By Robert Carcano, Senior SVO Counsel

♦ INTRODUCTION

Starting in 2010, the NAIC Securities Valuation Office (SVO), along with several other NAIC groups, began evaluating working capital finance investments (WCFIs) as potential invested assets for the insurance industry. The SVO developed a process to underwrite and assign NAIC designations to WCFIs. At the same time, the Statutory Accounting Principles (E) Working Group developed accounting standards for this new investment vehicle. After significant input from the state insurance departments, NAIC staff, industry representatives and other participants, WCFIs were approved as admitted assets for reporting entities with an effective date of Jan. 1, 2014, during the 2013 Fall National Meeting. The Statutory Accounting Principles (E) Task Force followed by adoption of the Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO). The culmination of all this hard work has resulted in a new investment vehicle for insurance companies: WCFIs.

♦ WHAT ARE WORKING CAPITAL FINANCE INVESTMENTS?

The foundation of a WCFI is the recurring financial exchange between buyers and suppliers of goods. The actual products bought and sold could be almost anything, from appliances and furniture to windshield washer fluid and wiper blades. Consider a large retail store and the many items they offer for sale. The store constantly purchases goods from a number of suppliers to stock its inventory. As goods are sold, the store uses the money from those sales to buy more goods and replenish its inventory. This ongoing buying and selling of goods between these companies is the type of recurring financial exchange mentioned earlier.

When the buyer (the retail store in our example) places an order to purchase items from the supplier, it creates a financial obligation between itself and the supplier to pay for those goods. For the buyer, this obligation is called a “payable”; i.e., an obligation or liability to pay a specified amount to the supplier. In turn, the supplier of the goods has a “receivable”; i.e., a right to receive a specified payment from the buyer, which is personal property and an asset.

Continuing our store example, a supplier may manufacture and deliver 50,000 gallons of windshield washer fluid of a specified quality to a large retail store chain. The retail store (or buyer) agrees under contract or purchase order to pay the supplier a specified amount of money in 90 days from the date the goods are delivered (not upon delivery). The supplier may lack the financial ability to enable it to finance its operations independently of the cash flow from the sale of the goods. The supplier’s cost of financing may be high in its nation’s capital markets. The supplier may have an immediate need for cash and, therefore, an incentive to convert the receivable it holds from buyer into cash, thereby “monetizing” the receivable sooner than the 90 days it agreed to with the buyer. For these reasons and many more, the supplier can choose to sell the receivable before the buyer of the goods is required or obligated to pay it. The supplier can do this because a receivable is an asset (i.e., a form of personal property). By selling the receivable, the supplier is transferring its asset (and its right to receive payment) to another person/entity in exchange for the payment of cash today.

♦ WORKING CAPITAL FINANCE INVESTMENT PROGRAM

Under a WCFI program, the parties are referred to by their legal role. The party that purchased the goods is called the “obligor”; i.e., it has an obligation to pay for the goods that it purchased. The “supplier” is the party that holds the receivable and is the one entitled to receive the payment for the goods or services it supplied and to which the obligor agreed to pay. The more important or critical a supplier is to an obligor, the greater incentive the obligor has to ensure the supplier is not financially distracted.

An obligor may try to protect its own interest by having reliable financial liquidity within its supply chain. Additionally, the obligor can lower its cost of goods by cutting the financing cost of the supplier. The obligor may create or ask a financial institution (i.e., its bank) to create and administer a working capital finance program that will permit its suppliers to negotiate the sale of the supplier’s receivables (due from the obligor) to the bank. The bank will seek appropriate compensation for advancing money today in exchange for the right to receive repayment from the obligor in the future; typically in the form of a discount to the full amount of the receivable.

