WINTHROP
CAPITAL MANAGEMENT

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The Great Balancing Act

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For investment managers of insurance assets, the current environment is defined by a delicate and increasingly complex balancing act. To drive portfolio returns, support competitive product pricing, and increase earned income, many insurers have aggressively increased allocation to private credit and highly structured alternative assets into their core fixed income allocations.

However, this structural migration of portfolio assets has triggered a sweeping, systemic regulatory response. The National Association of Insurance Commissioners (NAIC) has steadily increased its scrutiny of these asset classes, improving its statutory accounting framework to target structural complexity, "equity masquerading as debt," and perceived regulatory capital arbitrage. Today, generating alpha in an insurance portfolio is no longer strictly an exercise in fundamental credit analysis and underwriting; it is equally an exercise in navigating regulatory rules in order to optimize capital.

In this *Insurance Asset Management Insights*, we explore the maturation of the private credit markets, dive deeply into the latest NAIC regulatory updates—anchored by explicit citations of recently amended and newly implemented Statements of Statutory Accounting Principles (SSAP)—and conclude with an in-depth framework detailing how Strategic Asset Allocation (SAA) will fundamentally evolve for insurers operating in this new paradigm.

The Increased Allocation to Private Credit in Insurance Portfolios

Private credit is no longer a peripheral "alternative" allocation for property & casualty, life and annuity insurers; for many insurance companies, it is a structural balance-sheet pillar. As the global private credit market has increased well past the $1.7 trillion mark, the evolution of private credit in the insurance Strategic Asset Allocation (SAA) has given way to a period of bifurcation and strategic investment.

1. Beyond Direct Lending: The Ascendance of Asset-Based Finance (ABF)

Private credit refers to non-bank lending and is generally divided into direct lending, mezzanine & subordinate debt lending, distressed debt, and specialty finance & asset backed lending. While middle-market corporate direct lending remains the bedrock of private markets, insurance capital is rapidly migrating toward Asset-Based Finance (ABF). ABF encompasses a wide spectrum of collateralized cash flows—from consumer receivables, auto fleet financing and residential transition loans, to aviation leasing, equipment finance, and intellectual property royalties.

- **The Insurance Appeal:** For insurers, ABF can offer superior downside protection through hard, tangible collateral and protective covenants. It provides critical diversification away from traditional corporate credit and, crucially, features structurally senior tranches that readily secure Investment Grade (IG) ratings. This provides diversification and lower correlations to corporate credit assets. Further, this aligns perfectly with the need for capital-efficient yield that avoids the broader macroeconomic cyclicality inherent in leveraged cash-flow-based corporate lending.

2. The Differentiation Cycle in Direct Lending

As demand for private credit has increased, the underwriting standards have arguably deteriorated. With higher leveraged deals in the market, credit risk has increased. The demand for private credit from insurance companies, combined with a sustained higher cost of capital over the past few years has effectively provided a rigorous stress-test for the traditional direct lending market. Relative to the past five years, today's elevated base rates have resulted in higher level of interest expense, severely pressured interest coverage ratios (ICRs) for heavily indebted, sponsor-backed middle-market borrowers.

- **The Workout Reality:** While a systemic wave of macroeconomic defaults has not materialized, there is a marked rise in loan modifications including amend-and-extend activity, covenant relief, and the use of Payment-in-Kind (PIK) interest rate toggles. Insurers are heavily scrutinizing their General Partners (GPs) in private credit deals, shifting capital away from mere origination platforms toward asset managers with robust internal workout capabilities. Under *SSAP No. 36 (Troubled Debt Restructuring),* managers must expertly navigate these borrower distress scenarios without triggering punitive statutory impairments on the insurer's balance sheet.

3. Strategic Convergence: Insurers and Alternative Asset Managers

To secure proprietary deal flow, bypass the drag of double-layer fee structures, and tightly manage asset durations, the operational lines between insurance companies and alternative asset managers continue to blur. By acquiring minority stakes in—or forming exclusive joint ventures with—private credit firms, insurers are able to gain direct control over asset origination.

