculations for CLOs. Approximately 40% of our insurance company members believe that ratings from nationally recognized statistical rating organizations (NRSROs) should not serve as the basis for regulatory risk-based capital calculations for CLOs. Reasons given for this belief include the idea that credit ratings—while an indispensable part of the market—serve a fundamentally different purpose than risk-based capital calculations. Additionally, these members referred to the questions raised by the NAIC in December 2022about the appropriateness of using ratings as the basis for determining risk-based capital requirements[1].

On the other hand, approximately 60% of our insurance company members believe that NRSRO ratings can serve as the basis for risk-based capital calculations. These members note the degree to which CLO ratings have matched historical performance as well as the expertise of NRSROs in performing both qualitative and quantitative analysis of the bespoke structuring features of CLOs.

SFA also surveyed our members on their views of whether NAIC should move towards internal modeling of CLOs, or if NAIC should instead maintain the current filing exemption and modify the risk-based capital factors as needed to arrive at appropriate levels of capital reserves. Approximately 40% of our insurance company members believe that removing the filing exemption and moving towards internal modeling is the appropriate path forward, as they believe doing so would better capture the expected losses of CLO investments consistent with RBC purposes. Other reasons for this view include the belief that internal modeling by NAIC will allow the NAIC to better address their goals in determining risk-based capital, as well as their view that NAIC staff are well-positioned with staff and resources to undertake this role.

Approximately 60% of insurance companies believe under the current circumstances, the best path forward is to maintain the filing exemption and instead modify the risk-based capital factors as needed to eliminate any material RBC arbitrage to arrive at the appropriate risk-based capital levels[2]. Reasons for this view include the belief that NAIC has not yet adequately justified a

[1] https://content.naic.org/cipr-topics/structured-securities-project

[2] To clarify, some members in this group believe that modifying the RBC factors is not the best way to accomplish the goal to avoid RBC arbitrage. Insurance companies with this view believe that instances of material RBC arbitrage are in the small minority as compared to insurance company investments in broadly syndicated loan CLOs as a

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rationale for removing the filing exemption[3]. These members also have concerns about NAIC staffing and expertise to model CLOs, particularly given the extensive variation of structural features that exist across individual CLOs.

Finally, we surveyed our members about the role of NRSROs in the market more broadly, regardless of the approach taken by the NAIC towards the filing exemption and internal modeling of CLOs. Members strongly felt that credit ratings should and will continue to play a vital role in the CLO market, and that the NAIC should make clear that any move with regards to modeling does not necessarily negatively reflect on any particular rating agency methodologies or ratings. One insurance company who believes that the NAIC should remove the filing exemption and move towards internal modeling suggested that the NAIC should perhaps require CLOs to have a rating from a rating agency given the essential role that credit ratings play in the CLO market.

As noted above, SFA strives for consensus where possible, and seeks to provide context where there are differences of views among market participants. While we were unable to reach consensus on all these questions, we hope that the survey responses above provide the NAIC and policymakers with additional color on market participants' views. Additionally, we strongly encourage the NAIC to take appropriate steps where there are areas of consensus—such as in emphasizing the vital role of credit rating agencies in the CLO market.

2. *Assumptions for Proposed Methodology of Modeling of CLOs*

We note at the outset that our current feedback is necessarily incomplete, as we cannot assess the NAIC's proposed methodology without full transparency of all the assumptions and scenarios that will inform the models. The interplay of the various assumptions and scenarios will ultimately drive end results, and our responses reflect that reality. Furthermore, our members noted that there were vital assumptions missing including those related to interest rate movements and default curves. Therefore, while we have made best efforts to provide views on the assumptions, we will need revisit and potentially amend our responses as additional information is published and exposure drafts are released in the future.