A WCFI program is then an open account/evergreen financing facility created by a bank for a single obligor and its suppliers. Under the terms of the financing facility, the bank agrees to consider offers made by suppliers to sell its receivable due from an obligor for its own account. But bank managers may conclude that portfolio concentration limits, regulatory capital limitations or similar concerns could limit or constrain the amount of receivables due from a certain

(Continued on page 18)
oobliger that the bank could buy for its own account. If a bank estimates that its obligor customers could generate receivables in an amount greater than the bank thinks is prudent for it to purchase for its own account, it can build flexibility into the program by developing a process to offer supplier receivables it does not want to purchase to one or more investors that have previously been added to the obligor’s program for that purpose. This becomes the basis for the WCFI program.

**Traditional Receivable Financing**

There are other traditional receivables financing alternatives available to the supplier. One example is factoring. In these other processes, the supplier also wants to sell its receivables to a third party in order to generate the immediate cash it needs to finance its operations. The purchaser of the receivables will seek appropriate compensation for advancing money today in exchange for the right to receive payment from one or many obligors in the future. However, in these other alternatives, the buyer of the receivable may take it subject to the possibility that the obligor has a defense against paying the full amount of the receivable to the supplier, which it will assert against the buyer.

There are a number of structural ways to manage or mitigate this risk. For example, the financing source can “cherry pick”; i.e., select only the most creditworthy receivables. The discount rate can also be used to reflect these risks to the buyer, such as those associated with obligor defenses to payment, which is a kind of dilution risk. Such other alternatives can be expensive for the supplier. As discussed, factoring does not have the restrictions and controls associated with a WCFI program to protect the buyer of or investor in the receivable. Moreover, if the supplier is based abroad, the supplier’s local capital markets may not be mature enough to have factoring as an available service.

**The Differences Between A WCFI Program and Traditional Financing**

In contrast to traditional receivables financing, a WCFI program addresses the operational risk so that the buyer of the receivable (i.e., the bank or, as discussed below, the insurer) is not exposed to dilution risk and the exposure to fraud risk is significantly reduced. Dilution risk refers to and implies non-cash reductions in the receivable balance. This non-cash reduction can occur for a variety of reasons, such as product returns, discount programs, rebates or advertising allowances. As a legal matter, a supplier can never transfer more rights than it has in fact. The rights the supplier has to a specified payment are created during, and limited by, the underlying transaction between the obligor and the supplier that generated the receivable. Consider the following examples:

1. A retailer may have an agreement that the supplier receive less on a per-unit basis when the retailer places an order in excess of a defined size or amount.
2. The receivable could have been generated with the wrong pay rate.
3. A quantity of goods delivered might be less than ordered.
4. Some proportion of goods delivered may be defective. The defective goods would be subject to return with an adjustment made on the amount due under the receivable.
5. An obligor may decide to take a discount to which they are not entitled.
6. A supplier may fraudulently generate duplicate receivables.

The first four situations are examples of dilution risk; i.e., the risk the obligor will assert a right gained in the underlying transaction to pay the supplier less than the face amount expected or stated on a receivable. Dilution risk is unique to receivables financing. The last situation described is an example of fraud. Both types of risks imply partial payment or non-payment, but are referred to as “operational risk” because they are not related to the obligor’s actual ability to pay (credit risk).

Similar to other investments, an investor in a WCFI program is exposed to the obligor’s credit risk. Credit risk is ability of the obligor to pay its obligation on time and in full. The WCFI program requires the obligor to acknowledge in writing the receivable payment amount and date. The obligor is also required to acknowledge that the payment, with respect to the receivable, is a binding payment obligation and that the obligor has no legal defense to payment of the specified amount.

