Rated Note Feeders and Collateralized Fund Obligations[1]

By Mei Zhang and Charles Zang

The panelists on the "Rated Note Feeders and Collateralized Fund Obligations" panel discussed the invention of the Rated Note Feeders and Collateralized Fund Obligations ("***CFO***s"), along with their structural intricacies, current regulatory landscape, the market trends and future outlook. Here are the key insights from their discussions:

- Rated Note Feeders were developed to facilitate investments in private equity funds, particularly for investors constrained by regulatory capital requirements, such as insurance companies.

- CFOs are structured transactions supported by a pool of interests in private equity funds. Insurance companies can leverage the debt classification of CFOs for favorable risk-based capital ("***RBC***") treatment, which, for U.S. insurance companies, depends on whether the investment is categorized as a bond under statutory accounting and RBC rules, benefiting from more attractive RBC charges compared to equity investments.

- Recent regulatory changes include (i) the adoption of a "principles-based approach" by the National Association of Insurance Commissioners ("***NAIC***") for determining bond treatment (if the CFO is mainly supported by equity interests, there is the presumption that it is not a bond, which assumption can be rebutted by steady cash flow, subordination and/or overcollateralization), (ii) revisions to risk-based capital charges for asset-backed securities from 30% RBC charge to 45%, to take effect for 2024 year-end insurance company financial reporting, and (iii) potential discretion for NAIC's Securities Valuation Office ("***SVO***") to challenge investment ratings if the SVO determines that the assigned rating does not provide a reasonable assessment of risk for regulatory purposes.

- Despite tightening regulatory scrutiny, insurance companies remain active in the market, focusing on well-structured deals. The clarity provided by evolving regulatory frameworks enables insurance companies to navigate investments more confidently, finding solutions to become comfortable with principles-based bond treatment.

- Rated Note Feeders and CFOs have historically enjoyed decent reception among insurance companies in North America, with emerging interest from the Korean market. However, challenges persist in the European market.

[1] Moderated by Duncan McKay, Partner at Fried Frank, Harris, Shriver & Jacobson LLP, the panel included the following: Robin Gibb, Associate at Maples Group, Matt Ruggiero, Partner at PJT Partners, Pramit Sheth, Head of Structured Products, at Whitehorse Liquidity Partners, Ramya Tiller, Partner at Debevoise & Plimpton LLP, and Richard Wheelahan, Managing Director and Co-Founder at Fund Finance Partners.

- Differential pricing among the CFO tranches is not a concern when debt and equity are bundled together as a single package. It only becomes an issue when the debt is sold separately.

- Lenders exhibit increased confidence in the debt component of Rated Note Feeders while note purchaser is getting more comfortable with principles-based bond treatment.

- While the market is getting more clarity from NAIC on the regulatory framework, discussions with insurance companies increasingly center on transaction substance rather than regulatory nuances, with a growing emphasis on large-scale deals exclusive to sponsors with strong track records.