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The Bottom Line

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The Bottom Line
Raising Insurance Capital: Latest Developments in Collateralized Fund Obligations and Rated Feeders

Matthew K. Kerfoot | Gopal Narsimhamurthy | Chip Parsons | Luke Schlafly | Ahmet Yetis

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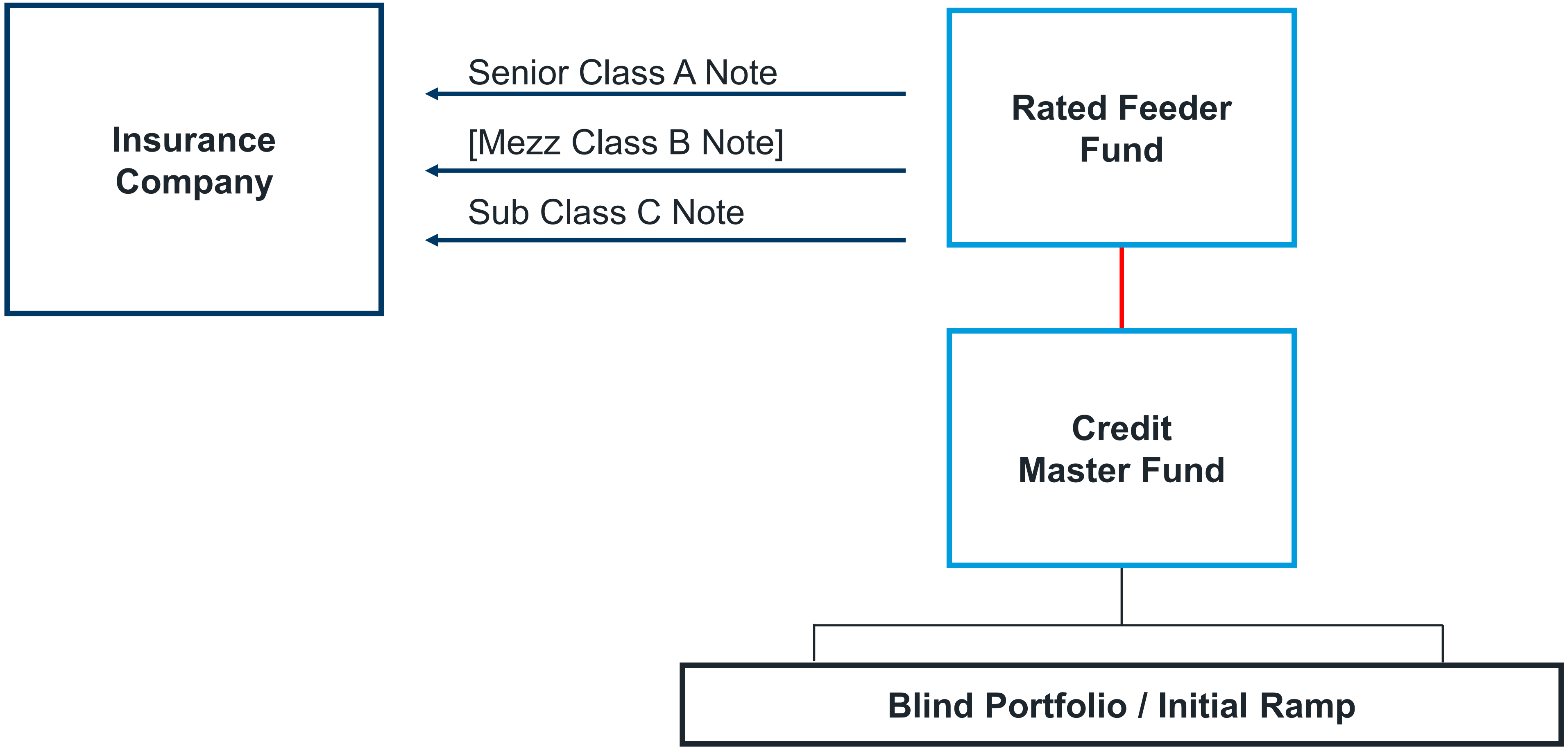
Rated Feeder Structure



Rated Feeder Overview

- Manager forms a feeder fund generally for US/Asian insurance company investors
  - Feeder fund issues debt and equity tranches
    - Often unitranche debt / equity structure
  - Feeder fund is typically formed for a single fund launch
  - Feeder fund’s single asset is master fund equity interests
  - Underlying master fund interests typically are *not* pledged to support the rated notes