**The Evolution of WCFNs at the NAIC**

WCFIs developed from an SVO project that was originally requested by the Nebraska Department of Insurance (DOI). That project resulted in the development of a working capital finance notes (WCFNs) program specifically for Nebraska. The Nebraska DOI approached the SVO because it was evaluating a question posed by Pacific Life Insurance Company: whether certain receivables could be assigned an NAIC designation by the SVO, because, if so, a Nebraska statute would permit the insurer to report the receivables as admitted assets. The Nebraska DOI asked the SVO to assess whether it could assign an NAIC designation to a receivable. The SVO

(Continued on page 19)
worked with Pacific Life representatives\(^1\) to obtain examples of transactions that it could evaluate and consider issues raised by the asset class, the market and governing law.\(^2\)

A team was formed comprising senior SVO staff members to assess the issues presented by the Nebraska DOI request. The team found that trade receivables generated in the U.S. totaled about $2.6 trillion in 2010. The overall objective of the team’s analysis was credit-centric; i.e., the focus was on identifying credit and legal characteristics of the asset; credit, legal and structural program elements; and parameters necessary to reduce nonpayment risk to the level of an NAIC 1 or NAIC 2 designation. Part of this analysis focused on how an investor (i.e., the insurer) would be able to enforce contract rights to the receivable payment in a default situation. The assessment included evaluating the severity of default, in addition to understanding likelihood of default. This overall credit assessment helped quantify the risk of default for WCFNs and, thereby, understand how to manage such risk.

Ultimately, the SVO and the Nebraska DOI were able to work through the analysis and frame a WCFN program in which Pacific Life was permitted to invest. This framework then became the starting foundation for a wider project.

**Toward a National Standard**

The Nebraska DOI requested that the SVO proposal be presented to the Valuation of Securities (E) Task Force for consideration as a national standard. The SVO presented the Nebraska program to the Task Force at the 2011 Spring National Meeting. The Task Force received the proposal and released it for a short comment period, intending to refer it to the Statutory Accounting Principles (E) Working Group. The Working Group asked for further information, whereby the Task Force referred the proposal to the Invested Asset (E) Working Group. This Working Group worked through the issues related to statutory accounting, reporting and risk-based capital (RBC). After a list of potential issues was developed, and hearings were held to discuss those issues with interested parties, the Invested Asset (E) Working Group ultimately recommended that WCFNs be considered admitted assets and provided the Task Force with a list of proposed criteria to be considered.

The SVO and the NAIC statutory accounting staff were then asked to develop a joint statutory accounting proposal using the original SVO proposal, along with the Invested Asset (E) Working Group’s proposed criteria as a basis. A revised proposal incorporating these changes, along with others provided by regulators and interested parties, was adopted by the Task Force and referred to the Statutory Accounting Principles (E) Working Group (to develop final statutory accounting guidance), the Capital Adequacy (E) Task Force (to determine which RBC factors would apply) and the Blanks (E) Working Group (to develop reporting instructions) with recommendations to each of the groups. The three groups proceeded to determine guidance for their respective areas.

**The WCFI Program as Adopted in SSAP No. 105**

The WCFI program that was recently adopted by the NAIC retained many of the proposed asset and program characteristics initially recommended by the SVO. Importantly, the proposal also addressed concerns from NAIC regulator groups regarding issues other than credit, reflecting that WCFIs would permit a new type of investment activity and asset for insurers. These changes ultimately added additional requirements to address other concerns and provide other protections as described below. The new requirements were included in *Statement of Statutory Accounting Principles (SSAP) No. 105—Working Capital Finance Investments*.

**General Requirements of SSAP No. 105:**

- Relates the confirmed receivable process to Uniform Commercial Code (UCC) processes for creating a security interest.
- Requires an annual audit of the consolidated financial statements of the finance agent and a Statement on Standards for Attestation Agreements (SSAE) No. 16, Reporting on Controls at a Service Organization, report, or an annual audit of controls to be reviewed by the SVO for materiality.
- Requires the insurer to monitor the obligor’s receivable activity and credit worth.
- Requires dispute resolution in a U.S. forum.
- Excludes insurance or insurance-related asset receivables from use in designated programs.
- Measures the maximum one-year receivables maturity from the date the invoice was issued.
- Excludes receivables issued by a parent or affiliate of the insurer.
- Requires the obligor to be an NAIC 1 or NAIC 2 designated entity.

