Date: 4/8/2024

Virtual Meeting

RISK-BASED CAPITAL INVESTMENT RISK AND EVALUATION (E) WORKING GROUP
Friday, April 12, 2024
12:00 – 2:00 p.m. ET / 11:00 a.m. – 1:00 p.m. CT / 10:00 a.m. – 12:00 p.m. MT / 9:00 – 11:00 a.m. PT

ROLL CALL

RISK-BASED CAPITAL INVESTMENT RISK AND EVALUATION (E) WORKING GROUP

Philip Barlow, Chair	District of Columbia	William Leung/Debbie Doggett	Missouri
Thomas Reedy, Vice Chair	California	Lindsay Crawford	Nebraska
Wanchin Chou	Connecticut	Jennifer Li	New Hampshire
Ray Spudeck/Carolyn Morgan	Florida	Bob Kasinow/Bill Carmello	New York
Vincent Tsang	Illinois	Dale Bruggeman/Tom Botsko	Ohio
Roy Eft	Indiana	Rachel Hemphill	Texas
Carrie Mears/Kevin Clark	Iowa	Doug Stolte	Virginia
Fred Andersen	Minnesota	Steve Drutz/Tim Hays	Washington
		Amy Malm	Wisconsin

NAIC Support Staff: Dave Fleming/Julie Gann

AGENDA

1. Discuss Review of Yearend 2023 Data Reported for Residual Tranches
   —*Philip Barlow (DC)* — Attachment 1

2. Hear a Presentation from the NAIC's Structured Securities Group
   —*Eric Kolchinsky (NAIC)* — Attachment 2

3. Discuss Comment Letters Received on the Oliver Wyman Report
   —*Philip Barlow (DC)*
   - Americans for Tax Reform — Attachment 3
   - Florida State Hispanic Chamber of Commerce — Attachment 4
   - Doug Dean (former Colorado Insurance Commissioner) — Attachment 5
   - Max Carter (Assemblyman NV state assembly) — Attachment 6
   - Cesar Aguilar (Representative AZ house of representatives) — Attachment 7
   - The Buckeye Institute — Attachment 8
   - South Carolinians for Responsible Government — Attachment 9
   - The American Consumer Institute — Attachment 10
   - National Association of Mutual Insurance Companies — Attachment 11
   - American Investment Council — Attachment 12
   - Bridgeway Analytics — Attachment 13
   - MetLife — Attachment 14

- Athene — Attachment 15
- Equitable — Attachment 16
- American Property Casualty Insurance Association — Attachment 17
- Western & Southern — Attachment 18
- Briscoe Cain (Member, Texas House Committee on Insurance) — Attachment 19
- The Harms Group — Attachment 20
- Alternative Credit Council — Attachment 21
- American Council of Life Insurers (ACLI) — Attachment 22
- American Academy of Actuaries' (Academy) — Attachment 23
- Paul Bailey (Senator, state of Tennessee) — Attachment 24

4. Discuss Any Other Matters Brought Before the Working Group
   —Philip Barlow (DC)

5. Adjournment

Attachment 1

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

TO: Members of the RBC Investment Risk and Evaluation (E) Working Group
Members of the Statutory Accounting Principles (E) Working Group

FROM: NAIC Staff

DATE: April 1, 2024

RE: Aggregated Residual Data – Year-End 2023

This memo has been developed to provide information on the reporting of residuals by life, P/C & health companies on Schedule BA for year-end 2023. Summaries of information are provided for the following aspects:

- Residual by Reporting Line
- Residual Acquisition Date
- 2023 Movement to Residual Reporting – Life Entities
- Residuals with NAIC Designations Reported
- Residual Investments Involving Related Parties
- Impact of 45% RBC Factor – Refreshed for 2023 Riling Results.

Residuals By Reporting Line:

Total Residuals	2023 Count	Reported BACV	% of Total	2022 Count	Reported BACV	% of Total
Life Entities	1,248	11,630,554,475	86.13%	874	5,742,324,464	81.86%
P/C Entities – 2022 Revised	419	1,551,970,807	11.49%	355	1,049,516,959*	14.96%
Health Entities	99	317,688,548	2.35%	80	220,517,642	3.14%
Title Entities	2	2,637,903	0.02%	2	2,799,992	0.04%
Total Residuals	**1,768**	**13,502,851,733**		**1,314**	**7,015,159,057**	

Notes: 1) The counts include any instance in which an investment is reported, regardless of if it had a BACV.

2) The increase in residuals may not be from 2023 acquisitions but could be a move to the residual reporting line. See the chart on page 4 for residual movement detail for life companies.

** In 2022 it was noted that $4.5B of this was likely misreported as residuals. This company did not include that amount in the 2023 residual reporting. The amount has been removed for comparison purposes.*

Key Elements:

- Life entities make up the significant majority (86%) of residual interests across the entire industry. Residuals reported on Schedule BA for life entities has doubled in BACV from 2022, from $5.7B to $11.6B.
- Residuals are predominantly classified as either fixed income or other. This is consistent with 2022.
- 48% of all residuals held by life entities involve a related party in some form. A much lower percentage of related party involvement exists for P/C and Health Entities.
- 25 life entities hold residuals that reflect 83% of the life industry BACV total. (8 companies represent 47% and 10 companies represent 55%.)
- Per the detail of largest residuals held, several are reported at an amount greater than cost. This will not be permitted for residuals acquired after Jan. 1, 2025, per the new measurement guidance in SSAP No. 21R.

<u>Life Entities</u>: Residuals reported on Schedule BA has doubled in BACV from 2022, from $5.7B to $11.6B. The number of residuals has increased in all categories, except for "Other-Affiliated," which reported an approx. count decrease of 100 and 51% decline in BACV. Although the count of residuals is significantly greater with unaffiliated investments, the BACV is evenly split between unaffiliated and affiliated.

Life Reporting Entities					
Unaffiliated	**2023 Count**	**Reported BACV 2023**	**2022 Count**	**Reported BACV 2022**	**% Change in BACV '22 to '23**
Fixed Income – Unaffiliated	651	3,829,582,270	428	1,717,933,527	122.92%
Common Stock - Unaffiliated	31	459,991,247	20	151,745,564	203.13%
Preferred Stock – Unaffiliated	9	15,559,571	6	4,999,986	211.19%
Real Estate - Unaffiliated	3	12,321,798	0	0	100%
Mortgage Loans - Unaffiliated	30	69,675,196	9	2,757,688	2426.58%
Other – Unaffiliated	163	1,423,560,678	147	682,127,139	108.69%
Total Unaffiliated	**887**	**5,810,690,760**	**610**	**2,559,563,904**	**127.02%**
Percent of Life Residual Total	71%	50%	70%	45%	
Affiliated					
Fixed Income - Affiliated	217	3,200,982,913	94	1,438,200,802	122.57%
Common Stock – Affiliated	85	1,503,564,184	30	110,512,247	1260.54%
Preferred Stock – Affiliated	1	0	0	0	100%
Real Estate - Affiliated	5	276,320,282	0	0	100%
Mortgage Loans – Affiliated	5	45,959,496	0	0	100%
Other – Affiliated	48	793,036,840	140	1,634,047,511	-51.47%
Total Affiliated	**361**	**5,819,863,715**	**264**	**3,182,760,560**	**82.86%**
Percent of Life Residual Total	29%	50%	30%	55%	
Life Residual Total	**1,248**	**11,630,554,475**	**874**	**5,742,324,464**	**102.54%**

<u>P/C Entities</u>: Residuals reported on Schedule BA has increased about 50% from 2022. Although it appears that the affiliated residuals have decreased significantly, four investments totaling $4.5B were misreported by one company as residuals in 2022. As those investments were not misreported in 2023, those investments represent the bulk of the decrease in affiliated. For P/C entities, a significant majority are unaffiliated investments.

Property / Casualty Reporting Entities					
Unaffiliated	**2023 Count**	**Reported BACV 2023**	**2022 Count**	**Reported BACV 2022**	**% Change in BACV '22 to '23**
Fixed Income – Unaffiliated	280	880,698,427	237	631,189,758	39.53%
Common Stock - Unaffiliated	83	293,210,673	69	132,695,423	120.97%
Preferred Stock – Unaffiliated	3	15	1	65,550	-99.98%
Real Estate - Unaffiliated	2	4,608,460	0	0	100%
Other – Unaffiliated	16	70,461,810	24	65,938,165	6.86%
Total Unaffiliated	**384**	**1,248,979,385**	**331**	**829,888,896**	50.50%
Percent of P/C Residual Total	92%	80%	92%	15%	
Affiliated					
Fixed Income - Affiliated	31	292,249,580	26	4,756,630,624	-93.86%
Common Stock – Affiliated	1	0	0	0	0
Other – Affiliated	3	10,741,842	1	15,239,928	-29.52%
Total Affiliated	**35**	**302,991,422**	**27**	**4,771,870,552**	-93.65%
Percent of P/C Residual Total	8%	20%	8%	85%	
P/C Residual Total	**419**	**1,551,970,807**	**358**	**5,601,759,448**	**-72.29%**

Health Entities: The increase in residuals reported on Schedule BA is for health is 44%, which is similar to the increase in P/C entities. Also similar to P/C entities, a significant majority are unaffiliated investments.

Health Reporting Entities					
Unaffiliated	**2023 Count**	**Reported BACV 2023**	**2022 Count**	**Reported BACV 2022**	**% Change in BACV '22 to '23**
Fixed Income – Unaffiliated	93	$300,528,301	64	$198,916,262	51.08%
Preferred Stock – Unaffiliated	1	2,323,187	0	0	100%
Other – Unaffiliated	2	705,038	12	3,584,975	-80.33%
Total Unaffiliated	**96**	**303,556,526**	**76**	**202,501,237**	49.90%
Percent of Health Residual Total	97%	96%	95%	92%	51.08%
Affiliated					
Fixed Income - Affiliated	2	$14,132,022	4	$18,016,405	-21.56%
Other – Affiliated	1	0	0	0	0
Total Affiliated	**3**	**14,132,022**	**4**	**18,016,405**	**-21.56%**
Percent of Health Residual Total	3%	4%	5%	8%	
Health Residual Total	**99**	**317,688,548**	**80**	**220,517,642**	**44.06%**

Title Entity – There is one title company that holds two residuals for a BACV of $2.6M in 2023. These investments were held in 2022 with a $2.8M BACV.

Residual Acquisition Dates

A vast majority of life entities (76% in 2023 vs. 83% in 2022) reported that their residuals (in BACV) were acquired in the most recent three years. Similar observations are noted for P/C and Health, with 78.2% and 80.7% of residuals BACV acquired in the most recent three years respectively. *(The count includes all reported investments, including those with 0 BACV.)*

	Life			**P/C**			**Health**		
Year Acquired	**Count**	**Reported BACV**	**%of BACV**	**Count**	**Reported BACV**	**% of BACV**	**Count**	**Reported BACV**	**% of BACV**
2023	247	2,810,468,654	24.2%	70	255,611,788	16.5%	26	86,522,773	27.2%
2022	345	3,591,694,216	30.9%	111	508,120,920	32.7%	51	163,729,104	51.6%
2021	246	2,467,916,903	21.2%	123	448,965,412	29.0%	13	6,214,651	2.0%
2020	89	1,048,139,934	9.0%	33	123,193,438	7.9%	-	-	-
2019	51	569,343,237	4.9%	30	72,359,962	4.7%	-	-	-
2018	52	127,519,073	1.1%	10	19,082,086	1.2%	1	14,033,114	4.4%
2017	49	60,369,061	0.5%	9	1,988,026	0.1%	-	-	-
2016	33	122,340,118	1.1%	7	20,667,734	1.3%	-	-	-
2015	6	7,323,326	0.1%	1	0	0.0%	1	694,655	0.2%
2014	93	323,179,676	2.8%	1	41,773	0.0%	-	-	-
2013	3	665,006	0.0%	5	1,208,799	0.1%	1	98,908	0.0%
2012	1	0	0.0%	3	99,561,943	6.4%	1	118,711	0.0%
2011	1	70,044	0.0%	1	809,408	0.1%	-	-	-
2010 or earlier	7	(1)	0.0%	6	242,224	0.0%	3	41,081,461	13.0%
No Date	25	501,525,228	4.2%	9	117,294	0.0%	2	5,195,171	1.6%
Total	**1,248**	**11,630,554,475**	**100%**	**419**	**1,551,970,807**	**100%**	**99**	**317,688,548**	**100%**

2023 Movement to Residual Reporting – Life Entities:

In 2022 it was known that residuals were under-reported as residual investments in LLCs were often retained within the LLC Schedule BA reporting line and not moved to the residual reporting line until explicitly directed. The detail below illustrates that residuals (in all categories except for "Other") were held in 2022 but not reported on the Schedule BA residual reporting line. This information is in aggregate count only. It would require a comparison of each insurance company's Schedule BA for 2023 and 2022 to identify the specific residuals and BACV that were held in 2022 and reported elsewhere. *(This review was completed for life companies only.)*

Life Entities	Total Count 2023	Acquired 2023	Acquired 2022 or earlier per 2023 Data	Total Count 2022	Difference in 2022 #'s
Fixed Income – Unaffiliated	651	131	520	428	**92**
Fixed Income Affiliated	217	37	180	94	**86**
Common Stock – Unaffiliated	31	14	29	20	**9**
Common Stock - Affiliated	85	14	71	30	**41**
Preferred Stock – Unaffiliated	9	2	7	6	**1**
Preferred Stock – Affiliated	1	0	1	0	**1**
Real Estate - Unaffiliated	3	1	2	0	**2**
Real Estate - Affiliated	5	2	3	0	**3**
Mortgage Loans - Unaffiliated	30	3	27	9	**18**
Mortgage Loans – Affiliated	5	3	2	0	**2**
Other – Unaffiliated	163	47	116	147	**(31)**
Other – Affiliated	48	5	43	140	**(97)**
Total Counts	**1248**	**334**	**1001**	**874**	

Note – Items that were not reported with an acquisition date were assumed to be acquired prior to 2023.

Residuals with NAIC Designations Reported

Life Entities: Residuals most commonly do not have designations, either SVO assigned or from CRPs. The information reported for year-end 2023 had 195 investments reported with an NAIC designations (as compared with 76 in 2022). The vast majority (in count and percentage of BACV) are not reported with a designation, or if reported, reflected an NAIC 6. Although designations can be reported for residuals, they have no impact on RBC. The reporting for P/C and Health companies is in line with the expectation that residuals would not have designations.

	Life			**P/C**			**Health**		
Designation	**Count**	**Reported BACV**	**% BACV**	**Count**	**Reported BACV**	**% BACV**	**Count**	**Reported BACV**	**% BACV**
NAIC 1	5	715,013,572	6.2%	-	-	-	-	-	-
NAIC 2	9	2,961,703	0.0%	-	-	-	-	-	-
NAIC 3	-	-	-	1	2,630,803	0.2%	-	-	-
NAIC 4	-	-	-	-	-	-	-	-	-
NAIC 5	18	110,531,073	1.0%	-	-	-	3*	9,762,289	3.1%
NAIC 6	163	968,700,137	8.3%	174	372,616,456	24.0%	3	60,615,371	19.1%
0 or None	1,053	9,833,347,990	84.5%	244	1,176,723,548	75.8%	93	247,310,888	77.8%
Total	**1,248**	**11,630,554,475**	**100%**	**419**	**1,551,970,807**	**100%**	**99**	**317,688,548**	**100%**

Note: For the life entities, all the NAIC 1s for life entities are reported as FE. For the NAIC 5, 8 of them are reported as 5GI with aggregate BACV of $1.2M

Residual Investments Involving Related Parties:

As shown, close to half (48% vs. 62% in 2022) of residuals owned by life entities involved related parties in some form (related party code 1 to 4). Most of these are from securitizations (or similar structures) with less than 50% of the underlying collateral in direct credit exposure (code 3).

Life				
Related Party Code		Count	Reported BACV	% of BACV
1	Direct credit exposure.	8	138,580,178	1.2%
2	Securitization with related party with 50% or more of the underlying collateral in direct credit exposure.	34	1,723,845,683	14.8%
3	Securitization with related party with less than 50% of the underlying collateral in direct credit exposure.	330	3,688,578,763	31.7%
4	Securitization where structure reflects an in-substance related party transaction, but does not involve a related party as sponsor, originator, manager, servicer, etc.	5	13,070,500	0.1%
5	Investment is identified as related party, but the role is a different arrangement from the prior options.	2	44,082,179	0.4%
6	Investment does not involve a related party.	855	6,022,397,172	51.8%
No Entry		14	0	0.0%
	Total	**1,248**	**11,630,554,475**	**100%**

Unlike life entities, the majority of residuals held by P/C (86%) and Health (94%) do not involve a related party.

P/C				
Related Party Code		Count	Reported BACV	% of BACV
1	Direct credit exposure.	7	15,584,624	1.0%
3	Securitization with related party with less than 50% of the underlying collateral in direct credit exposure.	17	111,499,671	7.2%
4	Securitization where structure reflects an in-substance related party transaction, but does not involve a related party as sponsor, originator, manager, servicer, etc.	1	7,096,432	0.5%
5	Investment is identified as related party, but the role is a different arrangement from the prior options.	3	83,133,797	5.4%
6	Investment does not involve a related party.	384	1,334,656,283	85.9%
No Entry		7	-	-
	Total	**419**	**1,551,970,807**	**100%**

Health				
Related Party Code		Count	Reported BACV	% of BACV
1	Direct credit exposure.	5	20,388,739	6.4%
5	Investment is identified as related party, but the role is a different arrangement from the prior options.	1	98,908	0.0%
6	Investment does not involve a related party.	92	297,200,901	93.6%
No Entry		1	-	-
	Total	**99**	**317,688,548**	**100%**

Note: Codes with zero entries were excluded from the P/C and Health Schedules above.

Impact of 45% RBC Factor – Refreshed for 2023 Riling Results.

Although company specific information cannot be shared publicly, estimated (@) individual company calculations of ACL RBC ratio, after removing the impacts of the 30% factor on the risk component totals going into the covariance adjustment and replacing them with the results of a 45% factor, was noted to have the following impact:

Percentage Change, in absolute term*	Number of Companies
> 5.0%	5
1.0% ≤ Percentage change <5.0%	19
0.5% ≤ Percentage change <1.0%	14
0.2% ≤ Percentage change <0.5%	19
0.1% ≤ Percentage change <0.2%	16
<0.1%	37
Total	**110**

@ The estimate does not take into consideration the effect of MODCO Reinsurance Adjustments, potential concentration factor/consideration and non-admittance of residual investments (if any).

* "Percentage Change in absolute term" is calculated by determining the percentage change in 2023 reported and estimated (@) ACL RBC ratios. For example, if a company reported an 860% ACL RBC Ratio and the application of the 45% factor within the estimation decreased ACL RBC to 859%, this would represent a 0.12% percentage change, in absolute terms | (859%-860%)/860%|. This exercise was completed for 110 of the life entities that reported ownership of residuals in Schedule BA as of March 13, 2024.

NAIC Staff also noted that none of the 110 companies analyzed above would trigger additional regulatory oversight prescribed for action levels such as Company Action Level, Regulatory Action Level, Authorized Control Level or Mandatory Control Level RBC, as a result of implementation of 45% factors. Coupled with the fact that over 95% of the companies experienced a less than 5% change in ACL RBC Ratio (as seen in analysis above), it was concluded that the 45% factor has inconsequential impact to the insurers' 2023 RBC.

Benchmarking BSL CLO Equity

Eric Kolchinsky

April 8, 2024

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Executive Summary

- This report attempts to benchmark the results presented in the Oliver Wyman (OW) Residual Tranche Risk Analysis date February 24, 2024.
- We focused on the results related to BSL CLOs as this constitutes our core expertise. In addition, it is not clear what is the total insurance company exposure to the other sectors.
- We sought to re-create the OW analysis using our 6 proxy CLO deals. The OW report was missing two critical pieces of information:
  - The total defaults (Cumulative Default Rates) for the portfolio in each of their scenarios. We attempt to reconstruct these.
  - The "Reference case" cash flows for the CLO Equity. This is the assumed carrying value of Equity on the insurance company balance sheet.