- Insurers typically purchase entire capital stack
  - Not dissimilar to SMA investment
  - Insurers receive same return as pure equity investor in fund but in a capital-efficient wrapper
  - Weighted average capital charge across debt and equity investment provides significant RBC-adjusted yield enhancement

Rated Feeder Overview (cont'd)

- Use case
  - Insurers holding loans directly on balance sheet incur capital charges based on ratings of loans
    - SMAs require infrastructure, scale and operational support, size requirements, etc.
  - Direct investments into same portfolio through a commingled fund results in a 30% capital charge
  - Rated feeder provides insurers with benefits of commingled fund structure but without RBC anti-arbitrage

- NAIC is currently reviewing risk-based capital treatment of rated feeder structures

Rated Feeder Structure

Assume $100mm Capital Structure	
$70mm Class A A/A- rating	70% LTV / 30% par sub
$10mm Class B BBB/BBB- rating	80% LTV / 20% par sub
$20mm Class C Subordinated Note	Equity / not rated

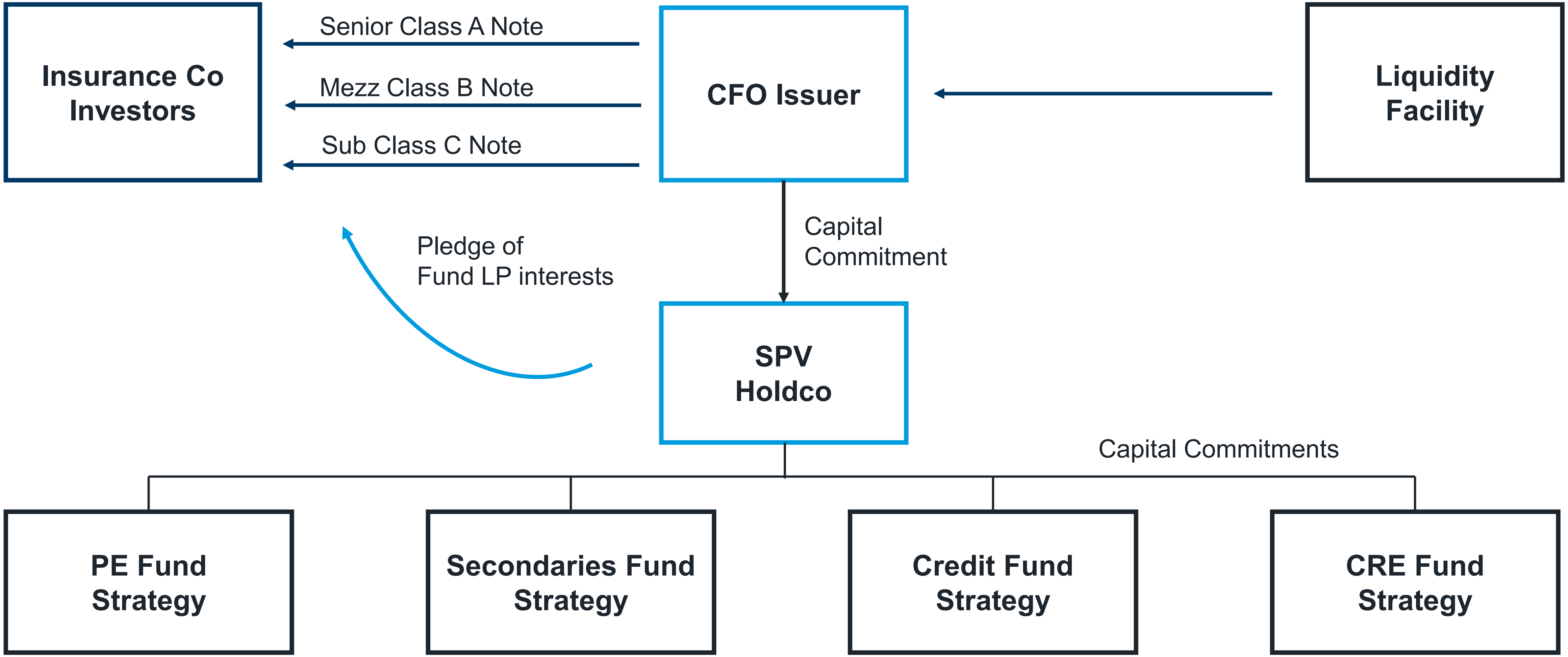
Rated Feeder Term Sheet

$100mm Feeder Fund	
Fund	Direct Lending Fund II
Senior Note	$70mm Class A A/A- rating 70% LTV / 30% par sub
Mezzanine Note	$10mm Class B BBB/BBB- rating 80% LTV / 20% par sub
Equity	$20mm Class C Sub note Equity / not rated
Maturity	Fund life / 5-7 years, with 1-year extensions at determination of GP
Waterfall	**During Investment Period:** • Administrative expenses • Interest on senior notes • Interest on mezzanine notes • Equity pay or residual to be recycled **Post-Investment Period:** • Same as above, other than residual proceeds to repay senior note principal, then mezzanine note principal

Rated Feeder Term Sheet

$100mm Feeder Fund	
Rate	Typically fixed subject to PIK
Investment Period	5 years (same investment period as the fund)
Portfolio Limits & Concentrations	Typically none specified / look-through to the fund
Recourse	No recourse to master fund or GP
Subscription Line	TBD whether commitments may be included in borrowing base (typically not)
Transfer Restrictions	• GP consent required for any transfers • Tranches may be transferred separately

Collateralized Fund Obligation (CFO)



Collateralized Fund Obligation (CFO)

Assume $100mm Capital Structure	
$50mm Class A A/A- rating	50% LTV / 50% par sub
$15mm Class B BBB/BBB- rating	65% LTV / 35% par sub
$35mm Class C Subordinated note	Equity / not rated

CFO Term Sheet

$100mm Collateralized Fund Obligation	
Funds	Private funds selected by sponsor
Class A Note	$50mm Class A A/A- rating 50% LTV / 50% par sub
Class B Note	$15mm Class B BBB/BBB- rating 65% LTV / 35% par sub
Equity	$35mm Class C Subordinated Note Equity / not rated
Maturity	15 years / amortization expected by year 10
Step-up Coupon	2% if notes remain outstanding after year 10
Liquidity Facility	Commitment of 15% of the total issuance amount. Maturity is typically 5 years with 1 year extensions
LTV Test	[70-75%], equal to (sum of Class A and B Notes and Liquidity Facility outstanding) / (sum of private fund NAV, liquid assets NAV, interest reserve and cash)
Liquid Assets	Portfolio of liquid assets, into which initial proceeds are to be invested

CFO Term Sheet

$100mm Collateralized Fund Obligation	
Waterfall	• Administrative expenses • *Interest on liquidity facility* • Interest on senior notes • Interest on mezzanine notes • Capital calls to fund commitments on underlying funds • Catch up for interest reserve • Reduce any outstanding principal amount on liquidity facility • Distributions on subordinated notes (as sponsor’s discretion) • Class A and B amortization (deal and structure specific)

CFO Overview

CFO Overview (Cont'd)