- **The Regulatory Nuance:** From a statutory reporting perspective, these strategic partnerships require careful execution. Equity investments in private credit transactions or unconsolidated joint ventures fall under *SSAP No. 48 (Joint Ventures, Partnerships and Limited Liability Companies) or SSAP No. 97 (Investments in Subsidiary, Controlled and Affiliated Entities)*. While vertical integration allows the insurance company to dictate loan cash flows to better calibrate their specific ALM duration targets, insurers must balance this operational "alpha" against the punitive equity-like capital drag of holding these private credit stakes on Schedule BA.

NAIC Regulatory Updates – Closing the Ratings Arbitrage Gap

While slow in its initial response, the growing and significant influx of insurance assets into private and structured credit has culminated in regulators to substantially improve their toolkit for measuring risk. Over the last 24 months, the NAIC has modified its regulatory insurance infrastructure including its Risk-Based Capital (RBC) framework and several statutory accounting rules. The overarching theme is clear: capital charges for investments must reflect the fundamental economic substance of the underlying risk, not just the legal wrapper it is packaged in.

1. SVO Discretion and the End of the Old Regime

In the absence of an existing rating by the SVO, historically, insurers relied on the Filing Exempt (FE) process, where ratings from Nationally Recognized Statistical Rating Organizations (NRSROs) automatically determined an asset's NAIC designation (1 through 6) and its subsequent capital charge.

- **The Update:** Citing concerns over "rating shopping" and, at times, overly optimistic private letter ratings (PLRs) in bespoke private credit, the NAIC has empowered the Securities Valuation Office (SVO) with expanded authority to challenge, review, and override external Credit Ratings Providers (CRP) ratings on a security-by-security basis if it determines the private rating materially understates tail risk. Asset managers must now explicitly underwrite the "regulatory downgrade risk" alongside fundamental credit risk.

2. The Principles-Based Bond Definition (PBBD): SSAP No. 26R & SSAP No. 43R

Last year the NAIC implemented a new asset classification system called Principles Based Bond Definition (PBBD). Having taken effect on January 1, 2025, with no grandfathering permitted, the PBBD represents the most significant modernization to insurer balance sheets in decades. It strictly evaluates the substance of an investment regardless of its industry asset classification, bifurcating bonds into two distinct statutory categories on Schedule D:

- **SSAP No. 26R (Bonds):** Defines *Issuer Credit Obligations (ICOs)*, which are securities supported by the general creditworthiness of an operating entity (e.g., direct lending to a corporate borrower).
- **SSAP No. 43R (Asset-Backed Securities):** Defines *Asset-Backed Securities (ABS)*, which are securities issued by trusts or SPVs created to raise debt capital backed by financial assets. To qualify, the ABS must possess genuine "creditor-like" rights, provide substantive credit enhancement, and generate meaningful cash flows independent of the sale or refinancing of the underlying collateral.
- **Potential Consequences:** Debt issued by certain feeder funds, highly structured JVs, or "equity masquerading as debt" that fail the PBBD cash-flow tests are strictly excluded from bond treatment and potentially not counted toward an insurance company's admitted assets.

3. The 45% Residual Tranche Penalty: SSAP No. 21R

The NAIC has taken a hardline stance against structures designed to transform equity into fixed-income profiles. Under the PBBD, residual and first-loss tranches of structured credit inherently lack contractual principal and interest features. As a result, the NAIC has clearly and effectively forced their classification scheme onto insurance company's balance sheet through to the statutory statements.

- **The Update:** Residuals are now governed by the revised SSAP No. 21R (Other Admitted Assets) and routed directly to Schedule BA. Furthermore, SSAP No. 21R removes standard amortization and accretion for residual tranches. Most importantly, residuals now trigger a highly punitive 45% base capital charge (C-1 asset risk factor). This effectively flattens the capital arbitrage curve and completely negates the historical RBC efficiency of holding the highest-yielding pieces of CLOs and ABS.

4. The CLO Finalization: Ratings Over Tranche Thickness

As the NAIC's Risk-Based Capital Investment Risk and Evaluation (RBC IRE) Working Group nears the finish line on CLO modeling, the regulatory picture is coming into sharp focus. The RBC IRE Working Group has been tasked with reviewing and updating the minimum capital requirements for U.S. insurers based on the inherent risk of their investments.