Overview

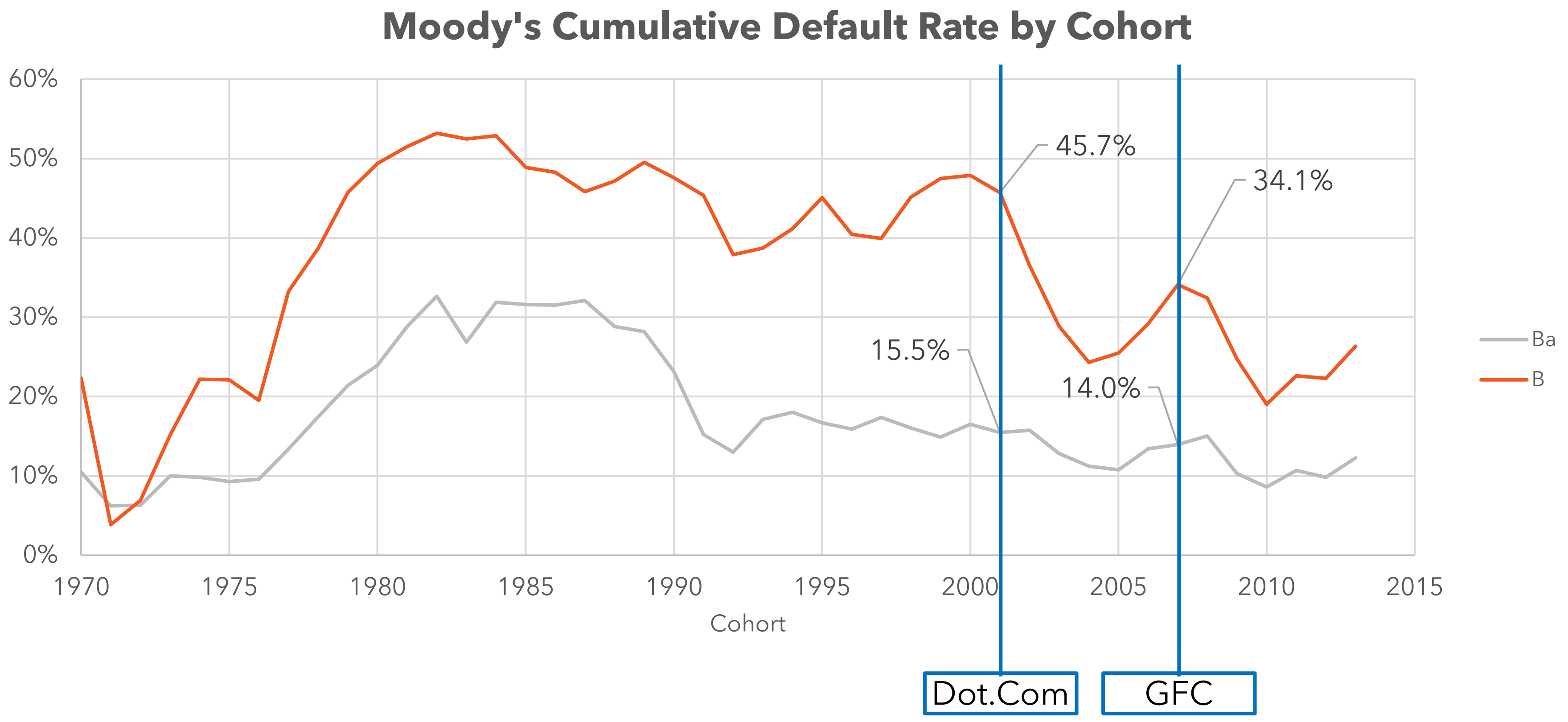
Below is a simplified procedure we employed to place the two scenarios (Dot.Com and GFC) within the context of our 10 scenarios:

1. Used Exhibit 47 of the 2023 Moody's Corporate Default Study: the 1/1/01 cohort for the Dot-Com bubble; and the 1/1/07 cohort for the GFC.
2. Cohort data is combined into rating categories by weights stated in the OW Paper.
3. Applied the portfolio weights to NAIC Default scenarios
4. Compared the two values at the 10-year level. The GFC scenario is analogous to the historical base case and the Dot.Com is analogous to the NAIC + 1σ.

Scenario	CDR
GFC Cohort	31.4%
NAIC Hist	31.6%
Dot.Com Cohort	40.2%
NAIC+1σ	40.4%
NAIC+2σ	49.3%

Attachment 2

Historical Moody’s Cohort Cumulative Default



Source: Moody’s Global Annual default study 2023; Exhibit 47

Reference Comparison

- Next step is to understand the loss to the investment. CLO Equity does not have a par value and does not promise the return of principal. Equity has a notional par, but that it is unrelated to any cash flows.
- To measure the risk of loss to the holder, a reference level for BACV needs to be assumed. In their analysis, OW calculates a value based on a constant default rate of 2.6% (approx. 23% over 10-yrs) and a discount of 12%. The actual assumed BACV is not provided.
  - NAIC staff believes that the base default rate used is too high and the discount rate is too low as market benchmarks. Nevertheless, it is difficult to understand the full impact of the decision without seeing the underlying cashflows.
- To overcome this limitation, we used a few common benchmarks to understand the losses.

Reference Benchmarks

- We used four benchmarks for the carrying value.
  - Two are less severe, NAIC default scenarios (Base and Hist -1).
  - We also used the simple rubric of Assets less Liabilities which marks the Equity "to book".
  - Lastly, we looked at the historical reporting for tranches identified as CLO Equity when they were reported on Schedule D. We used the ratio of BACV to Par Value for YE 21 to calculate an average 58 dollar price.

Scenario	Description
Hist. -1	NAIC historical default rates less 1 sd
Base	NAIC historical default rates
A-L	Assets minus liabilities
Schedule D	Historical reporting calculated as BACV over Par.

Results

- We used the previously generated cash flows from our 6 proxy deals available on our CLO website. (https://content.naic.org/sites/default/files/industry-ssg-clo-cashflow-20231208.xlsb)
- We compared the total Equity cash flows in the two stress scenarios (Historical plus +1σ and +2σ) against the various carrying value benchmarks.
  - Historical recoveries are used in these scenarios.
- Lastly, we take the minimum of the losses for each scenario.
- The Dot.Com cohort closely resembles the Hist +1σ scenario. As discussed before, the GFC corporate defaults were not significantly different from the base case. The Hist +2σ scenario is further provided as a reference.

Results

Hist+1σ

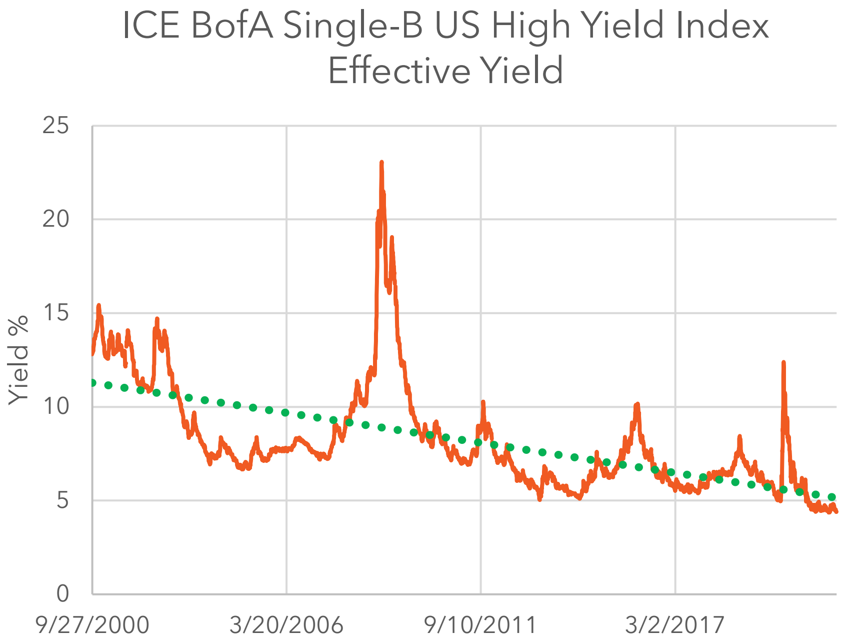
	ANCHC17	ARES LII	Carlyle	MAGN27	OHA3	Strata II
Sched D	80%	84%	70%	73%	80%	77%
A-L	83%	88%	80%	81%	76%	84%
Hist-1	88%	91%	78%	83%	82%	87%
Base Scen	60%	84%	45%	53%	58%	76%
Min Loss	**60%**	**84%**	**45%**	**53%**	**58%**	**76%**

Hist+2σ

	ANCHC17	ARES LII	Carlyle	MAGN27	OHA3	Strata II
Sched D	90%	89%	81%	84%	92%	89%
A-L	91%	92%	87%	89%	90%	92%
Hist-1	93%	94%	86%	90%	92%	94%
Base Scen	79%	89%	66%	72%	83%	89%
Min Loss	**79%**	**89%**	**66%**	**72%**	**83%**	**89%**

Discussion

- Based on our benchmarks, the OW paper understates the potential risks to BSL CLO Equity.
- The Dot.Com did see a spike in defaults in speculative grade issuers. However, CLOs were able to avoid a direct impact partially because the Federal Reserve lowered rates in response to the 9/11 attacks.
  - This helped floating rate issuers by reducing the cost of funds.
  - However, CBOs – backed by fixed rate bonds – imploded.
- The GFC did not materially impact the speculative default rate.



Note that the trendline above underestimates the cost of capital since very few issuers, issue at the spread peak.

Source: ICE BofA via FRED

Attachment 3

AMERICANS for TAX REFORM

722 12th Street, N.W. • 4th Floor • Washington, D.C. 20005

April 4, 2024

Mr. Philip Barlow
Chair, Risk-Based Capital Investment Risk and Evaluation (E) Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Oliver Wyman Report: *Residual Tranche Risk Analysis*

Dear Mr. Barlow:

Americans for Tax Reform (ATR)[1] appreciates the opportunity to comment on the National Association of Insurance Commissioners' (NAIC) proposed increase to the risk-based capital (RBC) charge for residual tranches and interests of asset-backed securities (ABS). ATR also appreciates the opportunity to comment on Oliver Wyman's (OW) report analyzing the risk of losses to the residual tranches and interests of ABS under certain stress scenarios.[2] **ATR requests that the NAIC delay the implementation of the 45 percent RBC charge by at least one year. If the NAIC fails to delay the implementation of the 45 percent capital charge, then the NAIC should vote to establish the interim charge for residuals at 30 percent.**

The NAIC is arbitrarily increasing regulations on life insurance companies that invest in residual tranches and interests of ABS.[3] It appears that the NAIC's goal is to push life insurance companies out of residual tranches without any quantitative analysis to justify this change. The implementation of the proposed regulations will disincentivize life insurance companies from investing in residual ABS tranches, which could increase the cost of Americans' life insurance and annuities. **ATR is deeply concerned the NAIC will deter financial companies from keeping life insurance and annuity products affordable for Americans.**

Third-party data and analysis provide evidence that NAIC's proposed regulations go too far. The OW report finds that common stock losses are higher than losses on residual ABS tranches on a portfolio level. The NAIC's proposed equity capital increase from 30 percent to 45 percent for residual ABS tranches is not commensurate with the residual tranche risk observed within the OW report. Meanwhile, the common stock charge is 30 percent. The OW report offers support for a 30 percent capital charge, not a 45 percent charge.

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[1] ATR is a nonprofit, 501(c)(4) taxpayer advocacy organization that opposes all tax increases and supports limited government, free market policies. In support of these goals, ATR opposes heavy regulation and taxation of financial services. ATR was founded in 1985 at the request of President Ronald Reagan.
[2] https://content.naic.org/sites/default/files/inline-files/Oliver%20Wyman%20Residual%20Tranche%20Report.pdf.
[3] https://content.naic.org/about.

Notably, another paper analyzing collateralized loan obligations (CLOs) found that "CLO equity exhibits a great deal of resilience to market volatility."[4]

ABS residuals offer significant returns to life insurance and annuities. Residuals are a "great return enhancer and fundamental diversifier."[5] These tranches and interests can also "play an effective role in generating return while keeping portfolio risk constant."[6] Increasing the RBC charge to 45 percent would limit life insurance companies' exposure to residuals, hamper returns, and increase costs for annuities that rely on those enhanced returns. Ultimately, American workers and retirees will bear the brunt of the increased RBC charge.

The NAIC's proposed regulations should be delayed by at least one year. If the NAIC fails to delay the implementation of the 45 percent RBC charge, then the charge should remain at 30 percent. This is more than reasonable considering the NAIC has not conducted a comprehensive cost-benefit analysis for increasing the RBC charge to 45 percent. Moreover, the OW report clearly shows the NAIC's proposed regulations are gratuitous. To date, no substantive quantitative analysis has been conducted to justify the NAIC's proposed 45 percent RBC charge for residuals.

Additionally, NAIC's proposed RBC charge should not be implemented simply to create parity with federal regulators' implementation of the Basel III Endgame bank capital requirements.[7] These bank regulations were originally formed by unelected bureaucrats in Basel, Switzerland. The NAIC should not implement rules for life insurance companies that will align with heavy-handed European-based regulations.

The proposed bank capital requirements arbitrarily punish securitizations by doubling the p-factor.[8] The increase in the p-factor fails to take into consideration the varying riskiness of different types of underlying collateral. So, the p-factor treats credit card debt and commercial paper as equally risky. Adding the NAIC's arbitrary RBC charge to residuals would unnecessarily, and without empirical evidence, label ABS as too risky for life insurance. The higher capital charges from the NAIC and the bank regulators will disincentivize banks and life insurance companies from adding exposure to securitizations. Life insurance companies will be forced to increase the cost of annuities, making them less attractive to American workers and retirees. Businesses "tend to pass on cost increases far more quickly than cost reductions."[9] Government-mandated capital controls will likely force life insurance companies to pass down these costs through annuities. It is widely observed that "[o]utput prices tend to respond faster to input increases than to decreases" in the producer and consumer goods markets.[10] Similarly, the cost of annuities will increase more quickly if the RBC charge for residuals increases to 45 percent.

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[4] https://w4.stern.nyu.edu/finance/docs/pdfs/Seminars/CLO-Performance.pdf.
[5] https://www.thornburg.com/article/think-abs-residuals-to-improve-your-risk-reward-trade-off/.
[6] Id.
[7] https://docs.house.gov/meetings/BA/BA20/20240131/116775/HHRG-118-BA20-Wstate-BashurB-20240131.pdf.
[8] https://www.federalregister.gov/d/2023-19200/p-564.
[9] https://www.cuna.org/content/dam/cuna/advocacy/priorities/documents/True-Impact-of-Interchange-Regulation-CornerstoneAdvisors-June-2023.pdf.
[10] https://www.jstor.org/stable/10.1086/262126.

NAIC's proposed regulations will force annuity providers to hold significantly more cash on hand. **Essentially, this will raise costs for consumers—acting as a *de facto* tax increase.** This is especially harmful to Americans considering the guaranteed lifetime income that annuities provide.[11]

The NAIC should not arbitrarily and capriciously increase the RBC charge for residual ABS tranches without a proper quantitative analysis. Since insurance is primarily regulated at the state level, state regulators wield significant power over the insurance industry. Although the NAIC is not subject to the *Administrative Procedure Act* (APA),[12] as a matter of proper due process, the NAIC should consider abiding by the APA's principles and allow for a structured notice-and-comment process that considers and analyzes hard data. Today, the NAIC possesses no hard evidence to suggest that raising the capital charge for residuals to 45 percent would provide any material benefits to life insurance companies or their clients.

One key element of ABS special purpose vehicles (SPVs)[13] is that they benefit from bankruptcy remoteness. Bankruptcy remoteness possesses advantages such as:

> *(i) the ability to segregate the assets to be financed such that they are held solely for the benefit of specific creditors and (ii) avoiding bankruptcy risks, costs, and delays including cram-down risk, the suspension of payments to creditors, and the limitations on enforcement actions against the [SPV] for nonpayment due to the automatic stay taking effect upon the filing of a bankruptcy case.*[14]

Legally isolating the securitized assets acquired by a SPV also gives ABS an advantage over corporate bonds and other non-securitized instruments. The "true sale" of assets creates a legal isolation between the SPV and the entity that originated the assets.[15] This structure "allows creditors financing the assets to focus on the credit quality of the assets rather than the credit quality of the originator, resulting in better financing terms for the issuer/borrower."[16] The "economic benefits" of bankruptcy remoteness "can significantly lower borrowing costs."[17] Increasing the RBC charge for residuals to 45 percent is more likely to worsen financing terms for annuities, not improve them.

The level of riskiness observed in ABS is further delineated by the NAIC itself. The NAIC has previously stated that "[a]sset-backed securities have proven over the years to be stable investments."[18]

The NAIC should avoid hindering American families from maximizing their nest eggs. Increasing the RBC charge for residuals to 45 percent would increase costs on annuities—effectively increasing costs on retirement options for American workers and retirees. Currently, there is no quantitative evidence to substantiate this RBC charge increase. **Consequently, ATR requests the 45 percent RBC charge on ABS residuals be delayed and remain at 30 percent.**

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[11] https://www.actuary.org/sites/default/files/2022-08/IB.SECUREact.8.22.pdf.
[12] https://www.justice.gov/sites/default/files/jmd/legacy/2014/05/01/act-pl79-404.pdf.
[13] https://am.credit-suisse.com/content/dam/csam/docs/articles/2022/cig-white-paper-collateralized-loan-obligations.pdf.
[14] https://www.choate.com/images/content/1/0/v2/104168/Bankruptcy-Remoteness-A-Summary-Analysis.pdf.
[15] Id.
[16] Id.
[17] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4178280.
[18] https://content.naic.org/cipr-topics/asset-backed-securities.

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ATR appreciates the opportunity to comment on the OW report and the proposed 45 percent RBC charge. If you have any questions or need any additional information, please contact Bryan Bashur at bbashur@atr.org.

Sincerely,

Americans for Tax Reform

cc: Mr. Dave Fleming
Senior Life Risk-Based Capital Analyst
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Submitted via electronic mail

Mr. Tom Botsko
Chair, Capital Adequacy (E) Task Force (CATF)
Via email: Eva Yeung (eyeung@naic.org)

Philip Barlow
Chair, Life Risk-Based Capital (E) Working Group (RBC IRE WG)
Via email: Dave Fleming (dfleming@naic.org)

Dear Mr. Barlow and Mr. Botsko:

As the President and CEO of the Florida State Hispanic Chamber of Commerce, I have always supported economic growth and free market principles to ensure success for all residents in our state. The strength of Florida's economy can be attributed to its free market practices. Following the recent National Association of Insurance Commissioners (NAIC) meeting, it seems the organization is seeking to stamp out competition that allows the free market to thrive. I find the precedent being set by the Risk-Based Capital Investment Risk and Evaluation Working Group (RBC IRE WG) and the Capital Adequacy (E) Task Force (CATF) troublesome. Both the RBC IRE WG's and CATF's decision to disregard objective, third-party data that they requested is concerning, and the findings should mandate a reexamination of the proposed 45% capital charge on residual tranches.

We've recently learned that many of the initiatives pushed by the NAIC are done so behind closed doors and not open to public input. However, this aggressive attempt at suppressing competition in the insurance market is open to public comment, and we'd like our voice to be heard. In the past, the NAIC has valued research and used data to drive its decisions, but now it seems like a lack of oversight has allowed the organization to run astray and be influenced by individual priorities and politics. The recent independent study conducted by Oliver Wyman provides validated data that demonstrates that asset-backed security (ABS) residuals don't have a higher risk, making the 45% charge in question unnecessary.

If the NAIC continues pursuing this charge, it would confirm that its real goal is to drive competition out of insurance markets, including life insurance and annuity markets. A frivolous 45% charge would clearly have an adverse effect on the market. The life insurance and annuity industry is critical to Florida's retirees, a community that primarily operates on a fixed income and would not be able to handle the impact of this proposed charge, which could reduce the number of affordable policies.

Further, this charge is also being proposed for property and casualty insurance companies, which would further increase costs in that market. As you know, Florida is experiencing an unprecedented crisis in the availability and affordability of homeowners insurance. Floridians are already leaving the state in droves because of skyrocketing insurance costs.[1] This is the

[1] https://www.newsweek.com/florida-faces-exodus-insurance-costs-cause-residents-leave-state-1838206

absolute worst time for regulators to arbitrarily raise costs. The effect of such increased costs will hit Hispanic communities particularly hard given that Hispanics are already substantially less likely to have homeowners insurance than the general population.[2] When insurers are prevented from investing in high-returning assets, they will be forced to minimize their offerings, which will lead to higher costs.

Unfortunately, the NAIC's recent actions are seemingly guided by political agendas rather than sound policymaking. The NAIC should be forging new ways to lower costs and provide more options for consumers, especially in states like Florida, not working to suppress the free market. I ask the NAIC to act in favor of data and in favor of consumers and vote in support of the one-year delay.

Sincerely,
Julio Fuentes
President and CEO of the Florida State Hispanic Chamber of Commerce

[2] https://consumerfed.org/wp-content/uploads/2024/03/Exposed-UninsuredHomes-1.pdf

Mr. Philip Barlow

Chair, Life Risk-Based Capital and Investment Risk and Evaluation Working Group

Dear Mr. Barlow:

As a former insurance commissioner who was active in leadership positions at the NAIC, as well as a former state legislator who served as Colorado House Majority leader and Speaker of the House, I have followed recent NAIC activity on structured securities very closely. Specifically, I write to support a one-year delay or a lowering of the risk charge to 30% until the data and full implications and potential unintended consequences of the "interim" 45% charge on residuals are better understood.

I have always sought to support substantive, innovative, and equitable policies that help maintain the health of the insurance market as governed by the states and state constitutions and support a diverse choice of insurance options for consumers. I am greatly concerned about the precedent being set by the Risk-Based Capital Investment Risk and Evaluation Working Group (RBC IRE WG). Recently published, objective, third-party data necessitates a delay and reconsideration of the implementation of the 45% capital charge on residual tranches.

The NAIC has historically maintained an approach that's underpinned by data as it works to drive agreement on policy that impacts all 50 states. A data-driven approach is especially important in areas of significant controversy around risk-based capital (RBC) charges – the nature of the accreditation system means that many state legislatures do not directly vote on policy changes that affect their state's policyholders.

In this case, rather than funding and conducting its own independent research, the NAIC asked for industry to fund and produce data regarding the proposed capital charge for residual tranches to inform a path forward. The recent study conducted by Oliver Wyman is the best response to this request the NAIC could have hoped for – the study provides a comprehensive third-party analysis demonstrating that asset-backed security (ABS) residuals don't represent a higher risk than other assets with a lower charge, which indicates that a 45% charge is too high. Should the NAIC forge ahead despite this analysis, the body would set a poor precedent for disruptive and frequent changes to the currently stable, long-term capital framework unsupported by data. I am concerned that such a move directly undermines the credibility of the NAIC and should in no way serve as a template for any future capital charge.