A. Reinvestment Price

The NAIC's proposed methodology for modeling CLOs currently assumes that "reinvestment collateral is purchased at par", which we believe fails to capture an important element of the economics of CLOs. Leveraged loans are commonly traded at discounts even in the primary

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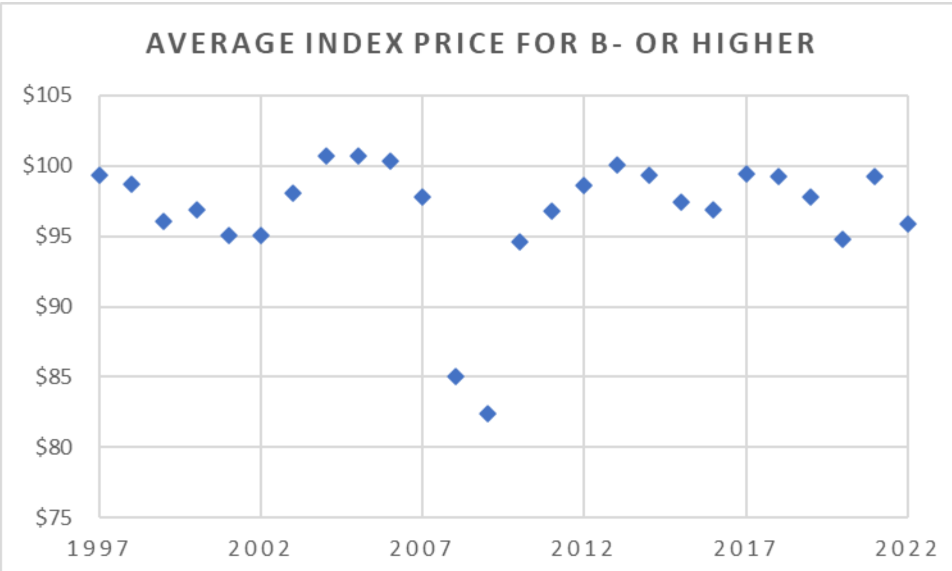
whole. Instead it would be more feasible for the RBC IRE WG to identify which insurance companies engage in material RBC arbitrage and take action in those unique situations. Moreover, they do not believe the risks posed by CLO investment justify this level of departure from current operating procedures.

[3] While there is a preference for adjusting RBC factors compared to internal modeling by NAIC, these insurance company members do not support the proposed NAIC Category 6 interim capital levels of 30%, 75% or 100% as they believe those proposed interim levels are not based upon sufficient analysis.

market and can become deeply discounted in adverse market conditions. The chart below uses LCD index data to plot the average annual price for loans rated B- or better going back to 1997:



These prices reflect only secondary price data, but if we look at primary pricing dynamics we see an average discount price of $99.3 over the last 10 years. Based on this data we would recommend that the NAIC follows a simplified scenario-based approach for reinvestment price similar to the below:

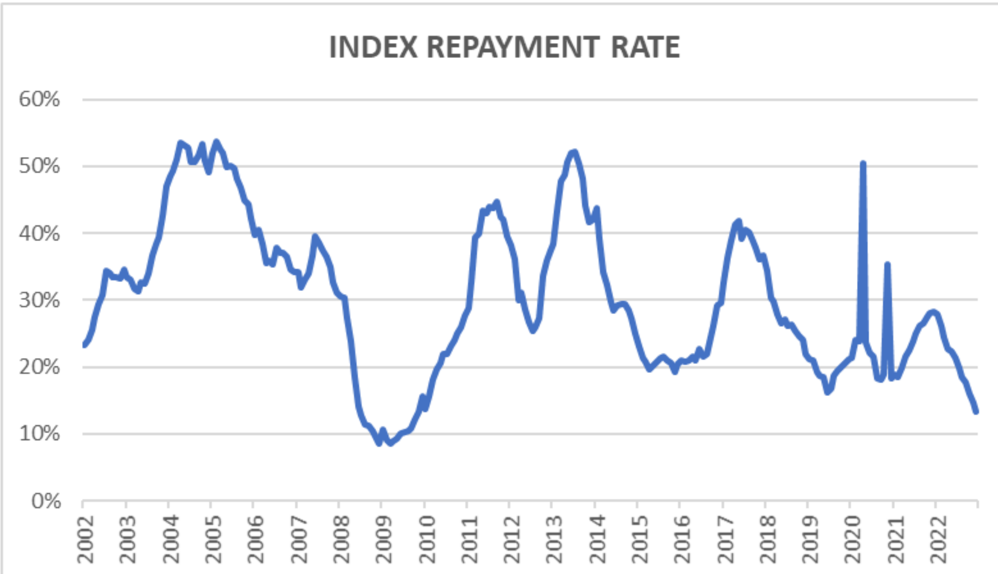
- Average or better scenarios: $99 to par
- Stress scenarios: $92
- Tail scenarios: <$87

Some of our members also believe a vector should be used in the Tail scenario.