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\(^1\) We express sincere gratitude for the confidence reposed in us by the Nebraska Department of Insurance and the assistance provided by the professional staff of the Pacific Life Insurance Company in the development of the initial proposal and the consistency of effort, professional skill, diligence and honesty they exhibited.

\(^2\) Under NAIC guidance at that time, a receivable was a nonadmitted asset under statutory accounting guidance and a short-term obligation not subject to filing with the SVO under the Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO).
• Requires the finance agent (typically a bank) to be an NAIC 1 or NAIC 2 designated entity.

Requires the finance agent to have the obligor confirm, prior to the sale of the receivable by the supplier or its purchase by the finance agent or an insurer, that it has no defenses to payment of the monetary obligation represented by the receivable.

**Risk Assessment of an NAIC WCFI by the SVO**
A WCFI program can only be submitted to the SVO as a submission to the Regulatory Treatment Analysis Service (RTAS). The applicant will receive an RTAS letter showing a preliminary NAIC designation only for the program. When the insurer files the program’s executed documents with the SVO, the SVO will issue an official NAIC designation for the WCFI program. An NAIC designation is assigned to a WCFI program on the basis of regulatory, legal, credit and structural assessment.

• **Regulatory** – The primary source of regulatory requirements is SSAP No. 105. Many of the same requirements are also identified in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO)* as criteria, either because they relate to assessment of credit and other risk and have always been part of the SVO assessment or because SSAP No. 105 requires the SVO to verify or obtain specified documentation. Regulatory requirements are concerned with the reliability and utility of processes used by the finance agent and how it is regulated; verification that the insurer has a reasonable belief it has obtained or can obtain a UCC security interest, compliance with provisions in SSAP No. 105 that require non-affiliation with insurer and with provisions that exclude certain receivables from the program, documentation standards as to remedies, payment to the finance agent or insurer, and other similar issues.

• **Credit Risk** – The obligor’s credit risk is derived through traditional corporate methodologies, such as financial analysis. This assessment is augmented by a review of the short-term risks that could affect payment, as well as an understanding of the level of operational risk presented by obligor processes and the industry of which it is a part.

• **Structure** – It is anticipated that WCFI programs will differ in the structure (i.e., the various internal mechanisms, processes, procedures used to sell the receivable, conduct the confirmation process and effect payment to the insurer). An assessment will be conducted by reviewing the governing legal documents for sufficiency, along with an assessment on other participants in the operations of the working capital finance program or investment as to quality, degree of legal responsibility owed to ensure the process works and other investor protections. Adjustments for deficiencies in structural elements are made to the obligor’s credit rating or quality designation.

• **Legal Issues** – Core legal issues center on the legal effectiveness of the transfer of the receivable as a true sale and of the manner and effectiveness of the confirmation process. Consistent with the revolving nature of the program, it is expected that the insurer will not be committed to buy new receivables from the finance agent.

**Conclusion**
A WCFI represents a new asset and a new investment opportunity for insurers. While there were initially many questions raised about the asset class and how it operates, the road to its approval by the NAIC reflects the successful collaboration of NAIC staff, insurance regulators and industry.

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**About the Director**

Bob Carcano is senior counsel at the NAIC Capital Markets and Investment Analysis Office. He provides legal, regulatory and analytical support to the Securities Valuation Office and the Structured Securities Group. He is a graduate of the Dickinson School of Law (J.D.), the Fordham University Graduate School of Arts and Science, (master’s degree in comparative politics) and Fordham University, Fordham College (bachelor’s degrees in history and political science). Before joining the NAIC in 1991, Carcano was a senior analyst in the Structured Finance Group of Moody’s Investors Service, where he performed legal and credit analysis of a variety of structured securities. Prior to his assignment with Moody’s, Carcano was with the boutique investment banking operation of the Financial Services Corporation of New York City, where he was engaged in asset-based financing, economic development lending and industrial development bond financing.
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