Given that the charge is likely to be permanent or long-term, it's vital to ensure that policy is decided carefully. It's not hard to imagine the cascading implications a 45% charge will have for stakeholders in the market. If insurers are blocked or dissuaded from investing in high-return and performing assets, insurers will likely have to shrink their offerings of affordable life insurance and retirement options to consumers.

This process has been accelerated due to ballooning fears of outsized risks that aren't substantiated. For example, the American Academy of Actuaries has stated that CLOs do not present a material solvency risk to the insurance industry.[1] In light of the Oliver Wyman study, I support the request by the American Council of Life Insurers (ACLI) that the NAIC postpone the implementation of the 45% charge for at least one additional year. During this time, regulators and stakeholders can carefully assess data in the Oliver Wyman study and any alternative proposals that account for the complexity of the asset in question.

Regulators should be accountable to consumers. It's unfortunate that the NAIC's recent actions seem to be guided by personal agendas and outside political pressure rather than sound policymaking. I implore the NAIC to do the right thing, maintain its credibility, and vote for a one-year delay so a data-driven result can be achieved.

Sincerely,

Doug Dean

Former Colorado Insurance Commissioner

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[1] American Academy of Actuaries C1 Work Group's (C1WG) December 14, 2022 presentation to the NAIC's RBC IRE. Slide 12: "In the C1WG's view, CLOs do not present a material risk to the aggregate solvency of the life insurance industry currently."

Attachment 6

MAX CARTER II
ASSEMBLYMAN
District No. 12

COMMITTEES:
Member
Commerce and Labor
Government Affairs
Growth and Infrastructure

State of Nevada Assembly

Eighty-Second Session

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Mr. Philip Barlow
Chair, Life Risk-Based Capital and Investment Risk and Evaluation Working Group

Mr. Barlow:
I find the RBC IRE Working Group's recent work on structured securities very troubling. As a member of the Nevada State Assembly, I understand the importance of deliberative, transparent, and informed policymaking. From what I've seen, the working group's actions are not indicative of the kind of rulemaking process my constituents and others across the country deserve. In fact, it seems unprecedented and in violation of the NAIC's standard operating procedures when making changes to risk-based capital (RBC).

Many people don't realize the broad impact the policies your organization put forward can have on their insurance options, livelihoods, and financial security. The NAIC was built around the idea that all state regulators should work together to develop the policies that fall under their jurisdiction, but the organization is now transferring that rulemaking authority to a small set of staff members and regulators pursuing agendas that clearly do not benefit consumers or protect markets from risk. Pushing through regulatory changes that don't reflect genuine consensus and the collective, informed preferences of all state regulators is a reckless way to make policy.

The working group has failed to follow standard NAIC practice in its efforts to change the risk factor for residual tranches. Specifically, the working group has already publicly signaled that it will mischaracterize and/or disregard reputable data related to the change, and it has failed to give the public an appropriate amount of time to provide public comment on that data. All of this has been done through a rushed process that only seems to be growing in breadth to include additional asset classes.

In fact, to many, it seems like your decision was already made — long before any calls for supporting data — and the process is now just a damn-the-torpedoes race to the finish line. This change will affect families, consumers, and businesses across the country, and it deserves the proper, responsible review it hasn't received. Unfortunately, it has also created a sense of doubt regarding the NAIC's credibility in this area. As a legislator, I take this very seriously, given that the policymaking done by the NAIC would otherwise rightly be in the purview of state legislatures and governments.

My hope is that the NAIC will change course and adhere to a credible process that allows for informed outside data and opinions and gives those it will affect the most an opportunity to understand and speak out against what is happening behind closed doors. Providing a one-year delay is one way the NAIC could do that, and I hope you take the opportunity to do just that.

Assemblyman Max Carter
Nevada State Assembly District 12

CC: RBC IRE Working Group.

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DISTRICT 26

GREAT SEAL OF THE STATE OF ARIZONA
DITAT DEUS
1912

COMMITTEES:
RANKING MEMBER
COMMERCE
MUNICIPAL OVERSIGHT &
ELECTIONS

Arizona House of Representatives
Phoenix, Arizona 85007

Mr. Philip Barlow
Chair, Life Risk-Based Capital and Investment Risk and Evaluation Working Group

Dear Mr. Barlow:

I believe strongly in the need for policies that are pro-consumer, pro-competition, and backed by data as a proud member of the Commerce Committee of the Arizona State House of Representatives. I am concerned about the NAIC Risk-Based Capital Working Group's (RBC IRE WG) insistence on implementing a 45% capital charge on the equity portion of asset-backed securities. Not only does the policy inhibit consumer choice and the competitive landscape of the life insurance and annuities market, but the process leading to this recommendation will set a dangerous standard for how the NAIC approaches policymaking. I am also concerned by the proposal pending in the Capital Adequacy Task Force to impose this increase on property and casualty and health insurers.

Historically, the NAIC has used a measured and researched-back approach to generate consensus when crafting insurance-related policies and guidelines. However, a handful of regulators, who certainly do not speak for the Arizona legislature or Arizona consumers, have abandoned this analytical and data-driven method to greatly accelerate the policymaking timeline with their attempt to quickly finalize a 45% capital charge. Now, research performed by a respected outside consultant, Oliver Wyman, demonstrates that asset-backed security (ABS) residuals don't carry higher risk. We have the exact data necessary to declare a 45% charge to be ill-advised and not needed, research that the NAIC should conduct itself before making major policy changes.

Not only has the RBC IRE working group failed to follow standard NAIC processes and give the public enough time to comment as it advances a change to the risk factor for residual tranches, but it has also failed to consider the negative effects this policy will bring about for consumers. If higher costs are to be tacked on to asset-backed securities, insurers will be dissuaded from investing in these reliable and high-return assets. I am very concerned that this change will hinder important markets, such as student loans, credit cards, lending to small businesses, and lending to finance the energy transition. These are all critical priorities, nationally, in Arizona, and among my constituents. In addition to restricting lending, in the wake of restricted insurer investment returns, the availability of premium insurance product offerings will be reduced, while costs for consumers soar.

The effect on the availability and affordability of life insurance and retirement products is of particular concern for my state and others with similar demographics. More than 17% of Arizonans are of retirement age, putting us at 12th in percent of the population aged 65 years and older in the U.S.[1] Hard-working Americans who are trying to plan for their futures deserve a wide array of retirement and financial planning options. It is unfortunate that a handful of regulators are poised to take this away from them with a misguided approach.

I implore the RBC IRE working group to change course and delay the implementation of the 45% capital charge on residual tranches for at least one year. The opportunity is before you to not only rectify the policy at hand to be more consumer and competition-friendly but also to restore credibility to the NAIC in its policymaking process. I sincerely hope you seize it.

Sincerely,

Representative Cesar Aguilar (D-26)
Arizona House of Representatives
CC RBC IRE Working Group

[1] Maricopa Association of Governments: "Age Friendly Arizona and Older Adult Demographics"

THE BUCKEYE INSTITUTE

April 5, 2024

Mr. Philip Barlow, Chair
RBC Investment Risk & Evaluation (E) Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Via email: **dfleming@naic.org**

Dear Mr. Barlow:

As an independent research and educational institution advancing free-market public policies in the states, **The Buckeye Institute** works to **reform regulatory codes and cut burdensome red tape.** The Buckeye Institute's recommendations have helped eliminate or relieve the burdens of more than 50 occupational licenses and have stricken hundreds of unnecessary regulatory restrictions from the Ohio Administrative Code.

With respect to the current proposal from the National Association of Insurance Commissioners (NAIC) to increase the risk charge for residuals, The Buckeye Institute recommends caution and joins the industry and other interested parties in calling for NAIC to allow more time to collect additional data. Without comprehensive data collection, new requirements of this magnitude could inflict unintended harms if implemented prematurely.

NAIC is right to protect insurance consumers from unsound corporate practices, especially as insurers acquire larger shares of opaquely structured securities. But such investments in a properly balanced portfolio also earn higher returns for insurers, which can help reduce consumer costs and premiums. Consequently, insurers and regulators must appropriately balance the risks and rewards of regulating insurer investment portfolios and strategies.

The Buckeye Institute has reviewed the report conducted by the management consulting firm Oliver Wyman (OW) and recently submitted to your office by the Alternative Credit Council. The well-designed study examined multiple risk scenarios for various asset classes and determined that residuals carried lower risk than equity in common stock. The OW study should not be dispositive, but it does challenge the prudence of rapidly increasing the current equity capital requirement from 30 percent to 45 percent. At the very least, it supports the call for more evidence that higher capital requirements will improve consumer safety. Without additional evidence, the proposed jump to 45 percent appears arbitrary and deviates from NAIC's typically data-driven approach to modifying risk charges.

Imposing higher risk charges and cash-on-hand requirements too fast and with insufficient supporting data will likely stifle innovation in the life insurance market and compel insurers to charge higher premiums to offset lower investment returns—an unintended harm to consumers. And given the credible data undermining the rationale for the proposed changes and the industry's request for further study, adopting the new requirements without reconsideration will weaken the industry's faith in the regulatory process as it questions NAIC's motives for proceeding unabated—another unintended harm.

Rather than risk these outcomes, NAIC should temporarily pause its proposal for one year to solicit further input and collect additional data on the risk-profile of residuals. That will allow NAIC to best calibrate the risk charges and achieve the right balance of risk and reward. A temporary pause will enhance rule-making transparency and reassure the regulated industry that NAIC makes important decisions prudently, methodically, and fully supported by hard evidence.

Sincerely,
Rea S. Hederman Jr.
Vice President of Policy
The Buckeye Institute

Mr. Philip Barlow
Chairman
Life Risk-Based Capital (E) Working Group

Dear Mr. Barlow:

A functioning, vibrant free market is the heart of the American economy. Competition drives innovation and ultimately gives consumers various options at fair prices for the goods and services they seek. This principle should apply across all sectors of the economy, including the life insurance and annuities market. These products represent valuable tools that Americans from all backgrounds and income levels can use to plan for retirement, provide for their families, and incorporate into their long-term financial planning.

The recent moves by the National Association of Insurance Commissioners (NAIC), particularly the Risk-Based Capital Working Group, demonstrate a fundamental disregard for the importance of innovation in the marketplace. The proposed 45% capital charge on asset-backed securities would do a great disservice to consumers by shrinking the offerings of life insurance and annuity policies available to them while raising the costs of those that are offered.

The proposed charge is even more troubling because it appears to not only be misguided but also predetermined. The working group has received a public study conducted by an independent researcher demonstrating that the risk the proposed charge attempts to address is nonexistent. Per Oliver Wyman, the assets in question actually carry less risk than other assets commonly held by insurers, which are not subject to a higher charge.

The research is decisive and available for all to see. It is troubling that the working group continues to press forward with a punitive measure aimed at risk that does not exist in the data. If the higher charge is adopted, the NAIC will not only embrace a policy that ultimately hurts consumers, but it will undermine its own credibility.

I ask that the Risk-Based Capital Working Group and the NAIC follow the data that is readily available. The proposed 45% capital charge is not only unnecessary, but it's harmful to consumers and markets. The NAIC should put a stop to it before its effects can be felt.

Thank you,

Tom Swatzel
Founder
South Carolinians for Responsible Government

The American Consumer Institute
Center for Citizen Research

April 8, 2024

Philip Barlow
Chair, Risk-Based Capital and Investment Risk and Evaluation Working Group
National Association of Insurance Commissioners

Re: Oliver Wyman Study on Residual Tranches and Interests

Dear Mr. Barlow:

The American Consumer Institute is honored to present the National Association of Insurance Commissioners (NAIC) with comments on its proposal to raise the risk-based capital (RBC) charge for residual tranches and interests of asset-backed securities (ABS) from 30 percent to 45 percent for life insurance companies. The effects of limiting financial options on life insurance policyholders are of great concern to us, particularly because the proposal will limit the availability and affordability of such a vital resource.

Life insurance provides financial solace for those who hold these policies and can be integral in supporting families after the passing of a household's primary breadwinner. The difference in feelings of financial security between those with and without life insurance is stark.[1] While nearly 70 percent of those with life insurance feel financially secure, less than half of those without insurance can say the same.

Furthermore, after just six months, nearly half of Americans say they feel the financial burden of losing their household's primary wage earner. Life insurance helps to provide families with the cushion they need to stave off the inevitable financial burdens of a loss. Even if a policy is never used, the peace of mind that it grants is still immeasurable to working families.

There is little debate that life insurance policies are beneficial. However, rules that limit investment opportunities for life insurance policyholders threaten to limit availability and affordability. Similar to the proposal from the Federal Reserve to impose "Basel Endgame"[2] requirements on banks, this sharp increase in RBC charges would

[1] Michael Jones, "Life Insurance Statistics and Industry Trends to Know in 2023," Annuity, January 24, 2024, https://www.annuity.org/life-insurance/statistics/#:~:text=About%252050%2525%2520of%2520Americans%2520do,compared%2520to%252046%2525%2520of%2520women.
[2] "Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity," Federal Register, September 18, 2023,

functionally limit the investments into residual tranches and ultimately hinder ABS.[3] These investments are high-performing and can offer life insurance holders greater access to financial markets. High RBC charges amount to cash-on-hand requirements, limiting investment capital which earns interest, and helping life insurers cover customers.

The report by Oliver Wyman on the risk of losses to residual tranches and interest of ABS under various stress tests does not lend support for a 45 percent RBC charge.[4] Instead, the Wyman report indicates that a 30 percent RBC charge would best satisfy risk, making the proposed 45 percent charge unsubstantiated by testing. For the NAIC to continue implementing the current proposal would essentially create an arbitrary RBC charge that would unnecessarily limit life insurance policyholders' access to financial options.

The NAIC should not implement this rule change. At a minimum, the NAIC should hold off on rule implementation for at least a year and conduct further risk-based testing to substantiate the increase in RBC charges to 45 percent, or the charge should be set at 30 percent as the Wyman report concludes. Anything else would endanger Americans' access to valuable financial tools which could be the difference between having or not having access to health insurance.

Based on our analysis of the proposal, we conclude that consumers would be harmed in two major ways. First, the increase in RBC charges would drive the costs of life insurance and annuities up because the charge would artificially reduce insurer investment returns. As a result, insurers would have to pass this cost on to consumers. This is happening at the very time that more Americans are facing retirement insecurity and need to protect their families.

Second, the increase in RBC charges would hinder the origination of lending to consumers, because many originators of consumer loans require securitization to finance such lending. Thus, making these securitization structures/investments less attractive by jacking up the risk charge would significantly reduce demand and make consumer loans more expensive.

Considering life insurance provides benefits both in peace of mind and financial ease following losses, it is incumbent upon policymakers to not unnecessarily limit its

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https://www.federalregister.gov/documents/2023/09/18/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant.

[3] Bill Hulse, "How New Banking Rules Might Harm Your Business," U.S. Chamber of Commerce, November 6, 2023, https://www.uschamber.com/finance/how-new-banking-rules-might-harm-your-business#:~:text=As%20a%20whole%2C%20increasing%20capital,by%20more%20than%2020%20percent.

[4] "Oliver Wyman Residual Tranche Report," Alternative Credit Council, February 26, 2024, https://content.naic.org/sites/default/files/inline-files/Oliver%20Wyman%20Residual%20Tranche%20Report.pdf.

availability through the implementation of RBC charges that are higher than what is supported through stress testing.

If you have any questions, we can be reached on 703-282-9400.

Respectfully submitted,

Steve Pociask
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April 8, 2024

Mr. Philip Barlow, Chair
Chair, Risk-Based Capital Investment and Evaluation (E) Working Group
National Association of Insurance Commissioners
c/o Dave Fleming
Via Email: dfleming@naic.org

Mr. Tom Botsko
Chair, Capital Adequacy (E) Task Force
National Association of Insurance Commissioners
c/o Eva Yueng
Via Email: eyeung@naic.org

RE: Oliver Wyman Residual Tranche Risk Analysis and Proposal 2024-02-CA

Dear Mr. Barlow and Mr. Bostko,

Thank you for the opportunity to comment on the Oliver Wyman Residual Tranche Risk Analysis and Proposal 2024-02-CA. The following is submitted on behalf of the member companies of the National Association of Mutual Insurance Companies (NAMIC).

NAMIC has more than 1,500-member companies representing 40 percent of the total U.S. property/casualty insurance market. NAMIC member companies serve more than 170 million policyholders and write more than $323 billion in annual premiums. Our members' direct written premiums account for 67 percent of homeowners' insurance and 55 percent of automobile insurance. Through NAMIC advocacy programs it promotes public policy solutions that benefit NAMIC member companies and the policyholders they serve and fosters greater understanding and recognition of the unique alignment of interests between management and policyholders of mutual companies.

NAMIC is writing to express our support for an additional one-year implementation delay of the increased 45% capital charge on asset-backed security (ABS) residual tranches and interests.

As noted by the American Council of Life Insurers (ACLI) at the March National NAIC meeting, the insurance industry is aligned that regulators and stakeholders must thoroughly assess new data and discuss and evaluate all residual tranche charges to ensure that they align with the actual risk. Aligning risk with capital is also consistent with a foundational principle of the recently proposed Holistic Framework – equal capital for equal risk.

We believe that providing an additional year will allow additional analysis, including by the Academy of Actuaries, to help the regulatory community arrive at an informed decision and produce specific recommendations that are based on fact, and specific to individual types of assets. This additional year can provide an opportunity for understanding the impact to property and casualty companies, as opposed to assuming the risk is the same as the life industry. Unlike the life risk-based capital calculation, there is no current mechanism for assigning a property/casualty Schedule BA asset charge by investment type. Such a change in charge is significant and should be supported by a holistic review of the treatment of property/casualty Schedule BA investment types in general, rather done in isolation for one specific investment type, such as residual tranches. This concern also supports the need for additional analysis.

Thank you for your consideration of our views and your support for a process that provides consistent rigor and standards when evaluating insurance company investments for purposes of changing RBC.

Sincerely,

Colleen Whiting Scheele

Colleen W. Scheele, Public Policy Counsel and Director of Financial and Tax Policy
National Association of Mutual Insurance Companies

April 8, 2024

VIA ELECTRONIC SUBMISSION

Mr. Philip Barlow
Chair, Risk-Based Capital Investment Risk and Evaluation (E) Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: RBC Factor for Asset-Backed Security Residual Tranches – Oliver Wyman Report

Dear Mr. Barlow,

The American Investment Council ("AIC")[1] appreciates the opportunity to comment on the Risk-Based Capital Investment Risk and Evaluation (E) Working Group ("RBCIRE") exposure of Oliver Wyman's *Residual Tranche Risk Analysis* ("OW Report") that was released for public comment on March 17, 2024. As always, we appreciate the RBCIRE's willingness to receive input from interested parties on its important workstreams.

The OW Report is responsive to the RBCIRE's request for interested parties to provide data regarding whether the "interim" 45% RBC charge for asset backed securities ("ABS") residual tranches is a reasonably conservative factor.[2] The OW Report evaluates the potential for losses in the residual tranches of commonly-held types of structured assets and assesses how they compare with the historical losses for other asset classes. Among other things, the OW Report concludes that ABS residual tranche investments realize lower losses on a portfolio-level than common stock under corresponding stress levels. This conclusion, and others noted in the OW Report, appear to be consistent with other reputable studies that analyze similar issues.[3]

Taken together, these materials support a conclusion that the current 30% RBC charge is likely a more "reasonably conservative factor" for residual tranche investments than the 45% charge that is

[1] The AIC is an advocacy, communications, and research organization established to advance access to capital, job creation, retirement security, innovation, and economic growth by promoting responsible long-term investment. The AIC's members include the world's leading private equity and private credit firms, many of which partner with insurers to achieve their long-term investment objectives and ensure the continued success of insurers and their policyholders. Among other things, by adopting appropriate, risk-adjusted investment strategies, our members are committed to helping secure the retirement of millions of pension holders and to policyholder protection. For further information about the AIC and its members, please visit our website at http://www.investmentcouncil.org.

[2] The "interim" 45% RBC charge for residual tranches was adopted by the RBCIRE in 2023 for the 2024 reporting year. As adopted, the amendment will result in a 50% (or 15 percentage point) increase to the RBC charge applicable to ABS residual tranches as so reported on Schedule BA of the Annual Statement for life insurance companies and fraternal benefit societies.

[3] *See e.g.*, our letter to the RBCIRE dated May 12, 2023 entitled *Comments regarding Risk-Based Capital Investment Risk and Evaluation (E) Working Group 2023-09-IRE Residual Factor Proposal,* which is memorialized in the NAIC 2023 Summer National Meeting Minutes at pages 2057-2059, available at: https://naic.soutronglobal.net/Portal/Public/en-US/DownloadImageFile.ashx?objectId=10416&ownerType=0&ownerId=26573.

currently slated to take effect for the 2024 reporting year. Stated differently, **we interpret the OW Report as establishing that the 45% charge is unreasonably conservative.** At minimum, the RBCIRE should afford itself and interested parties additional time to assess the valid issues raised by the American Council of Life Insurers ("ACLI") and other interested parties during the March 17 meeting, including obtaining additional information from Oliver Wyman and considering whether it is inappropriate to apply a single RBC factor to all ABS residual tranches. We urge the NAIC and RBCIRE to consider the differences between ABS categories and the adverse effect that an unreasonably conservative single residual RBC factor could have on lenders' willingness to originate loans and the real economy more broadly.