B. Maturities and Prepayments

The NAIC proposes that non-defaulting portions of each loan mature based on legal maturity. We hold that loans should be based on amortization schedules, not legal maturity given the impact on tail risk. For example, there will be different results in the tails if using 5-year amortization assumptions rather than the 7-year weighted average life for assumptions in the default data.

The proposed methodology states that no prepayments will be assumed. This assumption conflicts with the historical prepayment experience of leveraged loans and may have a material skewing effect on the NAIC's modeling results. The chart below shows the historical prepayment experience of leveraged loans based on LCD data:



Similar to our recommendation for reinvestment prices, we suggest following a simplified scenario-based similar to the below:

- Average or better scenarios: 20% prepayment
- Stress scenarios: 10% prepayment
- Tail scenarios: <8.7% prepayment

C. Assigning Ratings to Underlying Loans

To set the applicable default rating, the SSG will use ratings from Moody's, S&P, and Fitch unless the SVO has assigned an NAIC Designation Category, in which case, the NAIC Designation Category will be used. We believe that limiting (or giving the appearance of limiting) ratings on the underlying loans to the specifically named agencies in the Proposed Methodology could adversely impact market competition and unduly restrict diversity in opinions among credit rating agencies. Appreciating that there must be a balanced approach to promote competition while ensuring performance guardrails are in place, SFA welcomes the opportunity to have a further dialogue with the NAIC on this topic, particularly in light of the VOSTF's broader initiatives relating to rating agencies.

D. Correlation Risk

We understand that the current stress methodology does not explicitly model correlation. However, as the pandemic has revealed and continues to reveal there is contagion between industries that had previously been thought to be uncorrelated.

The impact of correlation risk on CLO tranches is uneven. Investors further down the capital structure will be more exposed to the underlying pool and the correlation risk that exists within that pool. Therefore, we believe that correlation should be incorporated as sudden shifts in credit correlation will disproportionately impact the risk distribution within CLOs.

E. Cash Flow Assumptions

Each CLO could have unique structural protections and risk – and these features can significantly impact the cashflow waterfalls. When evaluating cash flows, models must accurately incorporate all these features including priority of payments, asset spreads, liability spreads, the CLO capital structure, the amortization schedule of the CLOs relative to the underlying leveraged loan portfolio, and loan recovery and default timing. Therefore it is imperative that the cash flow analytics engine used by the NAIC accurately reflects the material differences in these features – and is readily accessible to market participants to review. SFA recommends that the SVO seriously consider a cash flow analytics engine that is already used extensively across the market as the source of CLO waterfalls for a given security. This would facilitate insurance companies and other market participants replication of the NAIC's analysis without having to expend additional funds for a separate service.

F. Additional Considerations

Other considerations raised by our members include questions around ongoing surveillance and frequency of updating NAIC designations, and potential communication from NAIC to market participants that promotes transparency, similar to how credit watch placements are communicated today. Additionally, there were question about how bespoke deals or new CLO features would be addressed on an ongoing basis. Some members asked about the timing of RBC assignments, and noted that investment decisions would be impacted of RBC assignments are not available when deals are priced. Finally, some members raised questions around how middle market CLOs would be treated, and what the NAIC's approach might be for assessing credit quality of non-publicly traded companies often found in middle market CLO portfolios.

As noted earlier our current feedback is necessarily incomplete, as we cannot assess the NAIC's proposed methodology without full knowledge of the assumptions and scenarios that will inform the models.

Once again, we thank you for the opportunity to share our members' views on these points and look forward to continuing engaging with you on these topics. If you have any questions, please do not hesitate to contact SFA staff.

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Regards,

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