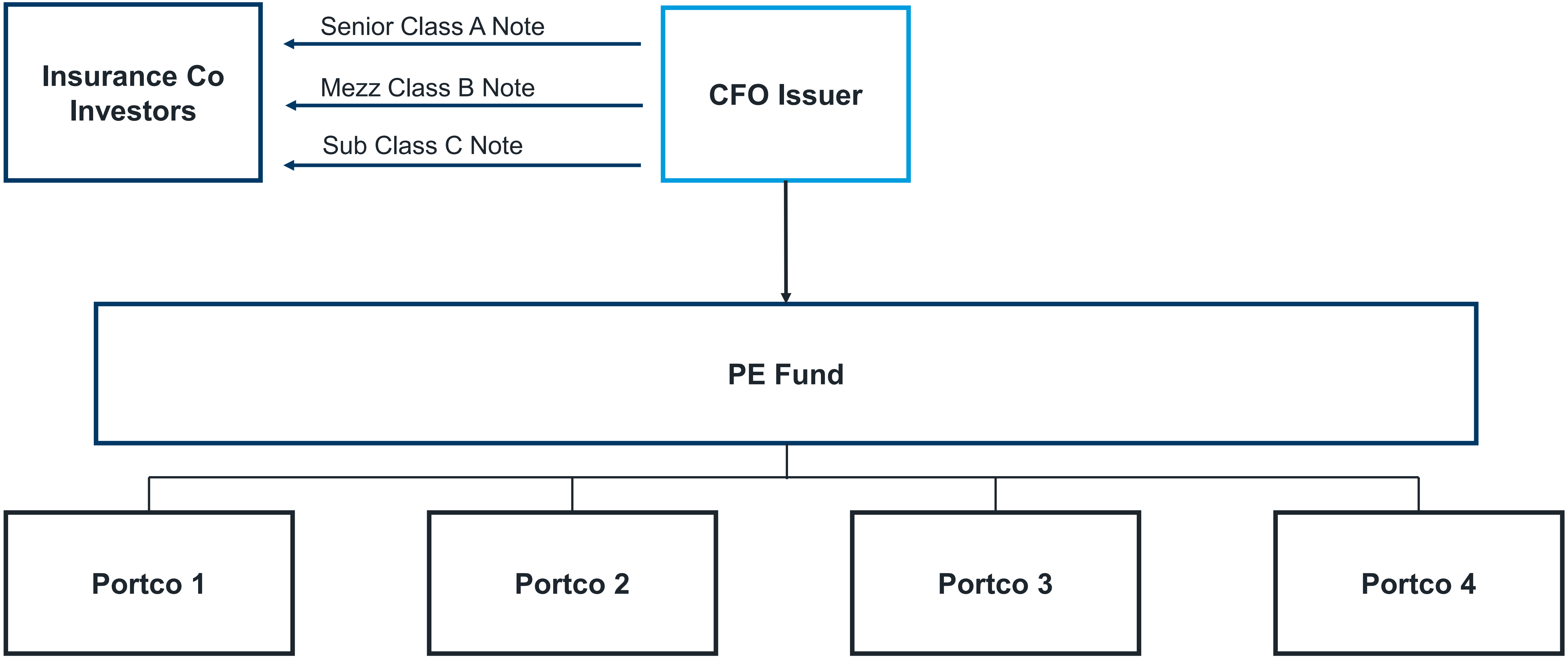
- CFO feeder issues debt and equity primarily to US insurers
  - Debt and equity is not stapled, as it is with rated feeders
  - Insurers often purchase only the A-rated tranche, or BBB-rated tranche, or equity, or some combination
- CFO pledges investments in underlying fund portfolio to collateralize debt tranches
  - Rated feeder typically does not include a pledge of the master fund interests
- CFO will enter into liquidity facility to support capital calls and interest payments