- **The Methodology:** Regulators are adopting modeled capital charges uniformly for both Broadly Syndicated Loan (BSL) and Middle Market (MM) CLOs. Interestingly, they opted for a streamlined approach: modeled capital charges will be associated with *ratings only*—discarding empirical evidence that tranche thickness materially improves model performance. For insurers running forward-looking SAA projections, the guidance is clear: utilize the "Thickness <4%" column from the NAIC modeling data as the benchmark expected C-1 charge for all CLOs, which steeply punishes mezzanine (BBB/BB) structures with higher C1 capital charges. This format is slated for formal implementation at Year-End 2026 (YE26).

5. The Next Docket: Rated Note Feeders and Regulatory Limbo

PBBD has effectively classified financial and non-financial ABS structures, however, bespoke structures like Rated Note Feeders (RNFs) are under increased regulatory scrutiny. RNFs historically allowed insurers to transform private fund LP debt and equity interests into rated debt notes to achieve Schedule D bond reserving treatment, and an efficient C1 capital charge.

- **The Challenge:** Under SSAP No. 26R, if a debt instrument is collateralized by an equity interest, there is a *rebuttable presumption* that it does not represent a creditor relationship. Furthermore, because RNFs rely on discrete, idiosyncratic underlying holdings (which often feature GP discretion to withhold distributions), they are structurally incompatible with broad actuarial modeling by the American Academy of Actuaries. Given that CLO modeling took roughly four years, applying similar rigor to opaque RNFs is a monumental task, leaving these Schedule D-1-2 assets in a potentially ambiguous regulatory holding pattern regarding their ultimate classification and C-1 capital treatment.

Strategic Implications for Insurance Asset Management

The intersection of the growing investment in private credit by insurance companies and the increased regulatory scrutiny of private credit dictates a new investment playbook. Under the new NAIC regime, a 50-basis-point gross yield advantage from investment in private credit can be actively destructive if it inadvertently triggers a reclassification on the statutory schedules and a more punitive disproportionate C-1 capital charge.

- **Solve for Capital-Adjusted Yield:** Under dynamic risk based capital modelling, gross yield now becomes a vanity metric; *Return on Regulatory Capital (RBC-adjusted yield)* becomes a more realistic measure of the relative value decision facing insurers. Insurance companies should deeply integrate NAIC C-1 capital modeling into their credit underwriting processes as part of the investment decision process, mapping exposures against impending YE26 modeled charges and PBBD stress tests.

- **Navigate the Rated Note Feeder Regulatory Limbo:** For those Feeder Funds which are ambiguous in classification, to overcome the rebuttable presumptions of SSAP 26R/43R, insurers should consider structural adjustments to their feeder funds. Investment strategy dictates security’s structure. This may include removing PIK features to ensure strict cash interest payments, establishing meaningful equity tranches to justify the debt subordination, and removing GP discretion to guarantee the uninterrupted pass-through of underlying cash flows.

- **Invest in Transparency and SMAs:** Because the NAIC requires sufficient, "look-through" visibility into underlying loan pools to satisfy PBBD rules, opaque commingled "black box" funds will rapidly fall from favor in the insurance industry. Private credit managers offering customized **Separately Managed Accounts (SMAs)** equipped with granular, loan-level data capabilities will win out, allowing insurers to seamlessly satisfy statutory reporting requirements and meet SVO requirements.

- **Pivot to Structural Quality:** Instead of relying on financial engineering, insurance portfolios are pivoting to inherently high-quality collateral. Robustly structured, senior-secured ABF naturally satisfies both the yield mandates of insurance companies and the risk management requirements mandates of regulators without triggering increased scrutiny.