In light of the foregoing, **we respectfully request that the RBCIRE retain the current 30% RBC factor for ABS residual tranche investments for an additional year in order to give regulators and interested parties time to evaluate whether a 45% charge is unreasonably conservative relative to other equity RBC factors.** We welcome the opportunity to serve as a resource to the RBCIRE as it considers both "interim" and "long-term" regulatory frameworks for ABS and would be pleased provide insight into our members' perspective on these issues.

Sincerely,

/s/ Rebekah Goshorn Jurata
General Counsel
American Investment Council

cc: Mr. Dave Fleming
Senior Life Risk-Based Capital Analyst
National Association of Insurance Commissioners (via email)

Amnon Levy
Bridgeway Analytics
Amnon.Levy@BridgewayAnalytics.com

April 8, 2024

Risk-Based Capital Investment Risk and Evaluation (E) Working Group
National Association of Insurance Commissioners
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Oliver Wyman Residual Tranche Report

Dear Associate Commissioner Barlow,

On behalf of Bridgeway Analytics, I am grateful for the opportunity to comment on the Oliver Wyman Residual Tranche Report. Our objective for submitting this comment should be interpreted as advocating for a thoughtful, long-term solution for the treatment of asset-backed securities (ABS) and their residuals, and we do not suggest using our analysis, in its current form, for quantitative inferences regarding a C-1 charge for corporate equity or CLOs across the rating spectrum. While the content in this document is informed by extensive discussions with our client base, the broader industry, NAIC staff, and state regulators and may contain analysis that Bridgeway Analytics had conducted as part of a commercial engagement and retains the right to reuse, the views in this document are solely those of Bridgeway Analytics and are based on an objective assessment of data, modeling approaches, and referenced documentation, that in our judgment and experience, are viewed as appropriate for the analysis at hand. For additional context, analysis in our comments includes Bridgeway Analytics research that may have elements that originated with commercial engagements that have *never been shared with a client as part of a paid engagement*.

Our comment letter has two sections:

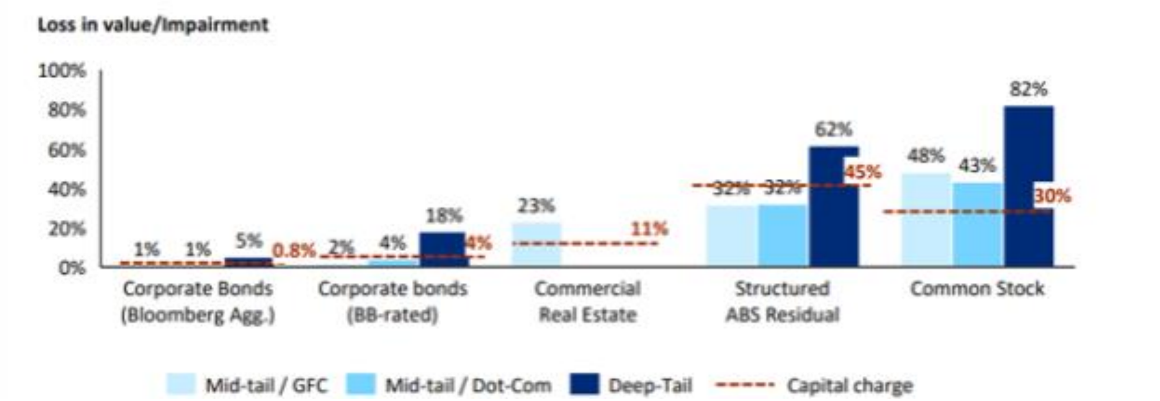
- A review of the Oliver Wyman study in the context of the C-1 framework. We focus entirely on the technical aspects of the approach. While we do not dismiss valuable lessons from the study, the methods depart from those used to estimate C-1 charges for bonds, equity, and other assets in several dimensions, including a lack of consideration for portfolio concentration and diversification effects. In addition, the study takes on the significant effort of assessing past experience and estimating baseline and stress loss scenarios across different markets, which is no easy task and requires a heavy dose of professional judgment. We conclude that differences in approaches can result in significant differences in risk assessments.
- Our own analysis of data to differentiate the risks of CLO residuals and those of other asset classes. We hope the American Academy of Actuaries and the broader community can leverage the analysis to expedite their long-term efforts to differentiate the RBC C-1 treatment of structured assets and possibly other asset classes. We draw two conclusions from our analysis:
    - Not all corporate equity or CLO residual interests exhibit the same risks, and ‘comparable attributes,’ defined by the American Academy of Actuaries in their *Principles for Structured Securities RBC* presentation in Attachment C, can help identify those risks.
    - The patterns are consistent across different lenses, suggesting differentiated tail risks of CLO residuals can be estimated for C-1.

In our opinion, a more thorough set of empirical calibrations and an assessment of other classes of ABS residuals needs to be conducted. A more thorough analysis of tail risks would require calibrated simulation methods that consider diversification and concentration risks across ABS residuals, which we discuss in *Section 2.2.2*. In addition, our results have us strongly support the Academy's approach to identifying 'comparable attributes' when differentiating risks of asset classes broadly, beyond ABS debt and their residuals.

1 A Review of the Oliver Wyman Study in the Context of the C-1 Framework

The Oliver Wyman study analyzes a random sample of ~30 residuals for several classes of ABS, including CLOs, auto loans, and student loans. Losses were estimated along tail scenarios designed for each class of ABS (e.g., loan default rates for CLO). The study concludes that, on a portfolio basis, ABS residuals perform better than common equity under all modeled stress scenarios. The study finds that losses on corporate equity (82% and 43-48%) are higher than ABS residuals (averaging 62% and 32% across ABS residuals) in the Deep-Tail and Mid-Tail stress scenarios, as represented in Figure 22 from the study, which we reproduce.

Figure 22: Capital charges compared to modeled scenario losses for selected asset classes[30]



The letter argues that the study provides ample evidence that more diligence should be done before imposing the 45% interim capital charge, with delayed implementation of changes to allow for further consideration of data put forth by interested parties.

1.1 Useful Insights

The study shares several insightful observations that we hope the community can incorporate into their understanding of ABS residual risks.

- **Characteristics that affect the potential losses on residual tranches**. The study finds residual tranche thickness and the rating of the next-most junior (i.e., the junior-most rated tranche) tranche can help differentiate losses on residuals, where thicker tranches are often associated with lower expected losses. To their credit, the study segments the residual tranche thickness by ABS class, which is critical given the significant heterogeneity in collateral risk characteristics across classes. However, risk characteristics within a class can also exhibit significant variation, resulting in inherent challenges in its use within this context. Meanwhile, agency ratings consider both thickness and collateral risk, which provides a measure that is normalized across ABS classes, in aspiration at least. This is an important point in the context of differentiating RBC C-1 using 'comparable attributes,' which we explore at greater length in *Section 2* below.
- **Analyzing risks across classes of ABS**. The study takes on the significant effort of assessing past experience and estimating baseline and stress loss scenarios across different markets, which is no easy task. We note limitations with our analysis, which focuses only on CLOs and does not attempt to take on this effort. Assessing a baseline default rate for corporates alone, for example, can lead one to significantly different conclusions depending on the market segment (e.g., broadly syndicated loans versus corporate bonds) and sample period; S&P provides useful context in A Tale of Two Markets: Credit Dispersion Characterizes U.S. Leveraged Finance

in 2024. Choosing comparable baseline and tail scenarios across, say, corporate credit, auto loans, and student loans requires a heavy dose of professional judgment. Notice, for example, that the study estimates loss on common stock for a scenario argued to be comparable to 95% at well over 40%, rather than the 30% that represents the 94% 2-year loss on the S&P 500 between 1960 and 1991 which was used to estimate C-1. That being said, the study highlights the wide-ranging performance across ABS classes and the wide-ranging risk factors that drive performance, which speaks to the possible diversification benefits of investments across different classes of ABS.

1.2 Additional Needed Analysis

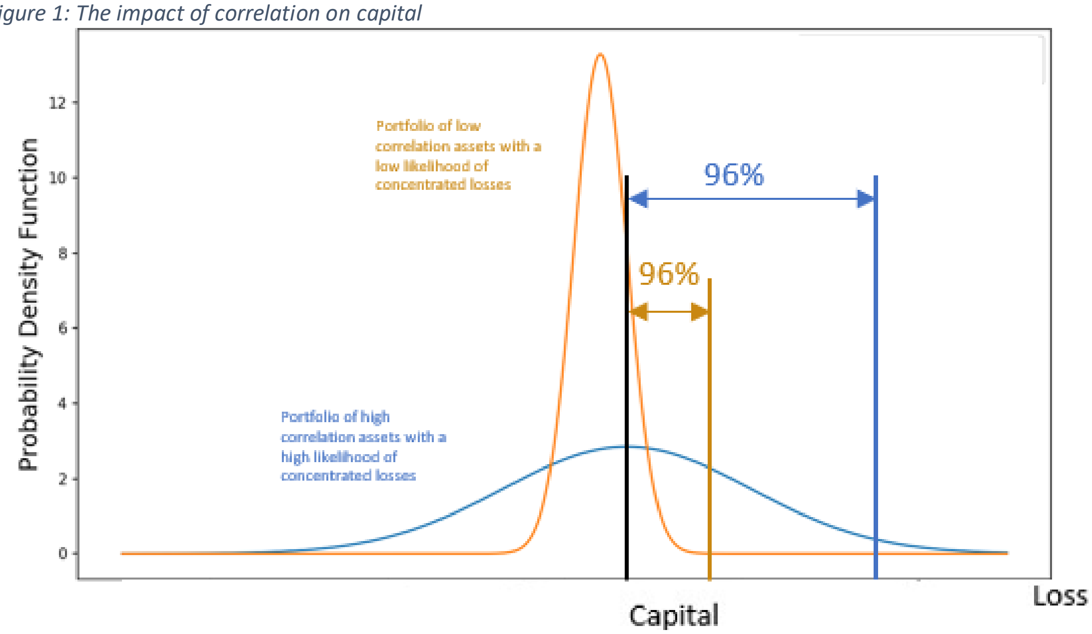
We now point to areas requiring additional analysis for the study to more closely align with approaches used to estimate C-1 charges for bonds, equity, and other assets.

1.2.1 Considerations for concentration and diversification when assessing portfolio tail risk

The study applies the same scenario to all residuals within a class of ABS, implying that the loss rates on the collateral pool are the same across all deals for each scenario. The loss rates would only be identical across the deals if the performance of the collateral pools were perfectly correlated, which could only be the case if all CLOs hold the same collateral loans - they don't. This departs from the RBC C-1 framework, where diversification and concentration effects are considered. C-1 bond factors measure the expected tail loss on a large portfolio of bonds and attribute that loss to a bond with a particular rating (e.g., A-rating), with considerations for their correlation and diversification, providing an assessment of the likelihood of concentrated loss. Similarly, the C-1 common stock factor is estimated using the S&P 500, which by its nature incorporates the correlation and diversification associated with its constituents, assessing the likelihood of concentrated loss. For context, the annual volatility on the S&P 500 is in the order of 20%, while the annual volatility on any single corporate is generally in the order of 60%-90%.

Visually, a portfolio of highly (low) correlated assets can lead to a higher (lower) likelihood of concentrated losses, as depicted in blue (orange), and should be assigned a higher (lower) capital.

Figure 1: The impact of correlation on capital



The challenge partly stems from the market convention of CLOs and ABS, which are generally analyzed using scenario analysis in the spirit of the study. Unfortunately, those scenario-based tools are not designed to capture concentration diversification and concentration risks of CLO or ABS residual portfolios.

1.2.2 The framework should aspire to backtest and represent observed dynamics experienced historically

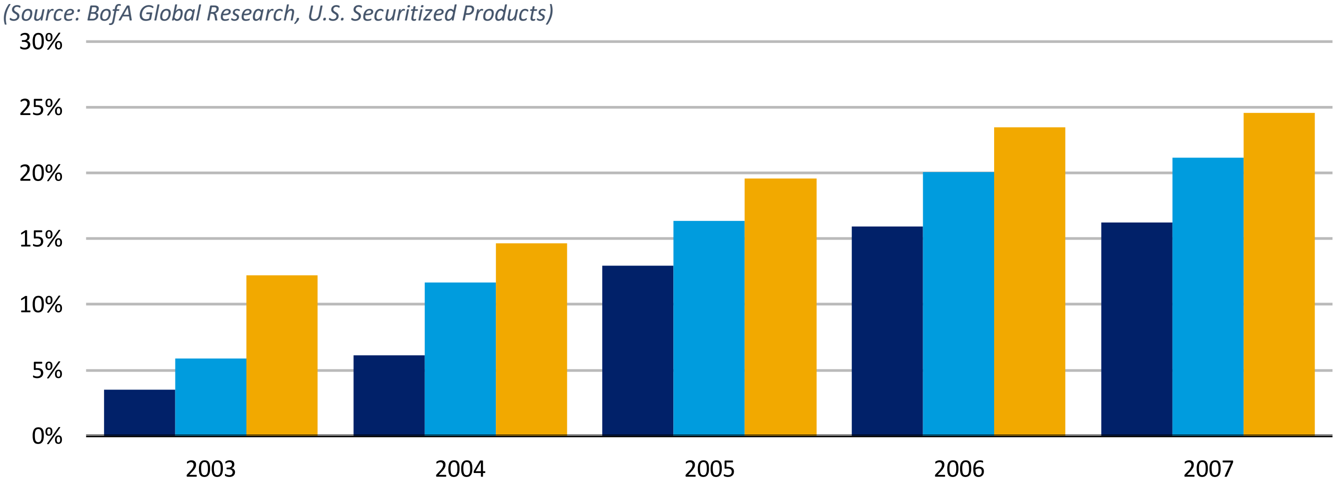
The study finds that ABS residuals experience broad performance in the mid-tail scenarios, ranging from the low teens to 45% (*Table 7*, reproduced from the Oliver Wyman study). For broadly syndicated loan (BSL) CLOs, an important asset class for insurers, average losses for residuals through the Great Financial Crisis (GFC) are estimated at ~45%.

Table 7: Portfolio average losses for all modeled assets across stress scenarios

Scenario Severity	Scenario	CLOs (BSL)	CLOs (MM)	Student loans	Subprime auto loans	Prime auto loans
95th percentile	Dot-Com	-45%	-27%	-	-	-
	GFC	-42%	-25%	-	-17%	-13%
	Mid-tail	-	-	-16%	-	-
	Long Mid-tail	-	-	-	-22%	-14%
99th percentile	Deep-tail	-72%	-55%	-20%	-74%	-26%

The 45% contrasts sharply from what transpired. A recent study by Bank of America Securitized Products Research, 2024 Year Ahead Outlook (CLO) CLO Outlook: A Tale of two CCCs, includes the lifetime profitability of residual interests of redeemed deals that originated just prior to the GFC and experienced the actual GFC; few deals originated through the crisis, with volume picking up in 2011. The Bank of America study highlights the significant positive lifetime annualized internal rate of return (IRR) (*Figure 2* reproduces parts of Exhibit 146 from the study). Another reference can be seen on the right-hand side of *Figure 3* below, which demonstrates that over 50% of CLO residuals maintained a positive return over 2-year windows straddling the GFC. While some residuals experienced losses over this period, the Bank of America analysis demonstrates they generally recovered, generating significant profits over their life. A formal statistical analysis demonstrating the strong performance of residuals through the GFC can be found in CLO Performance.

Figure 2: Annualized lifetime IRR for CLO residuals of redeemed deals by vintage – median, 25% and 75%
(Source: BofA Global Research, U.S. Securitized Products)



While the study acknowledges the modeled losses differ from the observed performance of CLO residual tranches during the GFC, pointing to several factors, including simplified modeled assumptions (see footnote 25 in the study), the significant difference between the modeled outcome and the actual performance (i.e., model backtesting) raises the question over the degree to which quantitative inference can be extracted from the ~45%.

2 Data to Differentiate Residual Risks

In this section, we present an assessment of CLO residual data that may be used to estimate their risks in the context of the C-1 framework, recognizing nuances such as the need to consider portfolio diversification/ concentration effects. As explained above, we believe that the analysis supports the American Academy of Actuaries to expedite the long-term efforts to differentiate the RBC C-1 treatment of structured assets and, in the process, provide insights to the broader community on the risks associated with the asset class. In its current form, we do not intend our analysis to be used to infer an appropriate interim charge for ABS residual interests.

We draw two conclusions from our analysis:

- Not all corporate equity or CLO residual interests exhibit the same risk, and 'comparable attributes' (as defined by the American Academy of Actuaries in Attachment C) can help differentiate those risks.
- The patterns are consistent across different lenses, suggesting differentiated tail risks of CLO residuals can be estimated for the purpose of C-1.

As referenced in the introduction above, we believe a more thorough set of empirical calibrations and an assessment of other classes of ABS residuals are needed. A more thorough analysis of tail risks would require calibrated simulation methods, which we discuss in *Section 2.2.2*.

2.1 Assessing Data to Differentiate Portfolio Risks

Two core elements of our approach allow us to arrive at the conclusions we outline above:

- **Comparable attributes**. We use the rating of a CLO's most junior tranche as an identifier of the risk of its residual interest. In spirit, the risk profile of operating company equity or ABS residual interests is determined by the predictability of cash flow generated by the respective business model and leverage to which those interests are junior claimants. The likelihood that the junior most tranche is impaired represents the same likelihood that the residual incurs a significant loss.[1]
- **Measuring risk in the context of the C-1 framework**.
    - We assess the data for estimating residual risks following the approach used for estimating C-1 for common stocks, in spirit. There are several motivating factors:
        - Classifying an investment fund as an equity interest (i.e., common stock) of an operating company or residual interest of an ABS under the bond definition is determined, in part, by how the fund is structured (e.g., its capital structure). For example, Business Development Companies (BDCs) face leverage restrictions by the SEC and are classified as common stock, while CLO residuals tend to be more heavily leveraged and are classified as those of ABS. In

[1] The approach can be formalized through a structural economic framework developed by Merton, Hull, and White (Merton's Model, Credit Risk, and Volatility Skews) and Vasicek (Modeling Default Risk). Intuitively, the framework would build off of the three main elements that determine the likelihood of a residual tranche experiencing loss:

1. The value of underlying collateral.
2. Risk or uncertainty with the value and predictability of cash flows of the underlying collateral.
3. Leverage, represented by the contractual liabilities.

Notice that the value of the underlying collateral and leverage represents tranche thickness, which is a key determinant of the risk of a residual. Agencies ratings generally also consider the risk profile of the underlying assets, which is equally critical in assessing the risk of residuals.

that regard, the consideration for the relative capital treatment of equity and residuals should be tied to considerations with their classification.
    - The accounting treatment under scenarios where residuals are incurring a loss, which is the region of interest, has them receive statutory treatment similar to common stock.[2]
- An important limitation is unavoidable and tied to the C-1 framework, which is inherently inconsistent with horizons over which capital for debt and equity is measured (10 and 2 years, respectively) and target probabilities (96% and 94% loss, respectively). These inconsistencies necessarily result in any approach leading to some form of arbitrage.

Assessing the loss distribution of CLO residual portfolios in the spirit of the C-1 equity factor requires an assessment of the actual variation in the performance of portfolios of CLO residuals over time or using simulation methods. The C-1 equity charge was estimated using total returns from the S&P 500, which includes the return from price fluctuations, generally the primary driver of return variation, and cash disbursements. Meanwhile, CLO residuals are not actively traded, which means that fluctuations in their value would need to be modeled, complicating the analysis.[3] Instead, we explore the return on equity (ROE), which measures the cash return, whether by an operating company or a CLO, that aspires to be comparable across corporates and CLOs.[4,5] We do so across the rating spectrum. We also explore the total return risk of corporate equity across the issuer ratings to benchmark the use of ratings as 'comparable attributes' for corporate equity within the context of the C-1 framework.

ROE performance for corporates and CLOs is presented in *Figure 3*. Portfolios are constructed across S&P issuer and junior most tranche ratings at the beginning of each two-year window. The two-year ROE is measured up to the reporting period and is computed for every firm and CLO. The left-hand (right-hand) plots the cross-sectional median and the 25% and 75% of corporates (CLOs) across issuer (junior most) rating, with BBB on top and below investment grade (IG) on the bottom. Inference for CLOs whose junior tranches are rated above BBB is limited

[2] The NAIC adopted revisions to the valuation of residuals that will now be reported at the lower of "adjusted cost" or fair value. It incorporates the "Effective Yield with a Cap" along with the "Cost Recovery Method," whereby cash flows shall be treated as a return of principal, reducing the adjusted cost. Under the "Cost Recovery Method," distributions are not recognized as interest or investment income until the residual tranche has a book adjusted carrying value (BACV) (adjusted cost basis) of zero, which is not standard and more conservative but is less onus than the "Effective Yield with a Cap," which is argued to require extensive non-automation work. Under the "Effective Yield with a Cap," BACV represents the acquisition cost, net of distributions in excess of the Allowable Earned Yield. Allowable Earned Yield, established at acquisition, is the discount rate that equates the initial best estimate of the residual's cash flows to its acquisition cost and other-then-temporary impairments (OTTI).

