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NAIC Rule on CTLs: Unintended Consequences

The National Association of Insurance Commissioners ("NAIC") recently set off a firestorm among life insurance companies that invest in credit tenant loans ("CTLs") and other so-called "loan-backed and structured securities" by adopting regulations that change the NAIC designation of debt securities (other than those already designated NAIC-1), which trade in the secondary market at either a discount from face value or at a premium (or are carried on the books of an insurance company at either a premium or discount). A lowering of a security's NAIC designation requires the insurance company holding it to set aside an increased capital reserve; conversely, an upgrade reduces the lender's risk based capital requirement. This update will describe the traditional approach to credit tenant loans by the NAIC, details of the new rule, and some of the consequences and possible distortions attributable to the new approach.

Traditionally, credit tenant loans were treated the same as corporate bonds for risk-based capital purposes. This was logical because the credit tenant lease structure—ultra-tight lease and bankruptcy-remote lessor/borrower—makes CTL debt dependent almost exclusively on the credit of the tenant. As a result, this debt's price in the secondary market is based principally on the creditworthiness of the lessee and the prevailing rate environment. Assuming that the creditworthiness of a lessee remains unchanged, its lease-backed securities issued at a time of relatively low interest rates will trade at a discount in a higher rate environment. Conversely, as interest rates decline, debt with a coupon rate reflecting an earlier, higher rate environment, will trade at a premium. The quality of the specific security has not changed—only the prevailing interest rates have moved.

Within the past year, following the lead of the New York Superintendent of Insurance, the NAIC moved CTL debt into a new category, "loan-backed and structured securities." This is the category where CMBS, RMBS and ABS securities are placed. These other securities are typically composed of pools of loans to multiple, unrated credits, and depend in large part for their quality on over-collateralization and carefully constructed tranches with subordination features to make the more senior tranches relatively secure. The prices in the secondary market are influenced by more complex factors than those determining the price of a conventional bond or CTL loan—individual refinance risk, geographical or sector concentration, "lumpiness" of the pool, delinquency and default rates among the various borrowers, and nature and quality of underlying assets, among other factors. As demonstrated over the last few years, these securities, particularly at the lower end of the quality spectrum, have far greater price volatility than conventional, single credit obligations.

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Despite the differences between the pooled products and the single credit security, the NAIC apparently elected to treat as bonds only those debt securities in which the credit on which the security depends is the named obligor; indirect obligations such as a lease-backed security are moved to the loan-backed and structured securities category for regulatory purposes. This seems a rather formalistic distinction without economic substance, but in the absence of a clear explanation from the NAIC, this appears to have been the guiding principle.

Interestingly, the logic of exempting NAIC-1 securities from this procedure is that the expected loss on an NAIC-1 security is zero. Moody's Rating Service shows that an Aa debt obligation has historically had a 0.02% chance of default in the first year after rating, and an A rated bond has had a 0.1% default risk during the same period; those are both NAIC-1 securities. Baa rated securities (designated NAIC-2) have had a 0.15% default risk during the first year after rating, which calls into question the "zero expected loss" premise and, more importantly, the significantly different regulatory treatment of NAIC-1 and NAIC-2 securities.

One immediate consequence of the move to the loan-backed and structured securities category is to require a lender to report impairment of the security and take an appropriate write-down on its books if the security is deemed impaired. In the case of a CTL loan, it is likely that the credit of the lessee could deteriorate substantially before there is any impairment to report. The fact that an A-rated security has become a BBB doesn't mean it is impaired, although it has stepped down from an NAIC-1 to an NAIC-2. That would only mean that a higher risk based capital reserve would have to be established for the security, but not that the security would have its value written down.

Another immediate consequence, which has already occurred in the secondary market, is the changing of the NAIC designation of CTL debt (other than NAIC-1 debt) that trades at a premium or a discount. One client has had both experiences, as described in a letter from the American Council of Life Insurers to the NAIC's Valuation of Securities Task Force. In one case, it bought some relatively low coupon CVS lease-backed paper at a discount; the paper (a small part of a widely held issue) carried the CVS rating and prior to the trade was an NAIC-2. Because the client bought it below the NAIC break-point for changing the designation, the obligation was upgraded to NAIC-1, although the quality of the paper had not changed a bit. The break points for changes in designation are shown in Table 1 below. This raises an interesting question: should all the holders of that issue of CVS paper trade with one another at a discount, thereby lowering their risk based capital reserves? That hardly seems to advance the regulators' purposes (and would create unacceptable book losses on sale, so it would never happen). Is it reasonable for the same paper to be an NAIC-1 investment for one investor but an NAIC-2 investment for an investor who bought it at par upon original issuance? The same client has publicly reported the reverse situation: some time ago it bought some relatively high coupon NAIC-2 paper in the secondary market, but due to interest rates at the time of the trade, paid a premium price to achieve a current market rate of return for a credit with a BBB rating. Due to the NAIC break-points, this investment has now become an NAIC-4 (the NAIC rule is retroactive). The sole reason for the downgrade was the discounted price, which had nothing to do with the quality of the security (as evidenced by its credit default swap pricing which indicated investment grade credit). NAIC-4 securities are expensive to hold (see Table 2), and no insurance company has an incentive to buy one, at least at market price. This means that the secondary

