

Make (Whole) A Minute: The New Burden of Proof for Private Ratings

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In this issue of Make (Whole) A Minute, we examine the new ratings rationale reporting requirements being implemented by the NAIC's Securities Valuation Office.

Insurance regulators have long sought greater transparency into insurers' investment portfolios and the methodologies used by nationally recognized statistical ratings organizations (NRSROs) for rating investment securities, in an effort to obtain greater insight into evaluating investment risk and improved oversight of insurance companies' investment practices. On January 1, 2022, new regulations go into effect that will require insurers to provide the National Association of Insurance Commissioners (NAIC), through its Securities Valuation Office (SVO), with private rating letter rationale reports for each investment security with a private letter rating, which private rating letter rationale reports will need to be provided both at the time of investment and annually thereafter.

Practically speaking, this will require NRSROs to routinely provide a written report describing the rationale and methodology behind their private rating decisions to accompany their private rating letters in order for the SVO to determine the regulatory treatment of the investment security in question and for the investment security to receive an NAIC designation. The Private Placement Investors Association (PPIA) has been in contact with all of the major NRSROs to address this new requirement and to begin evaluating how to implement it, though it is expected that the private rating letter rationale reports will be modeled after NRSRO public reports for specific asset classes. It is important to note that while this additional information will allow the SVO to better evaluate investment securities and their private ratings, the regulations do not permit the SVO to reject any such ratings decisions except in very limited circumstances such as invalidity of the rating (e.g., a general issuer rating vs. the required CUSIP-specific rating) or with respect to non-filing exempt assets. And while the regulations are focused entirely on information gathering for purposes of evaluating insurers' investment portfolio risk, one can speculate that these more limited regulations may eventually lead to broader regulations that could give the SVO greater discretion to question and/or reject private ratings with which it disagrees. This is particularly true given the SVO's previous stated concerns about certain types of bespoke securities in the market.

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Although the private rating letter rationale requirements go into effect on January 1, 2022, there is a two-year grace period (through December 31, 2023) in which to comply with the regulations for investments funding on or after January 1, 2022. Accordingly, if an insurer makes an investment for which it obtains a private letter rating at the beginning of 2022 but is unable to obtain a private rating letter rationale report to submit to the SVO until the end of 2023, it will not be penalized for doing so. But failure by an insurer to comply with the requirements by January 1, 2024 will potentially have negative risk-based capital (RBC) implications, as the insurer will either have to file the security with the necessary documentation with the SVO for independent determination by the SVO of an NAIC rating designation (the same as any non-rated or filing exempt ineligible security) or self-assign an NAIC 5GI designation for such investment (or have such designation assigned by the SVO upon failure to file). An NAIC 5GI requires RBC charges equivalent to an NAIC 5 (indicating obligations of the lowest credit quality, except for those in payment default).

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Please note that the regulations also include some retroactive obligations, which are fairly limited. With respect to private ratings of investment securities that were issued on or after January 1, 2018 (and through and including December 31, 2021), to the extent they were accompanied by a private rating letter rationale report and the insurer is not bound by confidentiality or other restrictions from sharing such report, insurers are required to file the report with the SVO. Private letter securities issued prior to January 1, 2018 are exempt from these filing requirements.

As January 1, 2022 fast approaches, it is important to be aware of these new requirements and to prepare accordingly. In private placement transactions where a private rating letter is being provided, investors should consider adding a closing condition in the relevant financing documentation requiring delivery of the private rating letter for the particular investment security, along with a private rating rationale report from the relevant NRSRO setting forth an analytical review of the investment, which includes a description of the transaction structure, the methodology applied by the NRSRO in determining its rating and, as appropriate, an analysis of the credit, legal and operational risk and mitigants supporting such rating, along with such other information relating to the rationale for the private rating as may be required from time to time by the SVO or any other regulatory authority having jurisdiction over any holder of the applicable securities. Given the on-going reporting requirements implemented by the SVO, a similar covenant should be included in the relevant financing documentation requiring delivery of an updated private rating letter and private rating rationale report on each anniversary of the closing date and promptly following any change to the private letter rating for such investment.

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