Green Street
Asset-Backed Alert
THE WEEKLY UPDATE ON WORLDWIDE SECURITIZATION

NAIC's Maturity Penalty Scrutinized

Bridgeway Analytics is circulating more details about research that questions the efficacy of a risk-weighting methodology the **National Association of Insurance Commissioners** is developing for collateralized loan obligations.

The NAIC plan, **proposed** in June, is part of a broader effort by the organization to reduce insurers' reliance on credit ratings in determining how much capital they must reserve against their investments. The model would be the same as those the NAIC implemented after the financial crisis to set risk weights for residential and commercial mortgage bonds.

Bridgeway's analysis, however, suggests that such an approach is less predictive of credit losses than the ratings it is designed to replace. The San Francisco firm initially shared its report with the NAIC and other regulators in late December, and now is exposing it for wider comment.

The NAIC's mortgage-bond methodology uses so-called intrinsic pricing, which measures the difference between a security's remaining par value and discounted expected losses. Bridgeway's analysis found that compared with credit ratings, the resulting NAIC designations are less correlated with prevailing bond spreads.

Specifically, Bridgeway concluded that rating-based designations for mortgage securities have a 70% correlation to spreads, versus 37% for the NAIC's intrinsic-price method. One of the reasons for the weaker correlation: The intrinsic-price approach carries heavier penalties for longer-dated holdings, reflecting a lower risk of principal losses among equivalent shorter-term positions.

The resulting magnification of risk weights for longer-dated exposures, and the accompanying increase in capital charges, is a key consideration for life insurers because they require cash-flows that match their long-term liabilities.

The NAIC, for its part, acknowledges the heavier penalties for longer-dated holdings, but it says this is a function of its risk weights, and not the proposed CLO methodology. These risk weights would result in higher capital charges for longer-dated exposures regardless of whether the NAIC models securities in-house or using credit ratings.

Bridgeway's analysis has its own limitations. Spreads are an imperfect proxy for credit risk, as they generally reflect market sentiment as opposed to actual future credit losses. Still, Bridgeway argues that the rank correlations should be closer if the maturity effects were deliberately considered when applying the intrinsic price approach in assigning designations.

The firm also believes it would be possible to improve the intrinsic-price methodology used for mortgage bonds by following the methods rating agencies use when accounting for maturity — though it would still be less predictive of market spreads. That's because, unlike agency ratings, the methodology does not take into account important features that act as credit enhancements.

Bridgeway's sample encompassed 3,271 unique Cusips, all for bonds issued since the financial crisis.

Bridgeway is circulating its research amid wider concerns about the NAIC's efforts to **develop** a CLO methodology. Bridgeway previously noted that the approach fails to consider credit-enhancement mechanisms that mitigate the effects of collateral losses on CLO securities. And the **American Academy of Actuaries** questions whether the NAIC has provided justification and performed sufficient analysis for switching to a modeling framework for CLOs.

The NAIC's aim is to reduce the use of what it views as regulatory arbitrage, whereby an insurer buying the entire capital stack of a CLO could hold less capital against the investment than if the insurer held the unsecuritized collateral. ❖