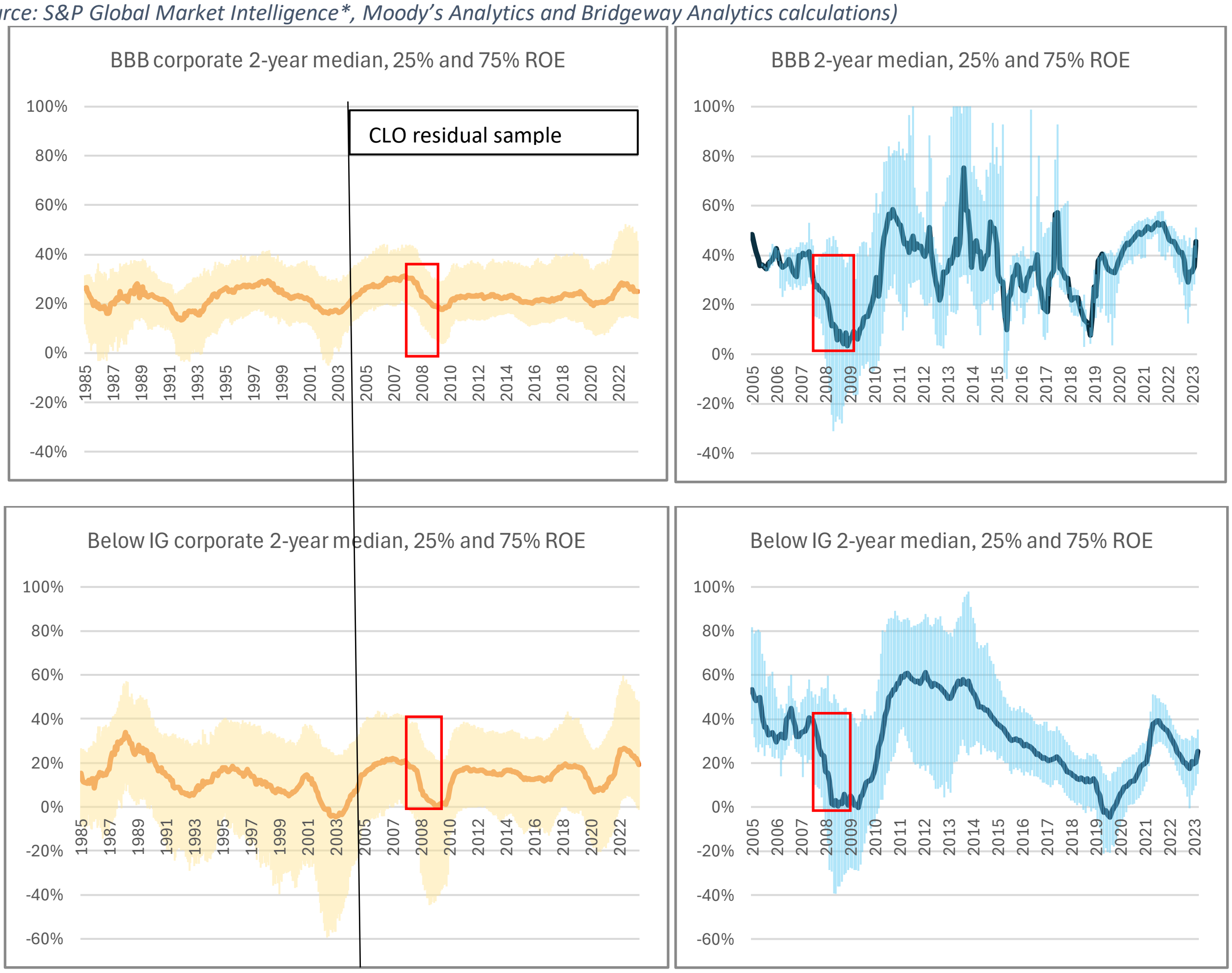
[3] Other differences needing consideration include residual interests having finite lives and designed to produce high yields, whereas corporate equity generally does not have contractual termination and often has the majority of its value driven by growth prospects.

[4] For corporate equity, ROE is measured using sales minus direct and indirect costs, depreciation and amortization, and taxes. It is intended to capture how much money is available to the equity holders of a firm after suppliers, employees, debt holders, and the government have been paid and asset decay. Notice that the measure includes funds that are reinvested in order to be comparable to CLOs, which generally do not attempt to grow their asset base. ROE is normalized by corporate book equity.

[5] For CLOs, earnings are measured as distributions to residual tranches, which include interest income and change in the book value of the residual. ROE is normalized by the par value of the residual at origination less payment principle against the residual.

given the limited sample and is excluded. While two-year windows are reported, results for longer horizons were explored and are broadly consistent with performance improving with the horizon. This pattern partly motivated C-1 equity to be measured over 2 years rather than 10 years, which is used for C-1 bonds and would result in an unacceptably low or possibly negative C-1 charge (see also *Figure 6*).

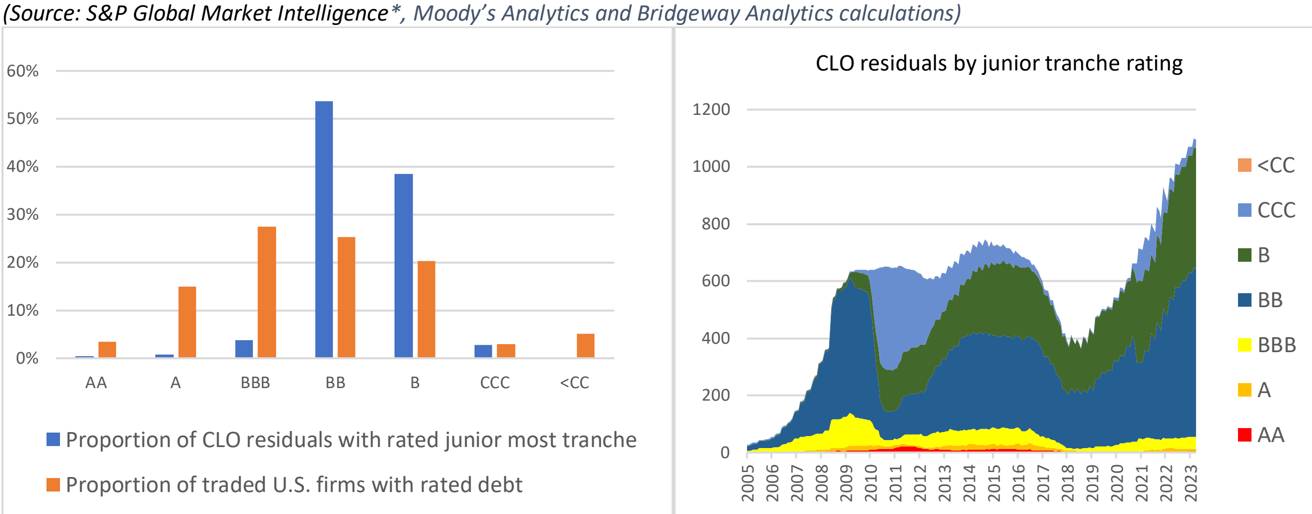
Figure 3: Corporate and CLO ROE dynamics
(Source: S&P Global Market Intelligence, Moody's Analytics and Bridgeway Analytics calculations)*



There are several notable visual patterns:

- There is significant variation in cross-sectional performance for corporate and CLOs.
- The performance of median CLO residuals tends to be higher than corporates for the BBB and below IG samples.
- The 25% worst performers in each period of the below IG sample tend to be worse for corporates than CLOs.
- The strong, positive performance will result in ROE volatility for CLO residuals appearing inflated compared to ROE volatility for corporates.
- BBB CLO performance is significantly noisier, partly driven by the limited number of transactions over varying periods (see yellow highlighted series on the right-hand side of *Figure 4*). Notice that the sample size drops with deteriorated performance, often associated with downgrades.
- CLO performance of the BBB and below IG sample in the second half of the sample is less varied, which might be driven by the shift to CLO 2.0s after the GFC (see CLO Performance).

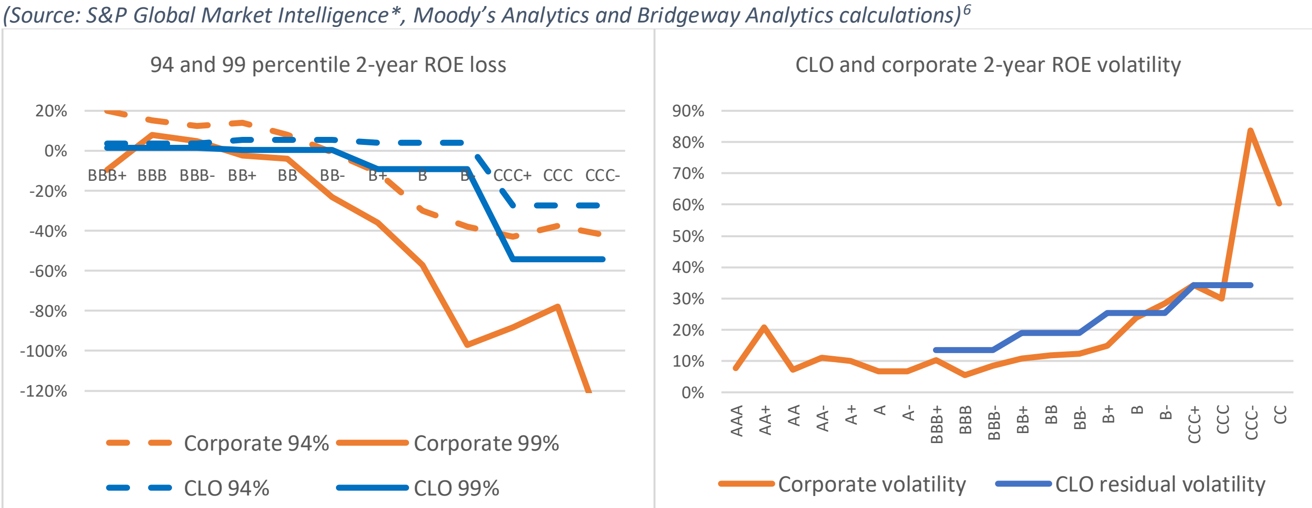
Figure 4: S&P rating composition of U.S traded corporate and junior most tranche of CLO residuals
(Source: S&P Global Market Intelligence, Moody's Analytics and Bridgeway Analytics calculations)*



The left-hand side of *Figure 5* presents the 94% (dashed) and 99% (solid) worst ROE for CLO (blue) and corporate (orange) portfolios across the S&P rating spectrum. Similarly, the right-hand side presents ROE volatility for CLO (blue) and corporate (orange) portfolios across the S&P rating spectrum. With some exceptions, losses become more negative, and volatility increases monotonically along the rating spectrum, confirming potential benefits for their use as 'comparable attributes.' Notably, risks are higher in the below IG, particularly in the B and CCC range.

The two 94% dashed lines stratal each other, with the corporate performing better in the BBB and CLOs performing better in the B and CCC range. BBB and BB CLOs and corporates exhibit similar losses at 99%, with B and CCC CLOs exhibiting higher ROE than corporates. Notice that higher performance for CLOs on the upside, as seen in *Figure 3*, has higher BBB and BB CLO volatility than equally rated corporates. However, the BBB CLO series is visibly more volatile, as discussed above.

Figure 5: CLO residual and corporate equity risk across the S&P junior most tranche/issuer rating spectrum
(Source: S&P Global Market Intelligence, Moody's Analytics and Bridgeway Analytics calculations)*[6]



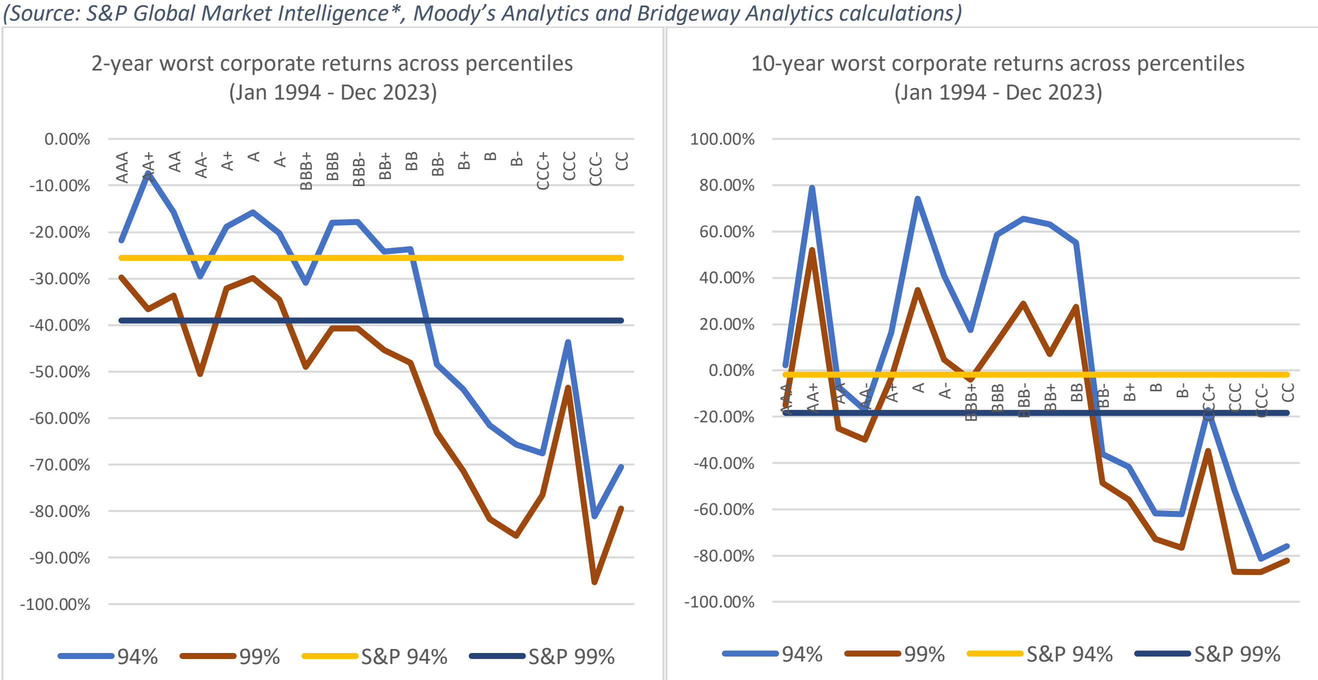
[6] Percentile losses are calculated using a time series of weighted average ROE, where the weights are book equity. The observed variation in volatility across adjacent ratings is likely due to small samples within each category.

We now shift our attention to an analysis of 2-year total return on corporate equity portfolios constructed across S&P issuer ratings to benchmark the use of ratings as 'comparable attributes' within the context of the C-1 framework. The left-hand side of *Figure 6* presents the 94% (blue) and 99% (brown) 2-year cumulative total returns on corporate equity portfolios reconstructed each month using their beginning period issuer ratings. The yellow (dark blue) line represents the 94% (99%) loss on the S&P 500. The 94% loss is slightly lower than the 30% obtained from the original 1960-91 study. Similar to the ROE analysis, the risk increases below IG and, noticeably, in the B and CCC range. The right-hand side represents the 10-year total return, which can produce close to zero or negative losses, which we reference above as a motivating factor of setting the C-1 common stock charge to be measured over 2 years.

We remind the reader that we do not suggest using *Figure 5* or *Figure 6* for quantitative inferences regarding a C-1 charge for corporate equity or CLOs across the rating spectrum. Additional analysis related to sample characteristics needs to be thoughtfully incorporated into the study, with smoothing techniques needing to be applied, possibly similar to the ones used in [Revisions to the RBC C-1 Bond Factors](). Rather, in its current form, our analysis allows us only to confirm that:

- There are potential benefits for using agency ratings as 'comparable attributes' of CLO residuals and corporate equity within the C-1 framework.
- At the lower end of the spectrum, CLO residuals and corporate equity exhibit higher risks and properties in the tail that have some similarities over the analyzed sample periods.

Figure 6: Total return on corporate equity portfolios
(Source: S&P Global Market Intelligence, Moody's Analytics and Bridgeway Analytics calculations)*



2.2 Limitations and Additional Needed Analysis

The analysis presented in this comment letter suggests potential benefits for using agency ratings as 'comparable attributes' of CLO residuals and corporate equity within the C-1 framework and that there are data and methods that can be used to estimate differentiated C-1 charges. However, there are known limits, and additional analysis is needed, which we now review at a high level.

2.2.1 There are known limits to our study

Several known limitations with our analysis need to be acknowledged and possibly addressed if it is to be extended and used to support a proposed refinement to C-1 charges:

- Although our results suggest the overall methodology of using the lowest rated tranche or issuer rating as a risk proxy applies broadly, an analysis of ABS residuals beyond CLOs needs to be conducted.
- The S&P 500 was used for estimating C-1 equity and had relatively few firms rated below BBB- and argued to be representative of insurers' equity portfolios. The analysis in this presentation uses a broader set of corporates to understand the risks across the rating spectrum better. Application within the C-1 equity framework should consider the following:
    - Aligning 30% with a representative portfolio (e.g., using S&P weights).
    - Derive monotonic and smooth representation of risk across ratings using techniques similar to Revisions to the RBC C-1 Bond Factors.
- The sample periods over which corporate equity and CLO residuals were presented differ.
- ROE risk needs to be linked with total return risk on the common stock, which was used to estimate C-1 equity.
- Further assessments of the sensitivity of measurement and accounting variation resulting in differences between ROE measured for corporates and those of residual interests.
- Other limitations that need to be considered:
    - S&P ratings are credit risk opinions with broad limitations.
    - Variation in rating standards, the types of firms and industries represented across the credit spectrum change over time.
    - The economic risks captured may not align with economic risks that reflect the historical experience of life insurers' holdings.
    - No statistical assessment of robustness has been performed.

2.2.2 Additional analysis of tail risks

Beyond the limitations of our empirical analysis discussed above, tail risks would require calibrated simulation methods that consider diversification and concentration risks across ABS residuals. For example, assessing the risk of CLO residual portfolios would ideally consider correlation across the underlying collateral pools and overlapping counterparties across CLOs.[7] That sort of analysis is challenging for reasons similar to those discussed in the Oliver Wyman study review in Section 1.2. Level-setting parameters across classes of ABS that face different risk factors are challenging; baseline and tail scenarios for collateral loan default scenarios for CLOs behave very differently from those of home prices and interest rates for RMBS.

Our analysis of CLO residuals and corporate equity suggests that we may efficiently leverage agency ratings to assess the stand-alone risk of a residual interest. Along with assessing correlation across ABS collateral, a parsimonious model can provide guidance on the likelihood of significant losses on a portfolio of residuals and an appropriate C-1 risk charge. Ideally, the approach would have generic components that allow the analysis to be extended to the broad classes of ABS.

3 Conclusions and Thank You

While, in their current form, neither the Oliver Wyman study nor our assessment of data to differentiate residual risks can provide quantitative guidance on the appropriate C-1 charge(s) for CLO residuals, both provide valuable insights which we summarize:

[7] This issue was raised in a comment letter from Equitable, dated October 9, 2023.

- **Conclusions from our analysis of the Oliver Wyman study**
    - The study finds residual tranche thickness and the rating of the next-most junior (i.e., the junior-most rated tranche) tranche can help differentiate losses on residuals, which is important in the context of differentiating RBC C-1 using ‘comparable attributes.’
    - Level setting baseline and stress loss scenarios across different markets face significant challenges, and the study takes the first step at attempting to do so, demonstrating significant variation in the performance of residuals across classes of ABS.
    - Considerations that we view as critical when estimating C-1 charges were abstracted from and should be considered in future studies:
        - Consistency with C-1 framework for bond, equity, and other asset classes requires considerations for portfolio diversification and concentration effects, which the study departs from in its current form.
        - The framework should aspire to backtest and represent observed dynamics experienced historically, which the study, in its current form, does not.
- **Conclusions from our assessment of data to differentiate residual risks**
    - Not all corporate equity or CLO residual interests exhibit the same risk.
        - There are potential benefits for using agency ratings as ‘comparable attributes’ of CLO residuals and corporate equity within the C-1 framework.
        - At the lower end of the spectrum, CLO residuals and corporate equity exhibit higher risks and properties in the tail that have some similarities over the analyzed sample periods.
    - The empirical patterns are consistent across different lenses, suggesting differentiated tail risks of CLO residuals can be estimated for C-1.
    - **With notable limitations that include**
        - An analysis of ABS residuals beyond CLOs needs to be conducted. However, our results suggest the overall methodology of using the junior most tranche or issuer rating as a risk proxy applies broadly.
        - The sample periods over which corporate equity and CLO residuals were presented differ.
        - ROE risk, which our study focuses on, needs to be linked with total return risk on the common stock, which was used to estimate C-1 equity.
        - Tail risks would require calibrated simulation methods that consider diversification and concentration risks across ABS residuals.

Bridgeway Analytics was founded with a mission to support insurers and their regulators in navigating capital markets and their regulatory landscape. We often gravitate toward the most complex and dividing issues and aspire to form consensus by framing issues objectively and through data-driven analysis that can be easily understood. We are grateful for the opportunity to contribute to this process and look forward to engaging further.

Sincerely,

Amnon Levy
Founder and Chief Executive Officer

Bridgeway Analytics supports the investment and regulatory community work to optimize the design, organization, and utility of regulations surrounding the management of insurance company portfolios. While the content in this document is informed by extensive discussions with our client base, the broader industry, NAIC staff, and state regulators and may contain analysis that Bridgeway Analytics had conducted as part of a commercial engagement and retains the right to reuse, the views in this document are solely those of Bridgeway Analytics and are based on an objective assessment of data, modeling approaches, and referenced documentation, that in our judgment and experience, are viewed as appropriate in articulating the landscape. Methodologies are available to the public through an email request at support@bridgewayanalytics.com. For more information visit www.BridgewayAnalytics.com.

