The Benefits of a NAIC 1.A Designation for Insurance Players

Key Takeaways:

- **Previously, we discussed the importance of a National Association of Insurance Commissioners ("NAIC") 1.A Designation on credit-focused exchange-traded-funds ("ETF").**
- **The most significant benefit of a favorable Designation is the impact it has on risk-based capital ("RBC") requirements; with a 1.A Designation, the NAIC recommends just 40 basis points ("bps") of incremental RBC.**
- **Accordingly, an ETF structure with a NAIC 1.A Designation opens up the CLO market to any insurance player, big or small, who are seeking efficient exposure to AAA-rated* Collateralized Loan Obligations ("CLOs").**
- **One of the many benefits that an ETF like 'AAA' provides is instant diversification across various CLO managers.**
- **It also offers immediate liquidity on a major exchange, eliminating the need to steer through the over-the-counter ("OTC") market.**
- **Finally, 'AAA' gives potential access to a new floating rate tool, which can help mitigate some interest rate risks.**

In an earlier piece, we discussed the importance of a NAIC 1.A Designation on credit-focused exchange-traded-funds ("ETF"). The most significant benefit of a favorable Designation is the impact it has on risk-based capital ("RBC") requirements for insurance industry investors. The higher the Designation, the less restrictive the constraints from a regulatory RBC perspective.

The NAIC provides Risk Designations based upon an internal rubric that tiers credits from best to worst. A 1.A classification is the highest Designation extended by the NAIC's Securities Valuation Office ("SVO"). The NAIC regulatory framework states that an ETF with a 1.A Designation will be considered as a principal protected security that demonstrates "obligations exhibiting the highest credit quality. Credit risk is at its lowest and the issuer's credit profile is stable" [1], like US Treasuries, as an example. At the other extreme, a 6 Designation represents the worst credit, "obligations that are in or near default"[2].

In Practical Terms

More consequently, from a commercial perspective, an investment with the highest Designation is subject to a RBC of just 0.4% on a pre-tax basis for every US$1 of investment. Contrast this with a 6 Designation. In this case, the NAIC would impose a 30% RBC factor.

The legal firm, Mayer Brown, highlights the RBC implications this way:

To illustrate the impact on an insurer's RBC calculations: the pre-tax RBC factors for a life insurer are currently 40 basis points for an NAIC-1 investment, 130 basis points for an NAIC-2 investment and 1,000 basis points for an NAIC-4 investment. That means that receiving a designation of NAIC-4 instead of NAIC-1...will increase the RBC charge to 2500 percent of what it used to be, and even receiving a designation of NAIC-4 instead of NAIC-2...will increase the RBC charge to 769 percent of what it used to be.[3]

In short, the impact of the various NAIC Designations is far-reaching to industry investors. A heavier capital charge creates an unnatural drag on capital usage that can serve as a severe impediment. On the other hand, a 1.A Designation is noteworthy as it can provide favorable support to the final investment calculus.

Efficient Exposure to AAA-rated CLOs

Given the highest NAIC Designation for an ETF like 'AAA', mid-to-smaller sized industry players are able to access the AAA-rated Collateralized Loan Obligation ("CLO") market through a neatly packaged ETF without the consequence of more onerous RBC requirements that most other ETFs face. Importantly, purchasing an ETF like 'AAA' provides access to the return profiles of a diversified basket of AAA-rated CLOs. (Note, 'AAA' carries an expense ratio of 25 bps, which must be factored in to the final return calculation.)

Anyone Can Take Advantage of the Attractive Relative Returns

Furthermore, investors with even smaller balance sheets without broad coverage of the CLO markets could take advantage of the relatively attractive yields generated by AAA-rated CLOs to attempt to enhance overall returns.

Diversification Achieved Efficiently

The simplicity of an ETF also saves the investment manager from significant operating expenses associated with managing a diverse CLO portfolio. An investment manager, in our opinion, can efficiently generate the benefits of diversification through a single line item without incremental investments into costly research platforms or additional human resources.

Immediate Liquidity Can Help With Risk Management

An ETF like 'AAA' also provides immediate liquidity to a New York Stock Exchange-listed security that can serve as an effective risk management tool. An investment manager can scale up exposure or reduce risk without having to trade multiple positions through a cumbersome OTC market at any point during market hours. As such, an investment manager can be more dynamic in terms of expressing his/her views of the market. An ETF like 'AAA' can offer a hedge against other risks in a portfolio like interest rates.

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The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and once available a copy may be obtained without charge, by calling the Fund at 1-800-617-0004. Read it carefully before investing.

Investing involves risk. Principal loss is possible. Shares of any ETF are bought and sold at market price (not NAV), may trade at a discount or premium to NAV, and are not individually redeemed from the funds. Brokerage commissions will reduce returns.

The Fund is also subject to the following risks: Collateralized Loan Obligations (CLOs) are generally backed by a pool of credit-related assets that serve as collateral. Accordingly, CLO securities present risks similar to those of other types of credit investments, including default (credit), interest rate and prepayment risks. In addition, CLOs are often governed by a complex series of legal documents and contracts, which increases the risk of dispute over the interpretation and enforceability of such documents relative to other types of investments. An increase in interest rates may cause the value of fixed-income securities held by the Fund to decline. The Fund may be subject to a greater risk of rising interest rates due to the current period of historically low rates and the effect of potential government fiscal policy initiatives and resulting market reaction to those initiatives. The Fund's income may decline if interest rates fall.

The Fund is a recently organized, diversified management investment company with no operating history. Additionally, the investment adviser has not previously managed a registered fund, which may increase the risks of investing in the Fund.

Diversification does not assure a profit or protect agains loss in a declining market.

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Investment grade indicates that a bond has a relatively low risk of default.

*Credit rating is determined from the highest bond rating as determined by S&P, Moody's or Fitch. Bond ratings are grades given to bonds that indicate their credit quality as determined by private independent rating services such as Standard & Poor's, Moody's and Fitch. These firms evaluate a bond issuer's financial strength, or its ability to pay a bond's principal and interest in a timely fashion. Ratings are expressed as letters ranging from 'AAA', which is the highest grade, to 'D', which is the lowest grade. In limited situations when none of the three rating agencies have issued a formal rating, the Advisor will classify the security as nonrated.

Basis points (BPS) refers to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument.

The AAF First Priority CLO Bond ETF is distributed by Quasar Distributors, LLC.

[1] https://www.naic.org/documents/svo_naic_public_listing.pdf, Page 2.
[2] https://www.naic.org/documents/svo_naic_public_listing.pdf, Page 3.
[3] https:// https://www.naic.org/documents/svo_naic_public_listing.pdfwww.mayerbrown.com/en/perspectives-events/publications/2020/05/major-change-in-capital-treatment-for-insurer-investments-in-principal-protected-securities