ART Special Report – 4-4-2023

The NAIC Spring National Meeting Review:

What's Next for the Rules that Govern Insurers' Investments

Synopsis:

The rate of change to the regulatory landscape governing US insurance investments is only accelerating, with broad implications for investment strategy. This report explores the evolving guidelines with an update from the National Association of Insurance Commissioners (NAIC) Spring National Meeting, focusing on possible changes to the treatment of investment vehicles, including feeder notes and structured assets.

We hope you find this resource helpful – it is consistent with our goal of bringing value to our community.

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- **ART System** provides users access to codified state investment guidelines in a searchable and understandable format.
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- **ART Newsreels** are a centralized repository of recent and possible future changes to the landscape, including NAIC and state investment guidelines. Our Newsreels consolidate Newsreel Updates in a distilled and easy to navigate format.
- **ART Heatmaps** provide a visualization of the varying investment limits that govern asset classes across states.
- **ART Investment Classification (beta)** assists with the classification of assets, that includes requirements under the proposed principles-based bond definition which consists possible heightened reporting requirements.

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Executive summary

The NAIC Spring National Meeting brought progress as regulators gained a better understanding of the issues that need to be addressed with the Risk Based Capital framework treatment of investments. Regulators and NAIC staff are finding a need to refine the rules to better align with the growth of insurers' investments in the likes of CLO tranches, feeder notes and the broad set of structured assets. This report reviews recent developments along with possible outcomes and their implications.

With scope of assets impacted likely valued at over $1 Trillion, changes can have noticeable implications for insurers' investment strategies and capital markets more broadly. The impact of the proposals on small insurers has been a sensitive issue given the use of these investment vehicles to access asset classes that would otherwise not be accessible given their size, ultimately supporting affordability of their policies, and allowing them to compete more effectively.

At a high-level, regulators are reevaluating the scope of the Structured Equity and Funds proposal that was fairly broad and would impact both debt and equity positions across many investment vehicles including feeder notes. It would result in filing requirements that would support the NAIC assign model-based designations, no longer allowing reliance on agency ratings in designation assignment. While regulators acknowledge the need to address shortcomings of the current framework, there was consensus that more time will be needed to understand redundancies with other efforts at the NAIC, and the need for the NAIC to provide added transparency with processes if a variant of the proposal is adopted. Concerns raised by NAIC staff on the quality and consistency of the roughly 8,000 private letter ratings (PLRs) considering their increased use, with the number of PLR roughly tripling since 2018. For context, YE 2022 holdings show:[1]

- Over $300 Billion in assets where filers reported PLRs
- 14 insurers with more than 20% of their admitted assets receiving PLRs, with the highest at 43%
- 11 insurers larger than $10 Billion with more than 10% of their admitted assets receiving PLRs, with the highest at 22%

Acknowledged by regulators as an area possibly needing more supervision, a request was made for NAIC staff to propose a process for reviewing PLRs and a process for the SVO to challenge those ratings.

Efforts to address observed regulatory capital arbitrage and the noticeable reductions in capital from holding CLO tranches, rather than the underlying collateral loans, highlighted regulators' varying views on urgency that would justify increasing capital for residual tranches as a stop-gap measure. There was consensus on the need for more analysis and a long-term initiative to align capital with economic risks. That said, there were questions regarding scope of the stop-gap measure. While clarifications were provided indicating the proposal applies to all residual tranches of structured assets, it was noted that residuals are not defined under the STAT framework, leaving it unclear as to whether, say, equity positions in feeder funds or other investment vehicles would be subject to the heightened capital treatment.

[1] Source: Bridgeway Analytics using data from S&P Global Markets, with a disclaimer found in the Appendix.

Meanwhile, with the collapse of SVB in the backdrop, regulators were deliberate in discussing insurers' exposure and management of duration risk, particularly in the context of reserving, asset liability management and liquidity stress tests, all of which have potential implications for investment and hedging strategies.