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MetLife

April 8, 2024

Mr. Philip Barlow
Chair
Risk-Based Capital Investment Risk and Evaluation Working Group
National Association of Insurance Commissioners

Transmitted via email to Dave Fleming at dfleming@naic.org

Re: Oliver Wyman Residual Tranche Report

Dear Chair Barlow:

This letter is submitted on behalf of MetLife, Inc. ("MetLife"). MetLife appreciates the opportunity to comment on the technical features of the Oliver Wyman "Residual Tranche Risk Analysis" report ("the Report") exposed for comment at the March 17 meeting of the Risk-Based Capital Investment Risk and Evaluation (E) Working Group meeting. As requested by Chair Barlow, this letter offers some recommendations on ways to enhance the analysis behind the Report.

Overview

The general approach of modeling structured security residuals based on the forecast performance of underlying collateral assets that the study followed is the industry standard approach to estimating the potential loss sensitivity of these investments. We have two recommendations to improve the analysis. The first recommendation is regarding the selection of individual securities to make the findings of the study more relevant to the actual holdings of residuals in life insurers' portfolios. Second, we recommend adjustments to modeling techniques to improve estimations of loss levels to be consistent with the RBC C-1 framework and appropriate to measure the binary loss behavior of subordinated structured securities such as residuals.

Our recommendations, if implemented, will result in significantly higher average losses among a relevant sampling of deals than what the Report currently shows. Despite the need for a more robust modeling technique, the portion of the Report's analysis most relevant to life insurer holdings leads us to conclude that an RBC factor of at least 45 percent for residuals is fully justified. Specifically, the subset of residuals of BSL CLOs is the only significant category presented in which life insurers invest. For this subset, results in adverse scenarios in the Report, even absent a fuller analysis of tail events, indicate loss sensitivities that are at least equal to the 45 percent interim factor.

The remainder of this letter explores these recommendations in further detail.

Relevant Sample Set

There are two important shortcomings in the deals selected for the study:

1. Only some of the sectors studied are relevant to the actual holdings of structured securities in life insurers' portfolios.
2. Only some of the residual structures included in the study are typically offered in the market and available for life insurer investment.

The Report selected three classes of structured securities based on the share of each class to total outstanding ABS volume, but notably excluded RMBS and CMBS from consideration. According to a recent industry benchmarking study, only about 4 percent of life insurers' holdings of all non-agency structured securities are in auto and student loan ABS transactions, while CLOs, RMBS, and CMBS comprise 78 percent of these holdings[1]. We would strongly recommend including RMBS and CMBS in a potential new iteration of the study. Given the well documented weak performance of these transactions in the Global Financial Crisis, we would fully expect that their inclusion will result in relatively higher loss expectations under appropriate stress scenarios.

In general, there are two underlying drivers of securitization – risk disposition and asset funding. A risk disposition securitization creates numerous debt-like tranches and a relatively thin first-loss residual tranche. All of these tranches are typically sold into the market, and these thinner residuals comprise the bulk of residuals readily available for insurer investment. Typically, in such structuring, the next junior-most tranche in the transaction is rated below investment grade – usually in the B or BB categories. Conversely, in an asset funding securitization the issuer intends to maintain exposure to the underlying collateral while seeking a funding stream for further credit creation. The issuer retains relatively thick funding residuals while offering for sale a few tranches of higher credit quality. The Report shows that the study included many of these funding-type residuals that were unlikely sold into the market – see for example the number of Middle-Market CLOs on Figure 19 of the Report, where the rating of the next junior-most tranche after the residual was single-A, BBB, or even AAA. Including these funding-type residuals, which are not typically held by insurers, results in an artificially low estimate in the Report of the average modeled losses for residuals actually held by insurers.

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[1] As reported in BlackRock peer study using S&P Global Market Intelligence data of insurers' holdings as of 12/31/2022.

Modelling Calibration Consistent with C-1 Framework

The modeling technique shown in the Report seems to select certain scenarios that it classifies as either 95th or 99th percentile scenarios. We would strongly encourage properly calibrating the scenarios, and applying a technique that analyzes the behavior of residuals across a spectrum of tail scenarios.

With a proper calibration of scenarios, certain key assumptions would likely need some important fine-tuning. For example, the recovery rate for defaulted leveraged loans in a real “deep-tail” scenario would unlikely be higher than the recovery rate we’ve seen in recent months – the Report shows a 55.9 percent recovery rate in this scenario vs. levels around 40 percent seen in instances in the past several months amid a generally benign environment. Similarly, prepayment rates are unlikely to be of any significance in a true “deep-tail” scenario, and the 10 percent assumed prepayment rate in the Report may prove overly optimistic. These and other assumptions likely need enhanced calibration, which again is likely to result in higher modeled losses than currently shown in the Report.

Perhaps more importantly, a study of residuals and other subordinated tranches of securitizations would benefit from a deeper analysis across a broader spectrum of tail scenarios to properly determine the prudent amount of capital necessary to back these types of investments. Such an analysis is a common best practice in assessing risk in structured products, and would show that, unlike more traditional investments like corporate bonds, residuals and other subordinated structured securities exhibit a binary loss behavior where losses go from low to exceedingly high in a step-like function after a given point of the loss curve. This contrasts with the incremental loss rates exhibited by more traditional investments in tail scenarios and highlights the need for a differentiated approach to determine RBC for subordinated structured securities like residuals. If applied to this study, a technique like the one we recommend will again show a more pronounced loss behavior for residuals than those currently shown in the Report.

Conclusion

While the general approach of modeling residuals shown in the Report sensibly analyzes the performance of the underlying assets in securitizations, the study will likely benefit from important adjustments to the sample studied and to the modeling technique used. Nonetheless, the more relevant findings in the Report seem to justify, at a minimum, the adopted interim RBC of 45 percent for residuals. We believe that the enhancements to the study we recommend above would only make more evident that the 30 percent factor historically applied to residuals is insufficiently conservative, and that a factor above 45 percent may need to be considered as part of a more fulsome permanent solution.

We reiterate MetLife's sincere appreciation for the opportunity to offer our recommendations for enhancing the study behind the Report. If you have any questions regarding the present letter, please contact Ben Cushman, Head of Global Regulatory Policy, via email at ben.cushman@metlife.com.

Sincerely,

Chuck Scully
Executive Vice President and CIO
MetLife Insurance Investments

April 8, 2024

Mr. Philip Barlow, Chair
Risk-Based Capital Investment Risk and Evaluation (E) Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197
Via email dfleming@naic.org

Re: Oliver Wyman Residual Tranche Report

Dear Mr. Barlow:

On behalf of Athene Holding ("Athene") we appreciate the opportunity to comment on the Oliver Wyman report offered during the 2024 Spring National Meeting.

Rather than offering a view on the methodology employed by Oliver Wyman or the appropriateness of the .45 interim factor, we believe the continuing debate around both offers the NAIC an opportunity at a critical juncture of the Framework's[1] implementation to embrace its principles in order to reach a resolution based on the application of sound data and expert analysis. As such, we support ACLI's request to delay implementation of the interim residual factor for a year, or until such time as NAIC members can make informed decisions on the appropriate outcome. We also recommend that the working group, as part of the Framework implementation and in consultation with the Academy, articulate the longer-term plan for developing permanent factors for the broad spectrum of ABS residuals.

The working group approved the .45 interim factor with an express commitment to apply a different factor (or factors) if stakeholders provided data demonstrating a different factor was more appropriate (i.e., a charge that reflects the risks associated with holding residual interests in ABS). At that time, working group members indicated a willingness to review information from stakeholders supporting a charge other than .45. Similarly, the American Academy of Actuaries ("Academy") agreed to review any such information and provide its feedback to the working group.

The Oliver Wyman report annunciates a modeling framework indicating that a lower charge may be warranted; we do not have comments on that. However, we observe that the debate around its findings further underscores the need for additional analysis. We anticipate NAIC members may receive a variety of stakeholder input with differing views on the Oliver Wyman report. This type of ongoing uncertainty is exactly why additional analysis is required to determine a reliable modeling framework for RBC to ensure we have reasonably accurate and consistent factors across asset classes. Fortunately, there is already a process underway in this area with the Academy that will allow the NAIC to do just that.

[1] *Framework for Regulation of Insurer Investments – A Holistic Review, as amended* (the "Framework")

We believe that the Academy work should continue, and we encourage the NAIC to maintain the current interim factor (30% and 15% sensitivity) until such time as NAIC members can make an informed decision based on that expert analysis. It is far more important for this process and NAIC credibility that its decisions be the right ones, not expedient ones.

We appreciate the ongoing thoughtful and transparent engagement afforded by the NAIC and the working group throughout this process and we commit to providing continued constructive input.

Sincerely,

Michael Consedine

Michael Consedine
Executive Vice President
Head of US Government Relations & Regulatory Affairs

EQUITABLE

Aaron J. Sarfatti
Chief Strategy Officer &
Head of Institutional Businesses and
New Ventures

April 8, 2024

Mr. Philip Barlow, Chair
RBC Investment Risk & Evaluation (E) Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Via email: dfleming@naic.org

Re: Oliver Wyman report on residual tranches

Dear Mr. Barlow-

Equitable is pleased to provide the following comments on the Oliver Wyman report titled "Residual Tranche Risk Analysis" that was exposed for comment by the RBC Investment Risk & Evaluation (E) Working Group (the "Working Group") on March 17, 2024 (the "Report").

At the outset, we note that one of the stated objectives of the Report was to "[provide] data to help inform the calibration of the capital charge of residual equity tranches." The Report goes on to conclude that an analysis of the data so provided demonstrates that "the losses for the modeled residual tranches of structured products are lower than equities" – the implicit presumption being that the recently adopted interim RBC factor of 45% for the residual tranches of structured securities was unwarranted.

Our commentary is intended to support two principal assertions:

1. Acceding to the eleventh-hour request for a delay in implementation of the 45% residuals charge would thwart the intent of regulators in adopting an interim solution
2. The Report, despite several technical limitations that create a bias toward lower loss estimates for ABS residuals, nevertheless lends support for an increased residuals factor

Our comments are constrained by the incomplete data made available for scrutiny by the Report and its authors. We anticipate further technical limitations will be identified upon a more complete release of the Report's underlying data, assumptions and extrapolations.

A. Acceding to the eleventh-hour request for a delay in implementation of the 45% residuals charge would thwart the intent of regulators in adopting an interim solution

In arriving at the decision to prescribe a higher RBC charge for residuals on an interim basis, regulators at the NAIC engaged in a thorough, deliberate and transparent process in which extensive industry input was invited and provided. For the following reasons we urge regulators to ignore calls from some parties for a last-minute delay:

- **The 45% charge for residuals is explicitly intended to be *interim***. Regulators have been clear that the 45% charge is being adopted as a temporary measure while work continues on permanent updated charges for both residual and debt tranches of structured securities. The contents of the Report may be worthy of consideration as part of the longer term project to set permanent charges, but nothing in the Report justifies delaying this much-needed interim measure. Indeed, we think it likely that regulators will conclude that charges higher than 45% are needed for all or many categories of ABS residuals.

- **The rationale for expeditiously adopting an interim 45% charge for residuals has not changed**. Regulators identified a significant flaw in the RBC framework as applied to CLOs and other structured securities and, as an initial step to stem growing instances of associated RBC arbitrage resulting from a well-documented marked increase in such holdings by life insurers, put in place a *temporary* increase in the capital charge for the equity tranches of those securities. This decision, while only impacting one subcategory of structured securities investments by life insurers, sent an important message to the marketplace that regulators are taking ABS-related investment risk issues – and the attendant potential adverse impacts on policyholders - seriously. Delaying implementation of the higher charge for residuals at this late stage would serve only to undermine this message and, by extension, regulator credibility.[1]

- **Consideration of newly emerging "alternative" solutions is not practical in the context of an interim fix that is needed now**. In recent weeks, some industry participants have been floating alternatives to a single 45% charge for all residual tranches held by all insurers – for example, applying a lower charge to insurers whose overall RBC level exceeds a preset threshold or setting varying charges for residuals of different categories of structured securities. These proposals lack the crucial quality desirable for an interim solution that the single 45% charge embodies: *simplicity*. Analysis of the merits – and complexities - of any alternative solutions will inevitably generate extensive debate that should be left to permanent solution discussions and not used a pretext for delaying implementation of the interim measure.

[1] We applaud the NAIC's commitment to continuing its work on investment risk regulatory reform "without delay or pause" as expressed in the E Committee's recently updated *Framework for Regulation of Insurer Investments – A Holistic Review*.

B. The Report, despite numerous technical limitations that create a bias toward lower loss estimates for ABS residuals, nevertheless lends support for an increased residuals factor

In this section we provide a high-level description of what in our view are meaningful flaws in the Report's methodology, awareness of which are pertinent for assessments of charges for residual tranches as well as any other ABS tranches. In addition, we explain why we think the analytics contained in the Report, notwithstanding these limitations, support a 45% charge.

1. The proffered data does not adequately reflect "equal capital for equal tail risk."

We note that the 95th percentile stress scenarios for leveraged loans utilized by the Report are based on data from the Global Financial Crisis ("GFC"). Yet the high yield default rates observed during the GFC were materially lower than the default rates that occurred during the credit crunch of the early 1990s and 2000s. Indeed, current NAIC C-1 bond factors are derived from credit stresses more severe than those of the GFC. Analyzing the performance of CLO collateral at a lower standard represents a deviation from the principle of equal capital for equal risk.

This anomaly arises because the Report's primary leveraged loan data source is the US LSTA 100, which only tracks data for the largest 100 leveraged loans between 1999-2021. That index therefore does not include data from the early 1990s credit crisis, and is skewed toward a more favorable rating distribution than present in current CLO collateral. For example, in 2007, less than 5% of the US LTA 100 was rated below 'B+' compared to more than 50% today.

2. The Report doesn't appropriately consider tail risk.

For modeling tail losses of residual tranches, the Report utilizes self-constructed stress scenarios and a Value at Risk severity measure that, among other flaws, are based on incomplete data and rely substantially on inferences for key parameters such as Loss Given Default ("LGD"). As a result, the extent of predicted tail losses is materially understated in the Report. A more thorough analysis would deploy a Conditional Tail Expectation risk measure – as endorsed by the American Academy of Actuaries (the "Academy") – that captures the significant cliff loss potential (i.e., sudden 100% loss of value) inherent in ABS residual tranches.

3. The Report draws on incomplete historical performance data.

Crucially, the historical analysis of ABS performance in the Report omits consideration of CMBS/RMBS. The GFC, during which CMBS/RMBS experienced deep and rapid losses, provided a practical illustration of how an extreme tail event (low probability but high impact) can unfold during a time of profound credit stress. While this type of event has not yet occurred with, for example, CLOs - due largely to their limited 20-year history of mainstream market penetration – it would be irresponsible to assume that residual tranches of CLOs and other ABS are incapable of experiencing deep losses in a credit crisis or other major tail event.

In addition, the time periods examined in the Report inexplicably omit the stagflation years of the late 1970s to early 1980s. Stagflation, characterized by high and rising interest rates along with low economic growth, present hostile conditions for the performance of the collateral backing the preponderance of ABS. Including this period is imperative for a credible assessment of ABS historical losses.

Moreover, the Report uses LGD assumptions for CLO collateral that are derived from the 2019-2021 data, a period of generally favorable markets. While the recency of this LGD data captures *part* of the recent weakening in debt covenants that is characteristic of the present universe of leveraged loans, recovery rates can be expected to decline precipitously in a stress environment when equity values are lower.

4. The comparison of ABS residual tranches to US equities is fundamentally flawed.

The Report purports to show that the performance of structured security residuals is similar to that of public US equities. However, several assumptions used in drawing this comparison are inappropriate – for example:

- Stress losses projected in the Report are based on changes in "fair value", whereas RBC charges for US equities are based on changes in market value;[2] and
- The discount rates used to establish fair value do not vary by stress scenario; the Report assumes a 12% constant discount rate for residuals, whereas, for example, spreads on CCC and lower-rated US debt peaked at over 35% during the GFC - properly reflecting the increased risk to investors. Incorporating the change in risk premium within the discount rate would sharply amplify the measured loss in a "fair value" that is more comparable to market value.

5. The Report uses prepayment assumptions that are overly generous.

The Report uses assumed prepayment rates under all stress scenarios, including deep stress scenarios, that are (a) material and positive and (b) fail to adjust for the observed positive correlation of borrower health and loan prepay rates. To put it bluntly, prepayment assumptions should reflect the reality that companies on the brink of default do not prepay loans. This behavior must be represented in projected cumulative loss rates in any objective analysis of ABS performance. Adjusting for this outcome in the Report will materially increase cumulative ABS losses, with particularly substantial increases to residual tranche losses.

6. Notwithstanding these criticisms, there are important elements of the Report that show that a minimum 45% RBC charge for residual tranches of CLOs is appropriate.

- For Broadly Syndicated Loan CLOs, which according to the Report represent roughly 90% of outstanding CLOs, losses presented for the residual tranches of those securities are in the 40-

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[2] The Academy has observed that calibrating a marked-to-market asset, such as the residual tranche of a structured security, needs to incorporate the market value or the volatility of that asset.

45% range for the mid-tail scenarios (~95th percentile per the Report) and over 70% in a deep-tail scenario. This result alone suggests a 30% RBC factor is too low.[3]

- The appropriate RBC level for CLOs would be shown to be well above 45% if the data in the Report was analyzed with a CTE risk measure, given the heavy-tail nature of CLOs (as discussed above).

- 90% of US Life Insurer holdings of the asset classes studied in the Report are CLOs, and given that RBC is a blunt instrument, extending the 45% charge for residuals to other ABS is both pragmatic and reasonable.

We would welcome the opportunity to discuss these comments with you in greater detail.

Sincerely,

Aaron Sarfatti
Chief Strategy Officer &
Head of Institutional Businesses and New Ventures

[3] We also note that the calibration of collateral losses in the Report was understated. Correcting for this anomaly would provide further support for a higher RBC factor for residuals.

April 8, 2024

Mr. Tom Botsko
Chair, NAIC Capital Adequacy (E) Task Force
Via email: Eva Yeung (eyeung@naic.org)

Mr. Philip Barlow
Chair, Risk-Based Capital Investment Risk and Evaluation (E) Working Group (RBC IRE WG)
Via email: Dave Fleming (dfleming@naic.org)

Re: Proposal 2024-02-CA (Residual Structure PC & Health)
Oliver Wyman Residual Tranche Report

Dear Mr. Botsko and Mr. Barlow,

The American Property Casualty Insurance Association[1] (APCIA) appreciates the opportunity to express our views on the Oliver Wyman study of the performance of residuals relative to other asset classes, exposed by the RBC IRE WG. We are also responding to the Capital Adequacy (E) Task Force's (CATF) proposal to impose a 45 percent interim risk-based capital (RBC) charge on residual tranche of asset-backed securities (residuals) held by property casualty insurers. We do not believe a sufficient basis has been demonstrated for this increase and agree with the American Council of Life Insurers (ACLI) that the NAIC should delay the implementation of an increased RBC charge on residuals by an additional year for all insurance lines.

Last year, the NAIC appropriately delayed imposition of a 45 percent charge on residuals on life insurers and sought industry data to conduct additional study. While we believe that any significant change in RBC charges, whether "interim" or not, should be underpinned by careful analysis conducted by the NAIC, regulators now have access to a thoughtful and credible study prepared by Oliver Wyman. In our opinion, the study does not justify a 45 percent charge on residuals. It does support the need for additional analysis in establishing an interim capital charge that is reflective of risk.

Moving forward with the 45 percent charge would be inappropriate in light of the new data. Oliver Wyman is a highly credible firm that the NAIC has appropriately relied on over the years to analyze important aspects of solvency regulation. The study constitutes compelling evidence that regulators should take additional time and analysis before making major changes to RBC. The NAIC has required substantially more rigor in the analysis underpinning every prior increase in RBC. We are concerned that failure to do so here would be inappropriate, especially insofar as applying this interim charge to property casualty and health insurers was only proposed at the March 2024 NAIC meeting.

[1] APCIA is the primary national trade association for home, auto, and business insurers. APCIA promotes and protects the viability of private competition for the benefit of consumers and insurers, with a legacy dating back 150 years. APCIA members represent all sizes, structures, and regions—protecting families, communities, and businesses in the U.S. and across the globe.

We are also concerned that this charge appears to be designed to align with the "Basel III Endgame" banking capital rules proposed by the Federal Reserve Board. For many years, the insurance industry and insurance regulators have rightly pointed out that banking capital rules cannot and should not be applied to insurance companies. The two business models are quite different, as property casualty insurers do not hold demand deposits and the terms of our liabilities do not subject insurers to a run on the bank, i.e., are not runnable. The Basel III Endgame proposal, whether it is appropriate or inappropriate for structured securities held by banks, should not translate to state insurance regulation. The charge of state regulators is to set insurance-specific rules that protect policyholders, not to adopt global banking rules that do not reflect the best available data.

Finally, we would like to point out that, unlike the life RBC formula, there is no current mechanism for assigning property casualty Schedule BA asset RBC charges by investment type. Assigning a different charge to one particular investment type currently within Schedule BA is a significant change and should be supported by a more holistic review of the treatment of property casualty Schedule BA investments in general. This consideration further supports ACLI's call for a one-year extension of the implementation date.

Thank you for the opportunity to convey our views and your continued commitment to ensuring that RBC changes reflect analysis and consistent standards of review by regulators. We hope that you will seriously consider our request to delay the implementation of this charge by an additional year to ensure that an appropriate charge is developed and adopted.