The Future of Strategic Asset Allocation

As the regulatory dust settles, the foundational philosophy of Strategic Asset Allocation (SAA) for insurance companies has crossed the Rubicon. Historically, SAA was primarily a two-dimensional exercise in matching expected asset cash flows to liability cash flows while optimizing the trade-off between default risk and yield. Going forward, modern SAA will function as a dynamic, **Three-Dimensional Optimization Engine: balancing Yield, Default Risk, and Regulatory Capital Efficiency.**

1. Solving for Return on Statutory Capital (ROSC)

The capital optimization equation for insurers has fundamentally changed. The mandate is no longer simply "maximizing yield per unit of volatility." The new objective function is to maximize yield per *unit of statutory capital consumed*.

When an insurer allocates to private credit, they map the C-1 (Asset Risk) charge under the new NAIC guidelines. An 8% yielding mezzanine CLO tranche (NAIC 3 or 4) that absorbs a heavy C-1 charge is now mathematically inferior to a 6.5% yielding senior ABF tranche rated NAIC 1 or 2 when measured on a ROSC basis. SAA models must accommodate the new NAIC RBC charges as a binding constraint in their risk based capital optimization models.

2. The Regulatory-Optimized "Barbell" Strategy

In addition, an increased allocation to private credit will have an impact on an insurance company's liquidity policy. As insurers increase their allocation to private credit, they consume their "liquidity budget." To navigate the liquidity versus regulatory risk trade-off, future portfolios will adopt a refined barbell structure. Below are several potential portfolio structures highlighting the allocation to private credit:

- **The Defensive / Liquid Core (20-30%):** Highly liquid, highly capital-efficient assets including U.S. Treasuries, Agency MBS, top-tier public IG corporates governed under SSAP 26R. This allocation to private credit would likely satisfy liquidity stress-testing (LST), effectively manage C-3 (Interest Rate) risk, and anchors the portfolio against potentially SVO overrides.

- **The Structural Yield Engine (50-60%):** The bulk of the alternative fixed-income allocation will shift toward rigid, highly rated private credit and Senior-Secured ABF under SSAP 43R. These assets capture the illiquidity premium without taking on significant regulatory risk, locking in predictable yield with low C-1 charges that mirror traditional publicly traded fixed income securities based on private letter ratings.

- **The True Alternatives Satellite (10-20%):** Insurers will abandon highly engineered mezzanine debt and bespoke Rated Note Feeders that are penalized by the new PBBD rules. Instead, Schedule BA risk capital will be deployed surgically into traditional alternative investments including Private Equity, Real Estate Equity, or joint ventures under SSAP No. 48. Insurers will accept the 30% to 45% capital charges here because the underlying return adequately compensates for uncapped equity risk, rather than attempting to disguise the risk as a capped fixed-income coupon.

3. Precision ALM via Custom Origination

As life and annuity insurers write longer-dated and increasingly complex liabilities, including Pension Risk Transfers and deferred annuities, public fixed income assets are not able to supply the duration and convexity required to fund those liabilities. Successfully funding to an insurance company's SAA will increasingly rely on proprietary private credit sourcing or origination. By structuring the engagement to manage SMAs rather than funds, insurers can direct their private credit allocation toward specific, bespoke loans that effectively immunize the balance sheet's interest rate risk and neutralize the ALM mismatch.

4. Pricing the "Regulatory Risk Premium"

Historically, private asset allocation within the SAA was defined by harvesting the "illiquidity premium"—locking up portfolio assets for 5 to 7 years in exchange for excess yield. However, going forward, dynamic SAA models will shock expected returns to account for a newly established "Regulatory Risk Premium**."** If a specific asset type carries a high probability of a punitive risk charge by the SVO, risk of being downgraded, or targeted by future RBC IRE Working Group models, the mathematically required yield premium to justify locking up that capital must incrementally increase in order to absorb potential future C-1 deterioration.

The Final Verdict

The days of simple loan structuring and easy regulatory capital arbitrage are firmly in the rearview mirror. Success for the investment program moving forward requires a highly synchronized, enterprise-wide partnership between the investment team, actuarial, the risk management team, and statutory accounting. The ultimate winners in the next decade of insurance asset management will be the insurance companies who manage an SAA that bridges the gap between high-conviction credit origination and surgical statutory capital efficiency, delivering premium investment returns while masterfully navigating the NAIC's ever-tightening rulebook.