Revisions to the treatment of investment vehicles

There are multiple interrelated NAIC initiatives to review and revise the treatment of investments. This section begins with some contexts for their impetus. We proceed with categorizing key efforts to align guidelines with the changing landscape, and subsequently unpacking each initiative and outline possible outcomes and implications.

Some contexts for our newly joined readership

Discussed in our report, The Evolving Regulatory Landscape That Governs Insurers' Investments, shifts in insurers' investment strategy since the Great Financial Crisis (GFC) toward less traditional vehicles had NAIC staff and state regulators review the rules that govern investments to ensure their ongoing appropriateness. NAIC staff shared observations of vehicles that were designed, intentionally or otherwise, in ways that allowed for capital arbitrage and in ways that limit the visibility of underlying holdings. In effect, limitations of the RBC framework allowed for significant reductions in capital when holding the vehicle and its liabilities, compared to the capital assigned to the vehicle's underlying investments; with the economic risks arguably being identical. In addition, the structures could permit entities to indirectly hold affiliate or related investments, or more assets than what state law permits to be held directly. A number of prominent examples that were highlighted by NAIC staff including Collateral Loan Obligations (CLOs) and feeder notes that have become increasingly prevalent.

An effort to align guidelines with the changing landscape

Limits with the RBC framework's ability to level-set capital with economic risk across asset classes is having regulators and staff question the broader process that is followed in assigning capital. A multi-pronged approach is being taken to address possible concerns. The issues are nuanced, with interconnected elements, often managed by different NAIC groups who themselves have interconnected mandates. Proposals often have elements that are seemingly redundant with possible stop-gap elements. Recent efforts, for example, to address CLO arbitrage are being addressed through proposed use of NAIC model-based designations by the Valuation of Securities (E) Task Force (VoS TF) supported by the NAIC Securities Valuation Office (SVO) and the Structured Securities Group (SSG), along with increased capital charges on tranche residuals by the Risk Based Capital Investment Risk and Evaluation (E) Working Group (RBC IRE WG) and the American Academy of Actuaries (The Academy).

Breaking down the initiatives, we now unpack proposals related to:

- Reducing reliance on credit ratings, and moving toward NAIC model-based designations
- Differentiating RBC C1 (i.e., the credit risk component of regulatory capital) across asset classes
- The principles-based bond definition, which will likely reclassify some credit investments, having them no longer receive favorable *bond* treatment in their capital allocation
- Heightened disclosure

Reducing reliance on credit rating, and moving toward NAIC model-based designations

NAIC staff and regulators have been looking to reduce reliance on rating agencies since the GFC, with NAIC staff pointing to several limitations with the applicability of agency ratings in assigning regulatory capital.[2] This subsection breaks down the NAIC's concerns and the resulting evolving mandates of the SVO and SSG. Subsequently we outline where the initiative stands and some insights into what might happen next.

The NAIC's concerns with the use of agency ratings

The SVO and SSG have raised several concerns with reliance on rating agencies, including:

- **Since the GFC, the NAIC saw a 'loss of market confidence with NRSROs.'** That view lead to the Structured Securities Project in 2009, and a move away from agency ratings-based designations toward NAIC model-based designation for CMBS and RMBS.
  Most recently the VoS TF broad referral to LA TF and other NAIC groups proposing Market and Analytical Information for Bond Investments, references the 2010 NAIC adoption of the Rating Agency (E) Working Group (RAWG) recommendations to motivate the move away from rating agencies. This additional data is key to moving toward broader model-based designations.
- **The appropriateness of agency ratings for regulatory purposes, specifically that Agency ratings are not comparable across NRSROs.** IAO staff's findings in their Nov 2021 memo regarding disparities between rating agencies that reviews PLRs. This is particularly relevant in the context of possible changes to the treatment of feeder notes that often rely on PLRs.
- **Removing arbitrage.** The move away from agency ratings is often referenced by NAIC staff as a way of removing RBC arbitrage from the likes of CLOs. [3]

Regulators' reactions to concerns and evolving mandates for the SVO and SSG

Regulators acknowledged concerns raised by NAIC staff, with the VoS TF formalizing mandates and clarifications:

- **Criteria permitting NAIC staff to assign designations**. The VoS TF charges (i.e., mandate) was formally updated for 2023 (item 10), allowing the TF to establish criteria to permit NAIC staff's discretion over the assignment of designations, to "…ensure greater consistency, uniformity and appropriateness to achieve the NAIC's financial solvency objectives."[4]
- **Clarifying the definition of an NAIC designation.** With the move toward model-based designations, there was an effort to further refine and clarify what designations are intended to measure. The VoS TF December 14, 2022 meeting Materials includes the SVO and SSG's proposed clarifications along with comments from the ACLI, the Capital Adequacy (E) Task Force (CA TF) and other interested parties. Comments from the CA TF along with its working groups, spoke to the proposed

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[2] Amnon Levy and William Poutsiaka, The NAIC Alternative to Agency Ratings, Insurance Asset Risk.

[3] Updated Amendment to the P&P Manual to Add Instructions for CLOs to Part Four includes recommendations by NAIC staff to address CLO arbitrage through modeled-based designations, "SSG can model CLO investments and evaluate all tranche level losses across all debt and equity tranches under a series of calibrated and weighted collateral stress scenarios to assign NAIC Designations that create equivalency between securitization and direct holdings, thereby eliminating RBC arbitrage."

[4] Amnon Levy and William Poutsiaka, The NAIC Alternative to Agency Ratings, Insurance Asset Risk

clarifications overreaching into their own mandate that includes determining RBC charges for investments. The comments closely mirror those from the ACLI on Structured Equity and Funds that view the SVO's arbitrage justification for model-based designations redundant and possibly beyond the scope of their mandate. 2022 meeting discussions suggested the VoS TF will work with the CA TF to better define and articulate what designations are intended to measure, perhaps also clarify the way in which they are different from agency ratings.

- **NAIC model-based designations for CLOs.** While clarifications to the definition of designations are still uncertain, the VoS TF February 23, 2023 adopted the NAIC intrinsic price-based model for CLOs, with agency ratings no longer applicable beginning YE 2024. An ad-hoc working group will be convening to review technical issues in the coming months.

Where do things stand?

Most recently, the VoS TF Structured Equity and Funds proposal would further widen the SVO's mandate, having the group assign designations to a broad set of investments in vehicles, including feeder notes and limited partnership interests, no longer allowing for the use of agency ratings. The March 23, 2023, VoS TF deliberations suggested regulators have varying views on proposed increased scope being proposed by the SVO. While we acknowledge limits to agency ratings that have been pointed out by the SVO and SSG, and we relate comments made by regulators, the ACLI and other interested parties that question the three justifications outlined above for moving away from rating agencies:

- **Since the GFC, the NAIC saw a 'loss of market confidence with NRSROs.** Much has changed subsequent to the GFC, with sweeping rating agency reforms. Dodd-Frank's creation of the US Office of Credit Ratings (OCR) forced rating agencies to increase the transparency of procedures, methodologies, and business practices. Alongside the Credit Rating Agency Reform Act, rating agencies are now required to report standardized statistics such as default rates for 1-year, 3-year, and 10-year periods. Europe imposed similar standards.[5]
- **The appropriateness of agency ratings for regulatory purposes, specifically that agency ratings, are not comparable across NRSROs.**
  - The concerns raised by NAIC staff in the Nov 2021 memo regarding disparities between rating agencies were specific to PLRs that have a unique set of characteristics which the memo and the Capital Markets Bureau report, Growth in Private Ratings Among U.S. Insurer Bond Investments and Credit Rating Differences, also points out. The memo and report suggest that larger and established agencies such as Moody's and S&P that rate the lion's share of public holdings tend to have highly correlated ratings (90%+). The question of whether NAIC model based designations can improve on these discrepancies is explored in Benchmarking the Treatment of CLOs by providing a point of reference, observing that S&P and Moody's CMBS ratings are much more similar with each other than with NAIC model-based designations.
  - The Securities and Exchange Commission deliberately avoids uniformity in agency rating in the interest of having multiple opinions which is viewed as critical when assessing risk. In

