Private Equity Collateralized Fund Obligations

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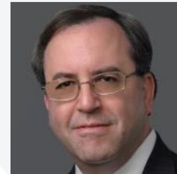

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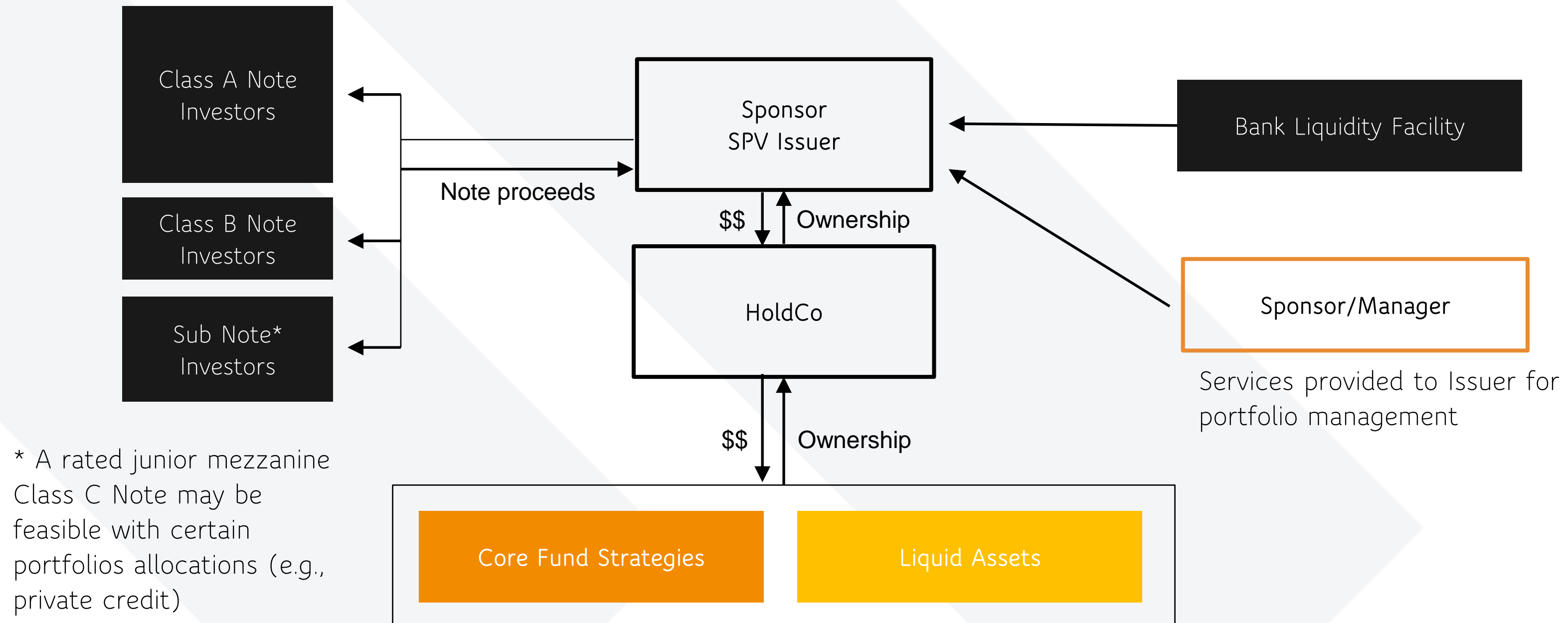
Overview

- Collateralized Fund Obligations (CFO) structures provide an efficient way for sponsors to raise investment capital through the use of securitization technology.
- Sponsor sets up a bankruptcy-remote SPV that raises funds in Rule 144A capital markets to be invested in one or more private equity and/or other alternative strategy funds managed by the Sponsor.
- The risks and returns on the SPV's assets are tranched, so that holders of senior tranches receive fixed returns while holders of the subordinated tranches (equity) receive variable returns but absorb losses on the underlying investments.
- Legal maturity of the CFO is generally 15 years, with expected senior debt maturities of 10 years:
  - (i) First ~5 years - investment period, with the funds being deployed and re-invested in Sponsor-managed strategies.
  - (ii) Second ~5 years – amortization period for the senior debt and harvesting of the underlying investments (with continuing investments pursuant to existing commitments).
  - (iii) Remaining years to maturity is finalization of the harvesting period.