Sincerely,

Stephen W. Broadie
Vice President, Financial & Counsel

Attachment 18

Western & Southern Financial Group®

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Kevin.Howard@wslife.com

April 8, 2024

Mr. Philip Barlow, Chair
RBC Investment Risk & Evaluation (E) Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Via email: dfleming@naic.org

Re: Comments on Oliver Wyman Report

Dear Mr. Barlow:

Western & Southern Financial Group, Inc. ("W&S") appreciates the opportunity to comment on the Oliver Wyman report titled "Residual Tranche Risk Analysis" (the "Report") that was exposed for comment by the RBC Investment Risk & Evaluation (E) Working Group.

W&S's review of the Report reveals that it actually *supports* the interim 45% RBC factor for the residual tranches of asset-backed securities. The Report notes that Broadly Syndicated Loans ("BSLs"), which W&S's proprietary life insurance industry peer study estimates as comprising 87% of the industry's CLO exposure, would experience losses of 42-45% in a moderate loss (95th percentile) scenario, and losses of 72% in a deep-tail (99th percentile) scenario. (See Table 7 of the Report.) While there are several problems with the methodology used and assumptions made by the Report, its findings on the risks associated with BSL CLOs alone is enough to maintain the 45% interim charge on ABS residual tranches.

Even as the Report supports a 45% charge, it still has several critical biases and flaws as discussed below.

1) The comparison to US Equities is flawed.

   The Report's conclusion that the 45% charge is too high is entirely dependent on a comparison to US Equities' 30% charge vs. projected losses. ABS residuals are, however, fundamentally different from US Equities. First, ABS residuals are the first loss position on a portfolio of assets, which is different from a diversified portfolio of US Equities. It is entirely plausible for an ABS residual to take 100% losses, as the ABS residual exists to take all losses before the rated tranches. Second, ABS residuals are expected to take losses in the baseline scenario and those losses tend to be permanent, whereas equity mark-to-market losses tend to be transient. Third, while some ABS residuals benefit from a reinvestment window that gives the investment manager time to wait out a market downturn, US Equities have an even longer time horizon to wait out a market downturn because there is no maturity date. In other words, the supposed liquidity and holding-period advantages cited for certain ABS residuals also exist for US Equities at an even greater level. Fourth, the US Equities market has hundreds of years of data to better calibrate loss distribution models with tail risk, while ABS residuals have just a couple of decades of data. Finally, a CLO residual tranche is underfunded on day 1 due to deal expenses and interest reserve accounts (typically by 10% or more), and then default losses are expected over the life of the securitization, further eroding principal recovery—that's how the investment is structurally designed—which is very unlike US Equities.

2) The Report uses Value-at-Risk (VaR), which is not a coherent risk metric.

   It is widely recognized that VaR is not a coherent risk measure because it fails the subadditivity property. The subadditivity property implies that two separate risks cannot get worse if they are pooled together (i.e., diversification is beneficial). The reason VaR fails the subadditivity property is because VaR looks at the loss at a specific probability (e.g., 95% percentile), but it is completely blind to the loss beyond that probability. For example, an investment could take zero loss at the 95th percentile but a full loss starting at the 96th percentile. In this example, the VaR at the 95th percentile would be zero, implicitly implying very low risk. VaR does a particularly poor job of assessing risk where significant "cliff risk" exists, which is the key risk with ABS residual tranches: losses can increase very quickly as the residual tranche absorbs all of the losses of the investment pool.

   This shortcoming of VaR is well understood by sophisticated investment managers that are VaR-constrained, which has led these investment managers to take additional risk not seen by VaR. The shortcomings of VaR likely exacerbated the Great Financial Crisis, as the risk of the CDO market was unseen by VaR.

   Because of this, we highly recommend using Conditional Tail Expectation (CTE) to calibrate risk charges. CTE is similar to VaR; however, it is a coherent risk measure. CTE looks at the average loss beyond the probability event, meaning it can see the cliff risk that is present in ABS residuals.

3) We cannot replicate the findings of the Report.

   The Report relies on a myriad of assumptions, some of which are provided, but many other key assumptions are not shared. Moreover, the Report only shows projected losses from three scenarios. As a result, it is impossible to fully assess and appropriately critique the shortcomings of the Report. And related to the VaR point above, we are unable to see if there is tail risk beyond the scenarios chosen.

   For comparison, W&S's CLO modeling shows a base case of the following: assuming a base case scenario of 20% CPR, 1% CDR and 50% Recovery rate, the loan portfolio would then be sold in the open market via a competitive bidding process when the CLO Equity holder calls the deal (approximately year seven). If the loan portfolio achieves a 98 average sale price (which is 67th percentile for performing loans since 2010), the residual tranche would experience a 45% principal loss. The 45% loss our modeling projects is in the base case, reflecting a greater loss than the 42% shown for the GFC scenario for BSL CLOs in the Report.

W&S strongly supports a data-driven solution to determine an appropriate capital charge for ABS residuals. We believe that the interim charge of 45% is appropriate given the diverse risks of the many asset classes employed in ABS residual tranches. Some of these asset classes merit a lower charge than 45%, and others may warrant an even higher charge; however, W&S believes that the temporary interim charge of 45% best represents the binary cliff risks that ABS residual tranches (and most notably BSL CLOs) present. We note that a 45% charge represents a level where the investment becomes a non-admitted asset for most insurance companies, and so a charge higher than 45% may not be necessary.

W&S recognizes that the many perspectives on an appropriate capital charge for ABS residuals is in part the result of the variability and complexity of ABS asset classes. We support a single charge for the interim solution, but anticipate that at least two charges will be necessary for the permanent solution.

It is important to remember that the *interim* charge of 45% is just that—it's a temporary stopgap until a long-term solution can be developed. Until the Academy and other objective commentators weigh in with appropriate data-driven proposals to achieve a permanent solution, we believe that preserving the "Texas compromise" previously agreed upon by regulators and the industry is important to maintain consistency and credibility.

Thank you again for the opportunity to comment on this important issue; please let us know if we can be of further assistance.

Sincerely,

Kevin L. Howard
Vice President, Deputy General Counsel
& Head of Government Affairs

TEXAS HOUSE of REPRESENTATIVES

Briscoe Cain
District 128

CHAIR, HOUSE COMMITTEE on AGRICULTURE & LIVESTOCK
MEMBER, HOUSE COMMITTEE on INSURANCE

April 8, 2024

Mr. Philip Barlow
Chair, Life Risk-Based Capital and Investment Risk and Evaluation Working Group

Mr. Barlow:

Insurance industry regulations must strike a careful balance. They must protect consumers and ensure the integrity of markets while also fostering competition and a wide array of affordable policy options. To strike this balance, policymakers must make a sober assessment of the risks assumed by insurers who invest premiums into varying assets in order to achieve returns strong enough to cover their obligations to consumers. Recently, the NAIC's Risk-Based Capital Investment Risk and Evaluation Working Group (RBC IRE WG) has discarded this careful balance and vastly overstated the risks of certain assets.

The NAIC is at its most effective when it uses data, research, and real-world information to develop pragmatic solutions and build consensus among its members. My experience as a member of the Texas House Insurance Committee has informed my belief in pragmatic, responsible insurance policy that puts consumers first. However, the RBC IRE WG's proposed 45% charge for asset-backed securities falls short on every front.

Unlike previous recommendations, the recommendation to tighten rules specifically around these securities was crafted without data. There was little consensus, as the recommendation was initially delayed when some policymakers expressed concern that the NAIC was moving forward with the higher capital charges without having any demonstrated reason to do so.

When the NAIC asked for data, they received it. An independent, third-party consultant delivered a thorough research report demonstrating that the 45% charge was unjustified and unnecessary. The RBC IRE WG dismissed this critical research and is hastily advancing its predetermined policy prescription with a limited window for public review and comment.

Consumers deserve strong protections against risk, especially when it comes to financial planning tools like life insurance and annuities. The RBC IRE WG's proposed measures do them a disservice by overstating, if not entirely misrepresenting, the risks associated with asset-backed securities. These securities are a critical asset class that allows insurers to offer competitive products that protect consumers.

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The NAIC and the RBC IRE WG must be thoughtful and intentional about protecting consumers, maintaining competitive markets, and letting the data guide policy recommendations. The process behind the recommended increase in capital charges for certain securities falls short on every front. I strongly urge the RBC IRE WG to consider the data that is now publicly available and halt its rush to adopt an unnecessary regulation that will ultimately harm consumers.

Sincerely,

B Cain

Briscoe Cain
Texas House of Representatives
Member, Texas House Committee on Insurance

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BRISCOE.CAIN@HOUSE.TEXAS.GOV

THE HARMS GROUP

April 8, 2024

Attn: Mr. Philip Barlow
Chair, Life Risk-Based Capital and Investment Risk and Evaluation Working Group

Commissioner Jon Godfread
North Dakota Insurance Department

Dear Commissioner Godfread,

As a staunch advocate of free market competition, I am concerned by the recent developments within the National Association of Insurance Commissioners (NAIC), concerning the Risk-Based Capital Working Group.[1] Mandating a 45% capital charge on asset-backed securities, after being confronted with third-party data that disproves the need for such a proposal, is a disservice to the market and the public.

The proposed capital charge is unnecessary and detrimental to consumers and the overall vitality of the life insurance and annuities market. Imposing this mandate on insurance providers will fragment the market and force providers to drive up costs. As a result, this action limits consumer choice and contradicts the spirit of a free and competitive market.

The NAIC has been criticized before because of its closed-door agreements.[2] NAIC has ignored independent research in the consideration of the proposed rule around residual tranches. That research has demonstrated that the perceived risks associated with these asset-backed securities are unfounded. Nonetheless NAIC insists on pushing forward with a policy that is not grounded in data.

As someone who is familiar with the insurance industry and has a record of public service in North Dakota, I understand the need for transparency and accountability in policymaking. I implore the Risk-Based Capital Working Group and the NAIC to prioritize evidence-based decision-making and consumer welfare. If we hope to uphold the state regulatory system and respect the NAIC, then the organization must honor the principles of transparency and

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[1] https://www.insurancebusinessmag.com/us/news/breaking-news/naic-accused-by-atr-of-bending-to-bidens-will-482877.aspx
[2] https://www.insurancebusinessmag.com/us/news/breaking-news/congressional-republicans-take-naic-to-task-over-proposal-452948.aspx

accountability, especially when proposing measures that could significantly impact consumers and the market.

I strongly encourage you to reconsider the 45% capital charge and to instead focus on policies that promote competition and consumer choice within the life insurance and annuities market. Thank you for your attention to this matter. I trust that you will carefully consider the concerns raised and take appropriate action to ensure that the interests of consumers and market participants are safeguarded.

Sincerely,

Robert W. Harms

Robert W. Harms, JD

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Philip Barlow
Chair, Risk-Based Capital Investment Risk and Evaluation (E) Working Group ("RBC-IRE")
NAIC
via email to Dave Fleming (dfleming@naic.org)

April 8, 2024

Dear Chair Barlow:

Re: Proposal 2024-02-CA; Oliver Wyman Residual Tranche Report

The Alternative Credit Council ("ACC")[1], the private credit affiliate of the Alternative Investment Management Association Ltd ("AIMA"), appreciates the opportunity to provide a few additional comments to supplement the RBC-IRE committee's discussion of the Oliver Wyman ("OW") analysis of asset-backed securities ("ABS") residuals. In addition, we would like to present new data analysis that further demonstrates the relative safety and outperformance of CLO equity tranches compared to common stock.

Claims of 100% cliff losses versus historical track record

One concern raised by regulators is whether ABS residual tail losses during periods of market stress could be 100% in absolute terms and much greater in comparison to public equities. However, Larry Cordell, an economist at the Federal Reserve Bank of Philadelphia, along with Professor Michael Roberts of the Wharton School at the University of Pennsylvania, performed a detailed analysis of CLO residuals from 1997 to 2021. The results of their analysis were published in the Journal of Finance and found

[1] The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents 250 members that manage over $1trn of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure, and the trade and receivables business. The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits. Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

that CLO equity outperformed the S&P 500 during that time period.[2] Their study also found that on a risk-adjusted basis, CLO equity outperformed equity "against a variety of public benchmarks."[3] A key finding of this study was the relative stability of CLO equity during two periods of significant market instability, namely the 2001 dot-com bubble and the 2008 Great Financial Crisis. The authors noted that CLOs' "equity performance highlights the resilience of CLOs to market volatility."[4] The authors attributed the outperformance of CLO equity to several of the structural features of CLOs, including "their closed-end structure, long-term funding, and embedded options to reinvest principal proceeds."[5]

The Cordell study provides a clear historical track record that CLO residuals do not suffer complete losses during periods of financial stress. In addition to the reasons cited above, residuals are priced well below par (unlike corporate bonds), reflecting both the high discount rates and an expectation of some credit losses. As a result, the interest payments are a meaningful contributor to the overall value--again, unlike corporate bonds. Even in a severe stress, both the Cordell and OW studies demonstrate that CLO equity investors can still expect to receive cash flows.

CTE 90 vs VAR 95-99 percentile

Some RBC-IRE members have asked about the difference between contingent tail exposure ("CTE") 90 and Value at Risk ("VaR") at the 95th or 99th percentile. While CTE represents the average probability-weighted loss above a certain probability level, VaR represents the loss at a specific probability level. The American Academy of Actuaries is using a CTE approach, so if the CTE 90 level is what becomes adopted, that would calculate the average of losses above the 90th percentile. The OW study examined losses at both the 95th and 99th percentiles. Those are both specific percentile points of the loss distribution but are at the higher end of the CTE 90 average range. This difference can also be explained by the fact that the OW study used stress tests during three different periods of financial stress, which is not compatible with the kind of Monte Carlo simulation used to calculate CTE. Also, the purpose of the OW study was to compare the interim capital charge for ABS residuals to that of established NAIC capital charges for similar assets, and the NAIC has historically used a 94-96th percentile VaR to establish capital charges.

BSL residuals vs the other ABS residuals in the OW study

The OW study clearly demonstrates that all three analyzed types of ABS equity outperformed common stock during periods of market stress, including the 2001 dot-

2 Cordell, R, and Schwert, M, CLO Performance, Journal of Finance, 2023. https://doi.org/10.1111/jofi.13224

3 *Id.* at 2. "Our central finding is that CLO equity tranches provide statistically and economically significant abnormal returns, or "alpha," against a variety of public benchmarks…"

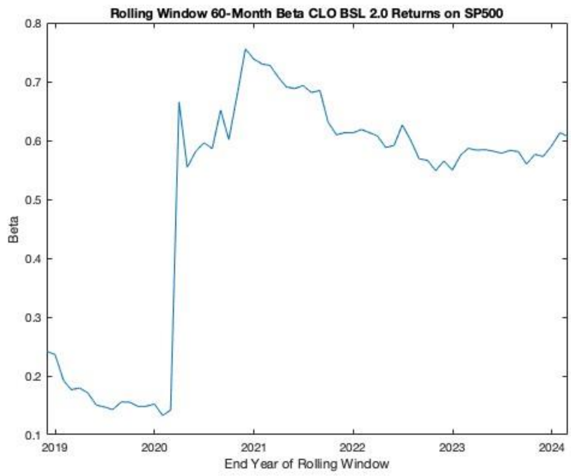
4 *Id.* at 20.

5 *Id.* at 1. *See also* Jeff Helsing, Can CLO Equity Outperform if the Economy Tips into Recession?, September 26, 2022, Can CLO Equity Outperform If the Economy Tips Into Recession? | Western Asset

ALTERNATIVE CREDIT COUNCIL

com bubble, the 2008 Great Financial Crisis, and the 1930s Great Depression. However, given that the equity of one sub-type of collateralized loans ("CLOs"), namely broadly syndicated loans ("BSLs"), performed better overall than common stock but similar in the two medium-tail stresses, we asked finance Professor Daniel Svogun to perform a beta analysis to determine whether or not BSL equity has lower volatility than common stock.[6]

Professor Svogun was able to use time series data from Bank of America on CLO BSLs monthly median equity prices to calculate BSL equity beta using the NAIC's formula for measuring monthly volatility over a 60-month rolling window. The results of Professor Svogun's analysis (see chart below) demonstrate that the 60-month rolling beta of BSL equity is well below 1 (any beta result lower than 1 indicates less volatility relative to the S&P 500). This beta analysis compared the monthly CLO equity price change to the S&P 500 index performance each month. The beta of the full period studied (Dec 2013 - Feb 2024) with over 750 BSL CLOs included is .4989, which is well below the NAIC's .75 beta threshold for the lowest charge of 20%. The chart shows the 60-month rolling average beta following the NAIC's formula. During that time period, the beta of BSL equity remains below the .75 threshold in all but one month, where it reaches .7564. Note the time indicated in the x-axis is the ending period of the 60-month rolling beta. As a result, to be consistent with the principle of equal capital for equal risk, it would be more appropriate for the NAIC RBC charge for BSL equity to be adjusted to 20% using the NAIC's formula to adjust the equity capital charge according to its level of volatility compared to the S&P 500.



Bank of America CLO data; calculations from finance professor Daniel Svogun, Ph.D., Busch School of Business, CUA

66 Professor Daniel Svogun is a professor of finance at the Busch School of Business, Catholic University of America, whose research specializes in the "time value of money, ratio analysis, [and] the valuation of stock and bonds." https://business.catholic.edu/faculty-and-research/faculty-profiles/svogun-daniel/index.html

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This finding that BSL equity is less volatile than the S&P 500 should not be a surprise because it is consistent with the results of both the OW study and the Cordell CLO equity research paper. Furthermore, it provides additional evidence of the relative outperformance of BSL CLO equity compared to common stock.

<u>The punitive nature of a single ABS residual charge</u>

In response to regulators' requests, we were able to anecdotally confirm that insurers invest in CLOs, investment-grade auto loan and student loan ABS residuals. However, several of our insurance and investment members noted that they invest in other types of ABS as well and expressed concerns about the inequity of a single residual C-1 charge of 45% for all ABS regardless of the type or quality of the underlying collateral.

One specific example where a 45% residual C-1 factor would be unwarranted is for Commercial Property Assessed Clean Energy (C-PACE) ABS[7]. C-PACE ABS are backed by loans to U.S. commercial property owners that finance energy efficiency, water conservation and renewable energy projects. C-PACE loans are high-quality, super senior to a mortgage loan on a property, given that the loans are repaid as a benefit assessment on the property tax bill. However, it is uneconomic and unfeasible to rate or invest in individual C-PACE loans at scale due to the relatively small average ticket size. As a result, these loans are aggregated in a securitization or structured product so that insurers can invest in the C-PACE asset class. However, the 45% C-1 charge on the residual tranche, even if it is a small part of the structure, can negatively impact the capital-adjusted risk-return profile of a C-PACE ABS. Insurance investors in C-PACE ABS are already subject to higher capital charges compared to investing directly in the underlying, so the interim 45% residual charge makes it even harder to justify the relative risk-reward analysis for an insurance investment. Investors are aware that the 45% residual charge is meant to be an interim one, but the reality is that it may be in place for many years, particularly for smaller ABS asset classes. This would, in effect, significantly disincentivize insurers from investing in high-quality and sustainable C-PACE assets.

<u>Conclusion</u>

At a high level, the OW analysis and findings demonstrate that expected losses in stress scenarios can vary depending on the underlying collateral and structure, which makes a 45% residual charge inappropriate. As more information is gained on insurers' residual exposure, it is very likely that there are other types of ABS beyond the ones in the OW study and C-PACE ABS for which a 45% charge would not be appropriate based on their specific level of risk. As a result, we respectfully request the NAIC to reconsider

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[7] C-PACE loans are used by commercial property owners to finance climate and environment-related projects, including climate resiliency, renewable energy, and water and energy efficiency improvements. *See generally*, "Credit FAQ: ABS Frontiers: The C-PACE Space Explained, (2024) at https://www.spglobal.com/ratings/en/research/articles/231213-credit-faq-abs-frontiers-the-c-pace-space-explained-12943764.

imposing the highest capital charge level in its history until the impact of this charge on all ABS residuals is better understood and determined to be appropriate. In addition, since the only two available empirical studies demonstrate that CLO equity outperforms common stock during periods of financial distress—and we now have evidence that BSLs have a lower beta—we respectfully urge the NAIC to maintain the 30% charge until additional analysis can be performed on what ABS residuals insurers actually hold on their balance sheet and whether a 45% charge would be appropriate.

We welcome the opportunity to discuss these supplementary comments and additional data analysis. From our perspective, there are now only two data-driven analyses available to you, both of which demonstrate that a single 45% charge on ABS residuals would not correspond to the actual levels of risk. If you have any questions about this new information, please reach out to me or Joe Engelhard, Head of Private Credit & Asset Management Policy, Americas, at 202-304-0311 or jengelhard@aima.org. The ACC will provide a similar comment letter to the Capital Adequacy Task Force, given that they have proposed a 45% charge for ABS residuals for the property casualty and health insurance RBC formulas.