[5] Amnon Levy and William Poutsiaka, The NAIC Alternative to Agency Ratings, Insurance Asset Risk

the context of assigning capital. A single modeling framework managed by the SVO in assigning capital introduces a potential systemic risk.[6]

- **Removing arbitrage.** The ACLI comments on the Structured Equity and Funds proposal spoke to this issue in particular, viewing the SVO's arbitrage justification for Structured Equity and Funds model-based designations redundant, with a view that arbitrage should be addressed by the RBC IRE WG that is currently reviewing RBC C1 capital for structured assets. This issue will be explored further below.

While the VoS TF chose not to adopt the proposal in its current form, regulators and SVO responded positively to the feedback, suggesting middle ground paths to ensure that transparency on behalf of both insurers and regulators, deferring the adoption until it can be further refined. It was noted that the use of PLRs has almost tripled to over 8,000 since their introduction in 2019, having regulators acknowledge the issue is material and requires additional supervision.

It is worth pointing out that rulemaking bodies have taken varying approaches in overcoming substantial challenges with level-setting an articulation of risk and assigning regulatory capital across asset classes. Discussed extensively in, Assessment of the Proposed Revisions to the RBC C1 Bond Factors, the challenges transcend the rulemaking process and impacts capital market participants more generally.

What's next?

VoS TF will be referring the proposal to the Statutory Accounting Principles (E) Working Group (SAP WG) with considerations for the proposed bond definition and associated heightened reporting possibly addressing many of the concerns that motivated Structured Equity and Funds; several examples referenced in the Structured Equity and Funds proposal were noted by the ACLI to not of have adhered to the bond definition.

Regulators also requested more transparency from NAIC staff on the possible process that would have them review PLRs and a process for the SVO to challenge those ratings, suggesting a possibly pared down version of the proposal would be of interest.

In a related set of discussions, VoS TF briefing to the Capital Adequacy (E) Task Force (CA TF) pointed to the punitive treatment investments in Schedule BA Non-Registered Private Funds With Underlying Assets Having Characteristics of Bonds or Preferred Stock receive for P&C companies being a possible reason for the use of feeder notes. While life companies receive favorable treatment for those investments, efforts to assign favorable treatment for P&C companies were paused as a more holistic approach was initiated with proposed revisions to the bond definition.

Differentiate RBC across asset classes

Referenced above, the CA TF along with its working groups, including the RBC IRE WG mandates include determining RBC charges for investments. The RBC IRE WG has been assigned to perform a comprehensive review of the RBC investment framework in 2023 with an initial focus on CLOs and other structured assets (i.e., ABS using the NAIC nomenclature). Acknowledging substantial efforts required to

[6] Securities and Exchange Commission Office of Credit Ratings, Annual Staff Report on Nationally Recognized Statistical Rating Organizations, February 2023

level set the rules for CLOs and other structured assets, regulators have been focused on stop-gap measures that would address arbitrage concerns, while preparing for more material longer-term initiatives.

Regulators varying views on the immediate need for stop-gap actions

The most recent RBC IRE WG meeting discussed stop-gap measure that would limit arbitrage by increase capital for CLO residuals and structured asset residuals more broadly. Several comments from regulators provided areas of consensus that seemed to be forming and provided several clarifications:

- While still contentious, there was consensus for the proposal to limit NAIC 6 to a single designation for residual tranches, with the splitting of designation 6 to 6.a, 6.b and 6.c no longer being considered. While a value hasn't been formally proposed, an increase from 30% to 45% has been discussed.
- A clarification was made indicating an interim proposal, if adopted, would not only cover residuals of CLOs, but residuals of structured assets more broadly including those of feeders and other investment vehicles.
- Comments related to the proposed bond definition and the proposed Structured Equity and Funds suggested some level of uncertainty with the scope of asset classes that would ultimately be impacted. This issue ties with questions on scope considering residual tranches are not currently defined under SAP, and with their identification possibly muddled by residual tranches held indirectly.