Overview (Cont'd)

- The most senior tranche (typically 50% of the issuance) is typically rated A-. If the senior tranche qualifies for SVO "filing exempt" status, then it will automatically receive an NAIC designation of 1.G, which receives a risk-based capital (RBC) charge of 1.016%.
  - By comparison, a direct investment in alternative strategy (like private equity) would receive an RBC charge of 30%.
  - While NAIC rules for CFOs have not been finalized (more on this later), most large US insurance companies have gotten comfortable with the debt treatment for the senior most tranches.
- Investors particularly interested in the CFO include U.S. insurance companies, sovereign wealth funds and certain regulated investors in certain jurisdictions in Asia.

CFO Fundraising Structure



* A rated junior mezzanine Class C Note may be feasible with certain portfolios allocations (e.g., private credit)

NAIC is in process of Revising the Definition of “Bond”

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- The “principles-based” approach originally proposed in October 2020 by staff of the Iowa Insurance Division has won the day.
- It has become the basis for the revisions to SSAPs No. 26R (Bonds) and 43R (Loan-Backed and Structured Securities) that are currently being developed by the NAIC Statutory Accounting Principles (E) Working Group (“**SAP WG**”).
- The earliest implementation date projected by the SAP WG is January 1, 2024.
  - However, once the new provisions go into effect, they are expected to apply to all investments, with no “grandfathering” of existing investments.

The emerging bond definition

- A “bond” is a security
  - representing a creditor relationship,
  - whereby there is a schedule for one or more future payments, and
  - which qualifies as either:
    - an issuer credit obligation, or
    - an asset-backed security (“ABS”).

Issuer credit obligations

- An **issuer credit obligation** is a bond, the repayment of which is supported primarily by the general creditworthiness of an operating entity or entities.
- Issuers can be either operating companies or holding companies that have the ability to access the cash flows of operating company subsidiaries through their ownership rights.
- The definition of operating companies is still being worked on.
    - For example, the latest draft proposal in March 2022 includes 1940 Act registered investment companies, but not private funds.

Asset-backed securities

- An ABS is defined as:
  - A bond issued by an entity (an "ABS Issuer") created for the primary purpose of raising debt capital,
  - backed by financial assets or cash generating non-financial assets owned by the ABS Issuer,
  - whereby repayment is primarily derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity.

Conditions ABS must satisfy to be a "bond"

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Condition #1

- The assets owned by the ABS Issuer must be either:
  - financial assets, or
  - cash-generating non-financial assets
    - Defined as assets that are expected to generate a "meaningful" level of cash flows toward repayment of the bond through use, licensing, leasing, servicing or management fees, or other similar cash flow generation (and not just through the sale or refinancing of the assets)
    - "Meaningful" criterion is deemed met if less than 50% of the original principal relies on sale or refinancing, but can also be met in other ways

Condition #2

- The holder of a debt instrument issued by an ABS Issuer must be:
  - in a different economic position than if the holder owned the ABS Issuer's assets directly
  - as a result of "substantive" credit enhancement through:
    - guarantees (or other similar forms of recourse),
    - subordination and/or
    - overcollateralization

Special rules for ABS backed by equity (e.g., CFOs)