Respectfully,

Jiří Król
Global Head of Alternative Credit Council

Mariana Gomez-Vock
Senior Vice President, Policy Development
American Council of Life Insurers
Marianagomez-vock@acli.com

April 8, 2024

Mr. Philip Barlow
Chair, NAIC Risk Based Capital (RBC) Investment Risk and Evaluation Working Group
National Association of Insurance Commissioners
[via e-mail to dfleming@naic.org]

Re: Exposure of Oliver Wyman Residual Tranche Report

Dear Chair Barlow,

The American Council of Life Insurers (ACLI) is pleased to submit these comments responding to the RBC Investment Risk and Evaluation Working Group's ("the Working Group") exposure of the Oliver Wyman ("OW") Residual Tranche Report. ACLI's 280 member companies represent 94 percent of the life insurance industry's assets. We are writing to you today on behalf of a broad coalition of life insurers – large, small, stock and mutuals, private-equity and non-private equity.

Since the emergence of the "Texas Compromise"[1] in June 2023, ACLI has worked diligently on residual tranche issues. The project has been complex and challenging. While ACLI is not as far along as we had originally planned, there has been significant progress – ACLI's Principles of Consensus on the C-1 Framework for Structured Securities, were adopted unanimously by the ACLI Board in September 2023. The Principles were labor intensive and took several months to develop but were necessary before ACLI attempted to undertake an analytical review of residual tranches. ACLI remains committed to finding a consensus-based solution to this issue.

ACLI is respectfully asking for a one-year deferral of the 45% factor, allowing time for regulators and stakeholders to consider the factor within the context of the Academy's work and the impact of recent changes in accounting treatment and reporting standards. With multiple workstreams engaged to develop fact and risk-based information, a finite deferral of one additional year will advance the objective of implementing a data-informed interim factor.

1. ***ACLI supports regulators' efforts to proactively evaluate and address concerns about particular asset classes – including residual tranches.***

As noted in our testimony at the March 17 meeting of the Working Group, ACLI is supportive of the Working Group's efforts in this area. It is regulators' prerogative to proactively evaluate any investment

[1] Texas Department of Insurance, June 9, 2023 comment letter in Attachment 2 of rbcire-6-14-23-materials, "TDI supports a compromise that would set the residual tranche base factor at 30% and a sensitivity test factor at 15% for the 2023 risk-based capital formula. Then, in 2024 the base factor would move to 45% and the sensitivity test factor would drop to 0%."

they believe merits greater scrutiny, including structured securities and residual tranches. Investments evolve over time – and regulations must evolve alongside them. We appreciate that the Working Group has strived to maintain a transparent process and that the Chair has created opportunities for stakeholders to share their views on this complex topic.

2. *ACLI supports further study on the potential drivers of risk within the residual tranches to determine appropriate interim RBC factors.*

Considering the brief exposure period and in a desire to avoid duplicative efforts, the American Academy of Actuaries ("the Academy") is the appropriate body to conduct a technical review of the OW study. While ACLI is not submitting comments on the study itself, we do believe it raises a relevant question on whether the variations of the residual tranche structure or specific attributes are driving risk.[2] For example, the OW study looked at residual tranche thickness and collateral types.

The forthcoming Academy analysis, expected this summer, will identify comparable attribute candidates to appropriately capture the major drivers of tail risk. The Academy's work should provide additional insights on this matter and help regulators determine the best approach for determining C-1 charges, for both Broadly Syndicated Loan Collateralized Loan Obligations ("BSL CLOs") and non-CLO Asset Backed Securities ("ABS"). Additional analysis on industry holdings and the risk drivers within the residual tranches across different types of asset classes would be useful to ensure that regulators have the most appropriate approach for the interim RBC factors in place. This analysis may also help avoid unintended consequences that may occur when the charge is applied to BSL CLOs and other types of securitizations, especially those that have not been specifically evaluated by regulators or the Academy. It is possible that the interim factor (45%) could potentially incentivize structures with lower equity subordination (higher leverage) rather than structures with higher equity subordination (lower leverage).

3. *It is important for stakeholders to understand the cumulative impact of recent regulatory changes impacting residual tranches.*

Since 2021, regulators have made multiple changes impacting the disclosure, reporting, and treatment of residual tranches and interests. First, these changes will increase the consistency in reporting by clarifying that residuals in substance should be treated as residuals and disclosed on Schedule BA. The changes mean that some assets that may have previously been disclosed on Schedule D-1, will be reported on Schedule BA and receive a higher RBC factor. Second, further changes are likely under the Principles Based Bond Definition ("PBBD"), which becomes effective in YE 2025. At this point, it is still unclear which assets will be classified as ABS (thus impacting residuals of those ABS) under the PBBD. It is possible that additional analysis and calibration of the ABS residual risk charges may be needed after understanding exactly which assets are classified as ABS under the new definition in 2025.

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[2] Other regimes, including Basel III have identified multiple risk drivers for securitization, including maturity, seniority level, tranche thickness, and final ratings. Tranche thickness and maturity were added to reduce the importance of external ratings and enhance risk sensitivity. *See* Moody's Analytics, *Capital calculations under the revised securitization framework* 3-5 (2017) (describing the inclusion of additional risk drivers to reduce dependence on external ratings and increase risk sensitivity), *available at* https://www.moodysanalytics.com/-/media/whitepaper/2017/capital-calculations-under-the-revised-securitasation-framework.pdf; *See also* Basel III Document: Revisions to the Securitization Framework 9-12 (2016) (describing the inclusion of additional risk drivers into the external-ratings based approach (ERBA) for securitizations).

The adoption of the PBBD will change the carrying value of residuals and as noted by one of the Academy's RBC principles for structured securities, the accounting must be considered when determining an appropriate RBC factor.[3] ACLI believes that consideration is appropriate for all factor changes, whether it is interim or not. Specifically, the new residual tranche accounting likely will result in carrying values broadly across the industry to be lower than fair values. As a result, any RBC factor developed using fair value loss RBC could potentially overstate exposure to loss broadly across all companies, especially in cases where companies account for residuals using the practical expedient. The carrying value accounting and the use of fair value as the loss metric should both be considered when determining whether an RBC factor is reasonably conservative and reflective of risk.

In 2023, there was a significant increase in the aggregate amount of residuals ($11.6B) reported by life insurers on Schedule BA, although the acquisition data indicates that reclassification of assets was the primary driver of increased exposure to Schedule BA residuals.[4] While the reporting changes make an accurate year-over-year analysis somewhat imperfect, the data demonstrates that life insurers' acquisition of residuals declined by 28% between 2022 and 2023.

The 2023 sensitivity test results give regulators the data they need to identify and mitigate potential solvency concerns now. The 2023 sensitivity test data also provides additional insight into the impact of the 45% charge on 110 life insurance entities. Five companies (5%) would see a change of at least 5% in Authorized Control Level RBC. The remainder of life companies examined (95%) would have less than a 5% change in Authorized Control Level RBC If the charge is applied. Around 33% of life companies examined would have a change of <0.1%.

The 2023 reclassification data, the ability to evaluate companies at both the 30% and 45% RBC charge through the 15% sensitivity test in place for YE 2023, and the consideration of the January 1, 2025 accounting changes are potentially material to the judgement of an appropriate interim RBC factor. It is prudent to review each of these concepts thoroughly prior to establishing an interim RBC factor which may be in place for several years.

4. *ACLI respectfully requests a one-year deferral to better understand emerging data and research by the Academy.*

In June 2023, regulators opted to impose a 45% interim RBC charge for residuals as of YE 2024 while the NAIC Structured Securities Group ("SSG") develops a more sophisticated approach for BSL CLOs.[5] However the 45% charge applies to all structured securities irrespective of their risk. The 45% factor is often described as a reasonably conservative solution for an interim RBC charge that would apply until the SSG's modeling work was done. However, the SSG has been focusing on BSL CLO debt. There is no apparent timeline for modeling asset-backed securities, nor is it clear that the SSG will model all classes of

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[3] Principles 3 states that "C-1 requirements should generally reflect the impact of risk on statutory surplus. Changes in accounting treatment will affect RBC." The Academy noted that "all else equal, assets that are marked to market ("MTM") may have higher C-1 requirements because C-1 on MTM assets incorporates price fluctuations in addition to credit losses. In practice, this means that C-1 for residual tranches would consider price fluctuations, whereas C-1 for unimpaired rated debt tranches only considers credit losses."
[4] NAIC Year-End 2023 Aggregated Residual Data, *available at* https://content.naic.org/sites/default/files/call_materials/2023%20Residual%20Aggregated%204-1-24.pdf.
[5] The initial modeling excludes Commercial Real Estate CLOs, asset-backed securities, resecuritizations, Collateralized Debt Obligations (CDOs), Trust Preferred CDOs, and Middle Market CLOs.

ABS or other types of residual tranches. Accordingly, the interim solution may be more enduring for certain types of ABS.

ACLI acknowledges that some regulators feel urgency about the work. ACLI is not suggesting regulators pause the workstream or abandon the inquiry into the appropriate treatment of residual tranches and structured securities. We are respectfully asking for a temporary, one-year deferral, allowing time for regulators and stakeholders to consider the RBC factor within the context of the Academy's work on comparable attributes and the impact of recent changes in accounting treatment. Regulators continually strive to "get it right". Spending a bit more time on this will help to ensure that a true data-informed RBC factor for residual tranches is adopted.

For the reasons cited above, ACLI respectfully requests an additional one-year deferral.

5. Conclusion

Thank you for the opportunity to share these views. We would be pleased to discuss this letter with you in further detail, at your request.

Sincerely,

Mariana Gomez-Vock

Mariana Gomez-Vock
Senior Vice President, Policy Development

AMERICAN ACADEMY of ACTUARIES

April 8, 2024

Mr. Philip Barlow
Chair, Risk-Based Capital Investment Risk and Evaluation (E) Working Group
National Association of Insurance Commissioners (NAIC)

Re: Review of Oliver Wyman study on ABS residual tranches

Dear Chair Barlow,

Oliver Wyman has conducted a study on Asset-Backed Securities (ABS) residual tranche risk (OW study) that was presented to the Risk-Based Capital Investment Risk and Evaluation Working Group of the NAIC (RBCIRE) at the 2024 Spring National Meeting. Working Group members asked the American Academy of Actuaries[1] C1 Subcommittee (subcommittee) to review and comment on the OW study. This letter focuses on the OW study's consistency with the six ABS RBC principles presented by the subcommittee to RBCIRE at the 2023 Fall National Meeting. A full technical review of the OW study is outside the scope of this letter.

The table below provides a summary of this review's conclusions, with detailed explanations provided throughout the remainder of this letter.

Principle #1	Partially consistent
Principle #2	Consistent
Principle #3	Consistent
Principle #4	Partially consistent
Principle #5	Partially consistent
Principle #6	Inconsistent

Principle #1: The purpose of RBC is to help regulators identify potentially weakly capitalized insurers, therefore changes that have a small impact on RBC ratios may not justify a change to the RBC formula.

Principle #1 includes two complementary elements. The first is that RBC is intended to highlight for regulators potential solvency issues with insurers. In other words, if an insurer is exposed to a

[1] The American Academy of Actuaries is a 20,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

risk, then its RBC ought to reflect that. The second is a materiality consideration where enhancements with the highest potential impact on RBC should be prioritized over potential changes that may increase precision but not materially impact RBC.

Regulators have identified residual tranches as a material risk warranting a change to the RBC formula. Therefore, the OW study, providing data on residual tranches, is consistent with Principle #1.

However, the subcommittee disagrees with the implicit suggestion from the OW study that C-1 for residual tranches can be informed by comparing risk of residual tranches to the risk of common stock (other sections of this letter also reference the comparison to common stock, which we believe is implied although not explicitly stated in the OW study). The subcommittee's view is based on the following:

- While leveraging existing C-1 factors from other asset classes may be a reasonable approach under some circumstances, the use of this approach should be predicated on similar risk characteristics or having insufficient data to support risk modeling (see Appendix 1 for the C-1 modeling flowchart that was introduced by the subcommittee at the 2023 NAIC Summer National Meeting).
- In the subcommittee's view, the risk characteristics for residual tranches (especially in the tail) are significantly different from common stock. Therefore, assessing the C-1 factor for residual tranches using the existing C-1 factor for common stock may lead to inappropriate conclusions.
- The C-1 factor for residual tranches should not be informed by the C-1 factor for common stock because statutory accounting for these two asset classes is different. Accounting for common stock is on a mark-to-market basis whereas SSAP 21R provides an option for residual tranches to be valued on a discounted cash flow basis (further discussed under Principle #3 below).

<u>Principle #2: Emerging investment risks create concerns for regulators, and existing regulatory tools can be considered alongside RBC for addressing these newer risks—but RBC needs to be considered when there are material solvency issues.</u>

Regulators have generally identified ABS as an emerging risk that could impact solvency. Residual tranches, specifically, are an emerging risk. By providing new data and analysis to explore the risk of residual tranches, the OW study is consistent with Principle #2.

In addition, emerging investment risk can arise in circumstances where the C-1 factor for an asset class is not commensurate with the underlying investment risk. The OW study brings to light material differences in risk characteristics across different types of residual tranches and therefore the potential need for differentiated C-1 factors. This is a helpful insight and is consistent with Principle #2.

<u>Principle #3: C-1 requirements should generally reflect the impact of risk on statutory surplus. Changes in accounting treatment will affect RBC.</u>

Statutory accounting for residual tranches is impacted by the recently adopted SSAP 21R where residual tranche valuations are not directly subject to mark-to-market volatility. SSAP 21R allows insurers to use a discounted cash flow approach to residual tranche valuation (an approach that was adopted after the development of the OW study). Under this approach, a discount rate for each residual tranche is determined at purchase and remains unchanged. The asset is impaired if the present value of cash flows is less than book value.

The OW study uses a fixed discount rate in assessing potential loss exposure for residual tranches, which in effect excludes potential mark-to-market exposure under a stress scenario. This approach is largely consistent with SSAP 21R and Principle #3.

<u>Principle #4: C-1 requirements for a given tranche should align with that tranche's risk, to the extent practical.</u>

Principle #4 addresses the idea that C-1 should reflect the level of risk in each tranche, rather than being constrained by requirements that C-1 on ABS equals C-1 on collateral. On this point, the OW study is consistent with Principle #4 where the exposure analysis of residual tranches is based on projected performance of the underlying collateral.

The subcommittee's view is that residual tranches and common stock have different risk characteristics, so the study's reference to C-1 factors for common stock may be inconsistent with Principle #4. Further, since the OW study assumes sufficient data to support modeling the risks, the C1 modeling flowchart would not end with using existing C-1 factors, whether for common stock or some other asset class, unless residual tranches are impractical to model individually. An assessment of individual asset modeling's practicality is outside the scope of the OW study and of this letter.

<u>Principle #5: C-1 requirements on ABS should treat the collateral as a dynamic pool of assets, incorporating future trading activities that are reasonable and vary appropriately by economic scenario.</u>

Principle #5 clarifies that no assumption should be made for reduced risk through better-than-market credit selection, which is consistent with the OW study.

Principle #5 also suggests that trading activity subject to or mandated by the structure's legal documents should be incorporated as part of the risk modeling in determining C-1 requirements. Specific to collateralized loan obligations (CLOs), the OW study does not incorporate trading activity in the form of reinvestments within the collateral pool. This simplification is inconsistent with Principle #5 and may potentially bias the results in a conservative direction, which the OW study acknowledges.

<u>Principle #6: Each C-1 factor is based on the asset class's risk profile. However, the risk profile for ABS differs from the risk profile for bonds. Therefore, C-1 requirements for ABS should be calibrated to different risk measures where appropriate.</u>

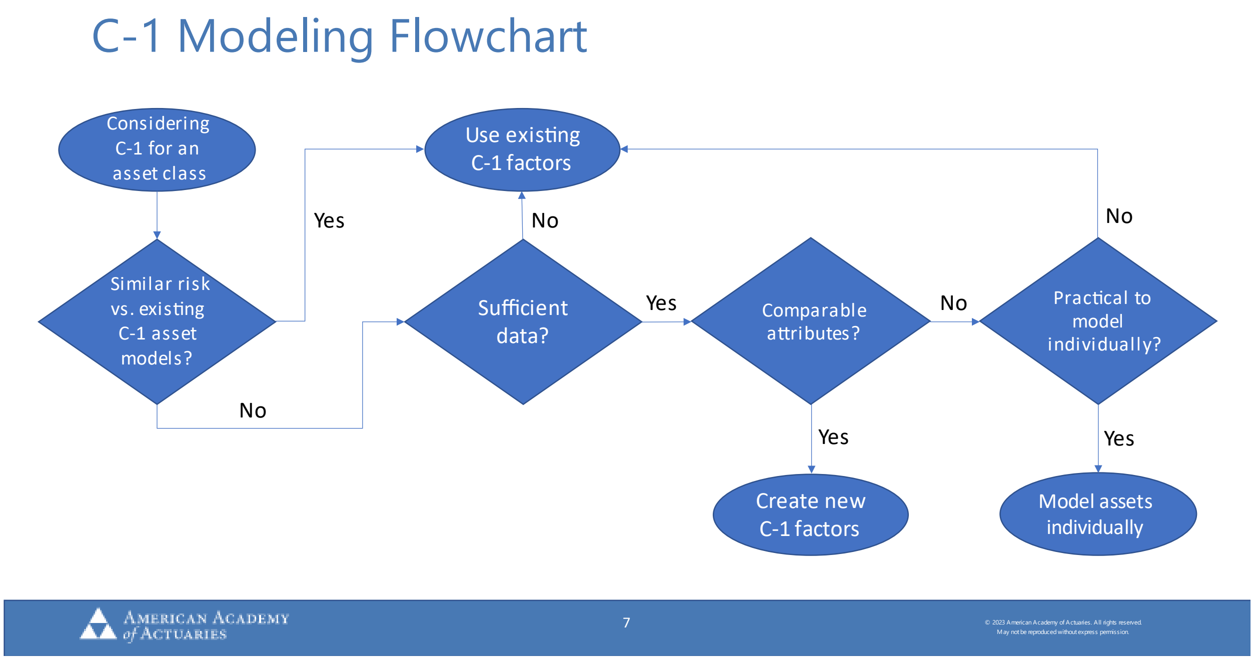
Principle #6 suggests that ABS and corporate bonds need not use the same risk measure and that a conditional tail expectation (CTE) risk measure is likely more appropriate than percentile for ABS to capture tail risk. The OW study is based on percentiles, which would be inconsistent with Principle #6 because percentiles may struggle to capture tail risk for ABS. While not using CTE explicitly, the OW study does include percentile results under a deep-tail scenario. This provides a potential upper bound for a CTE risk measure.

The C1 Subcommittee appreciates your attention to the issues raised in this letter and looks forward to discussing them further with you. Should you have any questions or comments in response to this letter, please contact Amanda Barry-Moilanen, life policy analyst (barrymoilanen@actuary.org).

Sincerely,

Stephen Smith
Chairperson, C1 Subcommittee
American Academy of Actuaries

Appendix 1


C-1 Modeling Flowchart
Considering C-1 for an asset class
Similar risk vs. existing C-1 asset models?
Yes
No
Use existing C-1 factors
Sufficient data?
No
Yes
Comparable attributes?
Yes
Create new C-1 factors
No
Practical to model individually?
No
Yes
Model assets individually
American Academy of Actuaries
7

SENATOR PAUL BAILEY

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MEMBER OF COMMITTEES
Chairman of Commerce and Labor
Transportation

April 8, 2024

Dear Mr. Barlow:

The life insurance and annuities market boasts a complex collection of products that provide hardworking Americans from all socioeconomic backgrounds with the crucial tools they need to get ahead in planning and saving for retirement. Given the important yet delicate nature of this market, I'm concerned by the NAIC Risk-Based Capital Investment Risk and Evaluation (RBC IRE) Working Group's recent conduct in moving forward on a 45% capital charge on asset-backed securities.

When drafting insurance rules, regulators should adhere to data and consider the costs and benefits of any changes. This is particularly important given the NAIC's unique role in guiding consensus for insurance policymaking across the entire country. However, this is not the path the NAIC has been following recently. Independent and verified data in the form of the Oliver Wyman study clearly demonstrates that asset-backed security (ABS) equity is less risky than other securities with a 30% charge. This demonstrates that a 45% capital charge on residual tranches is disproportionately high relative to other insurer investments. This study is thorough and uses a sophisticated analysis. Some regulators are misstating that the study supports a 45% charge. This is untrue and regulators should seek clarification from the study sponsors and authors if they have questions about the research conclusions.

Beyond being unnecessary, I worry that a 45% capital charge on ABS equity would be extremely burdensome for the life insurance and annuities market and, by extension, for American consumers. In my role as the Chair of the Commerce and Labor Committee in the Tennessee State Senate, I remain committed to safeguarding consumers and market competition. If ABS equity is saddled with a 45% capital charge, insurers will be dissuaded from investing in these assets. This would reduce investment returns, steer insurers into less appropriate investments, and reduce or eliminate options for consumers who need help protecting their families and saving for retirement.

Hardworking people across the Volunteer State deserve to know that rules affecting their insurance policies are made in full sunlight and with their best interests at heart. Therefore, it is concerning to see the NAIC forge ahead in such an unprecedented and thoughtless manner, despite data and research, to pursue this misguided policy proposal. I am concerned that this move undermines the credibility of the NAIC itself, and calls into question the wisdom of states permitting standard-setting by the organization.

Legislators like myself are questioning what ill-founded policy moves might be next, given that the NAIC seems willing to ignore data and harm our citizens.

Before it's too late, I encourage the RBC IRE working group to delay the implementation of the 45% capital charge on residual tranches. Regulators ought to review the data and adopt a more consumer- and competition-centric approach. The life insurance and annuities market is an integral facet of the American economy. I hope the NAIC sees things the same way.

Sincerely,

Paul Bailey

Paul Bailey

Chairman of Commerce & Labor

15th District of Tennessee