That said, regulators have a broad range of views on the need for an interim stop gap, with concerns raised over classification under SAP, identification, and disclosure and varied views on the level of urgency that would justify an interim solution mirroring comments from the Academy's December presentation.

What's next?

There will be a regulator only meeting in the coming weeks to, in part, review an analysis of YE 2022 residual filings under Schedule BA and assess overall industry holding as well as any material individual firm concentrations that may warrant action. In addition, there were suggestions that the concept of residuals need to be articulated and scope needs to be further clarified, with questions as to whether residuals/equity positions in feeders, for example, would be included.

What to expect for the long-term

There seems to be general consensus on the need for a long-term solution that would consistently assign capital across all tranches of structured assets. As is the case with these sorts of initiatives, The Academy is supporting the RBC IRE WG efforts in assessing an appropriate framework to level-set risk across CLOs and other credit issued by the likes of corporates and municipalities. To that end, The Academy communicated its next steps to:

- Form a proposed definition to *RBC arbitrage*, noting the varied views across stakeholders
- Develop an *ideal specification* for a CLO model that will be presented in the coming months

The proposed bond definition

Acknowledging nuances with level setting the classification and treatment of credit, there is an effort to revamp the NAIC's definition of how 'bonds' are classified, with a move toward a principles-based

approach. Important to note that the NAIC's definition departs from the SEC's definition and includes structured assets. At a high-level, the definition separates *issuer credit obligations*, which, in spirit, represents the likes of corporate or municipal bonds, from credit issued by investment vehicles, which the NAIC terms *asset backed securities*. The definition and its issue paper are exposed through June 9, 2023, and posted on the SAP WG page. They walk through typical characteristics that would have an asset receive favorable bond treatment, or not. Uncertainty with the timing or amount cash flows associated with direct holdings in feeder funds, for example, requires evaluation. Factors including discretion by the fund manager to withhold distribution would be considered when assessing whether the structure aligns with the spirit of the principles-based definition. Similarly, credit, such as a note, which is issued by a feeder fund would need evaluation that includes the terms and conditions of the note and underlying supporting assets of the fund. Keeping in the spirit of having the approach be principles based, while credit that is ultimately backed by equity interests is presumed to not qualified as a bond, it is not precluded from receiving bond treatment, but the credit would have to meet the equity backed requirements. Meanwhile, CLO tranches, other than residuals, which are singled out, would be treated as ABS, and ultimately receive favorable bond treatment.

Heightened disclosure

Related to updated bond definition, there are several initiatives that introduce heightened reporting requirements, allowing NAIC staff to buildout tools that will support regulators' assessments of investment risks. That includes reporting of additional analytics,[7] and the splitting up of Schedule D-1, with different reporting requirements for issuer credit obligations under Schedule D-1-1 and ABS under Schedule D-1-2 posted on the SAP WG page. In addition, under the proposed bond definition an asset classified as an ABS will require documented analysis supporting compliance with key concepts, such as the "meaningful cash generating" and "substantive credit enhancement" concepts.
While reporting refinements for affiliate and related party investments have rolled out already, state regulators in the Group Solvency Issues (E) Working Group continue to explore and frame possible concerns with contractual agreements that might be structured that avoid regulatory disclosures and requirements.

What are we optimistic about?

The NAIC and regulators continue to be open to feedback and have shifted course as new information has been made available. While a speedy resolution is desired, the interconnected nature of the framework inherently requires iteration as implications are better understood, allowing for unintended consequences to be minimized. With interested parties invited to join ad-hoc working groups, most recently by CA TF that is looking to review *missing risks* among other items, requires distillation of more information, we believe the end result will lead to an improved framework.

With the issues and challenges increasingly nuanced and complex, we are hopeful that ART will keep the community informed of developments and their potential implications.

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[7] SVO memorandum on alternatives to add fixed income analytical risk measures to investments reported on Schedule D, Part One

Appendix

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