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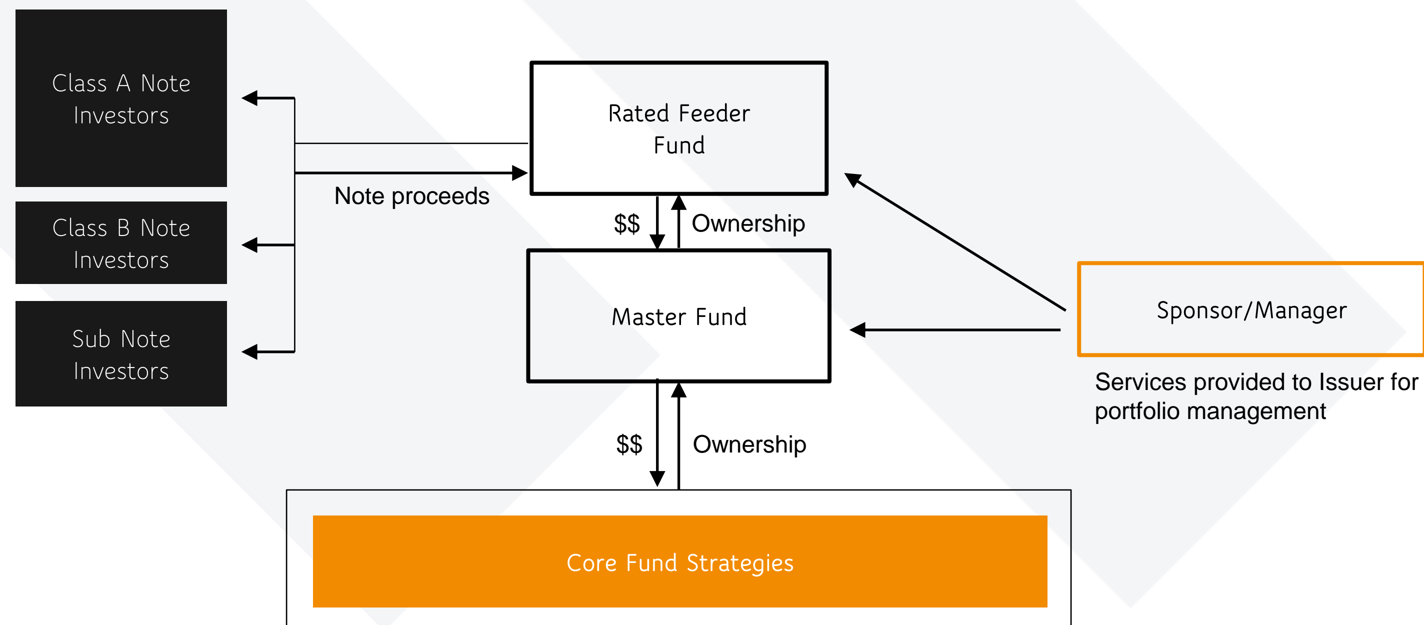
- There is a rebuttable presumption that debt instruments collateralized by equity interests do not qualify as bonds because they do not reflect a creditor relationship in substance.
- Notwithstanding this rebuttable presumption, it is possible for such a debt instrument to represent a creditor relationship if the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer.
- A documented analysis supporting the predictability of cash flows must be completed to overcome the rebuttable presumption.
- Factors to be considered include, but are not limited to, the following:
  - Number and diversification of the underlying equity interests
  - Characteristics of the equity interests
  - Liquidity facilities
  - Overcollateralization
  - Waiting period for the distributions/pay-downs to begin
  - Capitalization of interest
  - Covenants (e.g., loan-to-value trigger provisions)
  - Reliance on ongoing sponsor commitments
  - Source(s) of expected cash flows to service the debt (i.e., dividend distributions from the underlying collateral vs. sale of the underlying collateral)

Other relevant NAIC initiatives

- A new Risk-Based Capital Investment Risk and Evaluation (E) Working Group was formed by the NAIC in 2022
  - It is looking at the RBC treatment of ABS such as CFOs and CLOs to assess how best to capture the risk (including "tail risk") of these assets – ratings, modeling (akin to CMBS/RMBS) or some other method.
  - It is also looking to address RBC treatment of residual tranches to reduce arbitrage incentives.
- On June 9, 2022, the NAIC Valuation of Securities (E) Task Force ("**VOS TF**") exposed for comment an issue paper from the NAIC Investment Analysis Office ("**IAO**") recommending that capital required for holding all tranches of a structured security should be consistent with the capital required when holding all of the underlying collateral.
- Meanwhile, an informal study group of the VOS TF that includes NAIC staff and industry representatives is considering potential responses to a IAO memorandum that reiterated the IAO's long-held concerns about ratings provided by the NRSROs and included:
  - an SVO staff review of a sample of privately rated securities, where the NAIC designations equivalent to the NRSRO's rating differed significantly from the staff's own analysis (being 3 to 6 notches higher than staff's estimates); and
  - an IAO analysis of both publicly rated and privately rated securities, showing significant rating notch differences between NRSROs that rated the same security.

Rated feeder Structure

- A version of the CFO structure offers sponsors the ability to offer newly launched funds to insurers on a capital efficient basis
- A dedicated feeder fund issues rated notes to insurers, typically without required collateral or bank liquidity support
- SEC filings provide view of market and participation of tier 1 sponsors and asset managers



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Questions

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