CFO Overview (Cont'd)

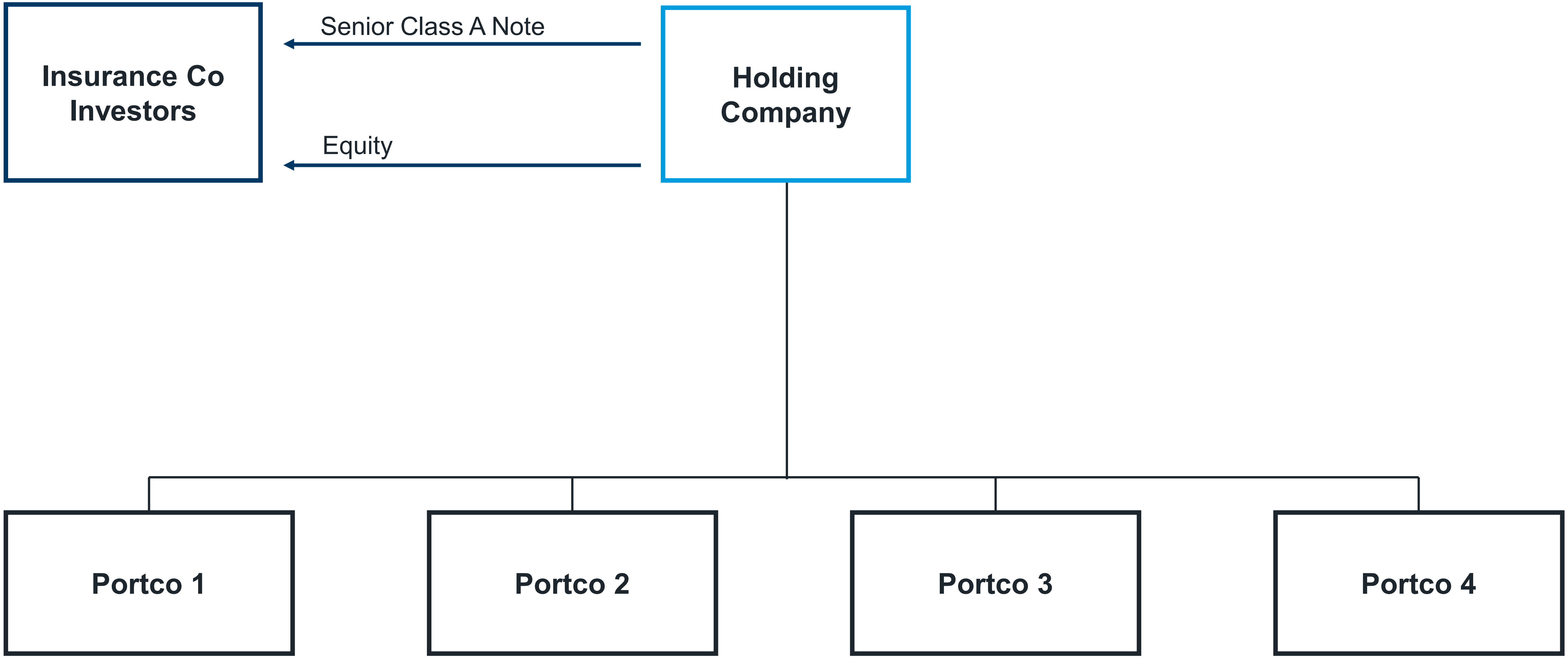
- Legal maturity generally 15 years, with expected senior debt maturities of 10 years
  - First five years – investment period, with funds deployed and recycled
  - Second five years – amortization period for senior debt; harvesting of underlying investments
  - Remaining years to maturity – finalization of the harvesting period
- NAIC focus on rated feeders includes CFO structures