TABLE 1: NAIC Designation Breakpoints for Loan-Backed and Structured Securities

LIFE	1>2	2>3	3>4	4>5	5>6
NAIC2	97.88	100.00	104.69	116.23	132.04
NAIC3	93.49	95.52	100.00	111.02	126.12
NAIC4	84.22	86.04	90.08	100.00	113.61
NAIC5	74.13	75.73	79.29	88.02	100.00

Source: Determining NAIC Designation for LBaSS: December 1, 2010 market for low coupon CTL debt (and other loan backed and structured securities) will contract significantly, if not dry up altogether, at least as far as insurance companies are concerned (the customary investors in this type of security). Since the bond market has been in a historically low rate environment for some time, there is a growing inventory of long-term, low coupon debt that is not likely to be tradable to insurance companies.

This situation is likely to lead to efforts to game the system. Despite the tax issues created by original issue discount, the trade-off for materially lower risk based capital reserves may make such securities unwarrantedly attractive.

TABLE 2: Risk-Based Capital Reserve Requirements

Class	Life Insurance Companies
NAIC1	0.4%
NAIC2	1.3%
NAIC3	4.6%
NAIC4	10.0%
NAIC5	23.0%
NAIC6	30.0%

Source: NAIC Life Risk Based Capital Report: 11/8/2007

The American Council of Life Insurers wrote to the NAIC on June 27, 2011, voicing the concerns of the life insurance industry about the rule and highlighting the regulatory anomalies that it creates. The NAIC has a regularly scheduled national meeting at the end of August and we understand that even before that date discussions have been underway among some of the key NAIC personnel. It is unclear whether this topic will be discussed in August—they have a busy agenda (see http://www.naic.org/meetings_home.htm). But the topic is certain to be dealt with at some point in the not-so-distant future since the stakes are unusually high for what, at first glance, appears to be an innocuous shifting of regulatory categories.

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This update was authored by Lewis A. Burleigh (+1 617 654 8601; lewis.burleigh@dechert.com) and Margot L. Mendelson (+1 617 728 7122; margot.mendelson@dechert.com).

Practice group contacts

For more information, please contact the authors, one of the attorneys listed or any Dechert attorney with whom you regularly work. If you would like to receive any of our other *DechertOnPoints*, please click here.

Lawrence V. Berkovich
Charlotte
+1 704 339 3154
lawrence.berkovich@dechert.com

Lewis A. Burleigh
Boston
+1 617 654 8601
lewis.burleigh@dechert.com

Laura G. Ciabarra
Hartford
+1 860 524 3926
laura.ciabarra@dechert.com

Timothy J. Boyce
Charlotte
+1 704 339 3129
timothy.boyce@dechert.com

Katherine A. Burroughs
Hartford
+1 860 524 3953
katherine.burroughs@dechert.com

Matthew T. Clark
Boston
+1 617 728 7118
matthew.clark@dechert.com

Patrick D. Dolan
New York
+1 212 698 3555
patrick.dolan@dechert.com

Malcolm S. Dorris
New York
+1 212 698 3519
malcolm.dorris@dechert.com

Dr. Olaf Fasshauer
Munich
+49 89 21 21 63 28
olaf.fasshauer@dechert.com

Steven A. Fogel
London
+44 20 7184 7444
steven.fogel@dechert.com

David W. Forti
Philadelphia
+1 215 994 2647
david.forti@dechert.com

William Fryzer
London
+44 20 7184 7454
william.fryzer@dechert.com

Joseph B. Heil
San Francisco
+1 415 262 4510
joseph.heil@dechert.com

Bruce D. Hickey
Boston
+1 617 654 8602
bruce.hickey@dechert.com

Geoffrey K. Hurley
New York
+1 212 698 3598
geoffrey.hurley@dechert.com

Andrew Hutchinson
London
+44 20 7184 7428
andrew.hutchinson@dechert.com

Richard D. Jones
Philadelphia
+1 212 698 3844
richard.jones@dechert.com

David M. Linder
San Francisco
+1 415 262 4511
david.linder@dechert.com

Ralph R. Mazzeo
Philadelphia
+1 215 994 2417
ralph.mazzeo@dechert.com

Jason S. Rozes
Philadelphia
+1 215 994 2830
jason.rozes@dechert.com

Jodi Schwimmer
New York
+1 212 698 3505
jodi.schwimmer@dechert.com

Timothy A. Stafford
New York
+1 212 698 3504
timothy.stafford@dechert.com

Laura Swihart
New York
+1 212 698 3644
laura.swihart@dechert.com

Barry J. Thorne
London
+44 20 7184 7413
barry.thorne@dechert.com

John M. Timperio
Charlotte
+1 704 339 3180
john.timperio@dechert.com

Cynthia J. Williams
Boston
+1 617 654 8604
cindy.williams@dechert.com

Jay Zagoren
Philadelphia
+1 215 994 2644
jay.zagoren@dechert.com

Dechert
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