CFO Overview (Cont’d)

CFO (Debt & Equity)



Holding Company (Debt & Equity)



Summary of SVO Proposal (Nov 28, 2022)

- SVO processed several private letter rating filings for rated feeder-type structures
- SVO concerned about:
  - Debt investments that could be in substance equity investments
  - Reliance on ratings for filing-exempt status for investments into equity that would not be eligible for a direct rating
  - Improved RBC treatment than if the underlying equity investment were held directly
- SVO recommendation
  - Create a definition of “Structured Equity and Fund”
    - A note issued by an SPV, LP, etc. that payments of which are dependent on distributions from underlying equity or fund investments

Comments to Proposal

- Scope of proposal could capture other more traditional fixed income securities
  - Holding company debt
  - Debt issued by 40 Act funds (e.g., closed-end funds)
  - NAV loans (which may have up to 90% closing subordination)
- There are related NAIC initiatives to increase the RBC charge on the equity tranche of securitized products
  - Potential for roughly equivalent RBC chargers for direct exposure vs. exposure through feeders
- Feeder fund structures help equal playing field for smaller insurers
  - Smaller insurers may not have size and operational capacity to handle managed accounts
  - Investments into a commingled fund can be RBC anti-arbitrage

Comments to Proposal (Cont'd)

- Debt structures common in feeder funds are common in many other types of debt
  - PIK (provided the principal is capitalized)
  - Maturity extensions
  - Pricing (not in comments, but pricing to reflect broader strategic relationship is common)

SVO Process on Credit Ratings Review

- At Spring National meeting (March 23, 2023), VOS (E)Task Force directed SVO to draft process on how it may contest credit ratings
- SVO proposed a process on April 25, 2023 which sets out, among other things:
  - A method of identifying to insurers securities that may raise concerns
  - A review process by the SVO with a consultation opportunity for applicable insurance regulators
  - Establishment of materiality threshold to remove a credit rating from filing exempt eligibility

SVO Process on Credit Ratings Review (Cont'd)

- Materiality threshold
  - Credit rating is three or more notches different than assessment by NAIC's Investment Analysis Office
  - Observable factors, including
    - Comparison to securities rated by other agencies
    - Comparison of security's yield to other comparably rated securities

- SVO proposal is set out in materials available for discussion during May 15, 2023 meeting

Risk-Based Capital Investment Risk and Evaluation (E) Working Group

- Reviewing RBC charges assessed to the residual tranches of CLOs and other structured securities
  - Interim project associated with longer-term review of RBC treatment of CLOs
- 30% RBC charge on residual tranches may be increased on an interim basis to 45%

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