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October 9, 2023

Mr. Dan Daveline
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Re: Framework for Regulation of Insurer Investments

We are pleased to provide Equitable's perspective on the memo titled "Framework for Regulation of Insurer Investments – A Holistic Review" that was exposed for comment by the Financial Condition (E) Committee on August 15, 2023 (the "Proposal").

This letter offers five principal positions for consideration by regulators charged with updating the regulation of life insurer investment risk, which offer support for and augment provisions within the Proposal:

1. **Reform is necessary.** Comprehensive NAIC reform of how investment risk levels are regulated across multiple asset classes is warranted by the significant and ongoing shift in life insurer general accounts toward private and structured credit.¹ Enhanced disclosure of structured securities holdings alone will be inadequate to address the increased risks posed by this shift.
2. **Rely on CRPs – with oversight.** Determining capital charges for private credit that rely principally on the outputs of Credit Rating Providers (CRPs) with expertise in a given ABS asset category is appropriate and pragmatic, but such ratings must be subject to robust regulatory governance.
3. **Focus on tail risk.** In pursuing these reform initiatives, regulators should prioritize balance sheet resilience by affirmatively committing to a technical goal of setting equal capital for equal tail risk. Emphasis on tail outcomes aligns with stated regulatory imperatives to use RBC to identify poorly capitalized insurers - instances of which are most likely to emerge in a tail economic scenario - and avoid *acute* insolvencies of individual insurers.

¹ BlackRock survey shows 89% of 378 global insurance executives surveyed expecting to increase allocations to private credit in the next 2 years. <https://www.bloomberg.com/news/articles/2023-09-27/blackrock-sees-insurers-betting-on-credit-paring-private-equity#xi4y7vzkg>

4. **Introduce CLO and other ABS concentration factors for lower rated securities.** An updated “holistic” regulatory framework should supplement RBC C1 capital charges with concentration factors. Such a system is necessary to maintain balance sheet resilience in a tail scenario for companies with large allocations to lower rated tranches of CLOs and other ABS, given the uniquely high loss correlation among these securities. Specifically, this correlation refers to the tendency of securities backed by collateral with a common risk profile to experience large losses at the same time, thereby creating the conditions for systematic losses.
5. **Continue prioritizing CLO modeling.** Existing NAIC initiatives to address investment risk capital charges should continue unabated, with the Securities Valuation Office (“SVO”) CLO modeling project serving a critical role in informing how to translate “expected loss”-oriented CRP ratings to tail-oriented capital charges. Such translation is necessary because the ratings methodologies of CRPs – by their own admission – typically do not provide a sufficient signal for setting capital charges.

The remainder of this letter offers context for our positions, followed by details and support for the latter two recommendations.

Observations for context

The history of NAIC investment risk regulation and RBC development is characterized by continuous and holistic evolution commensurate with changes to (and learnings from) the risk profile of US life insurers.

Challenges arising in insurer balance sheets led to the rise of riskier asset allocations

The decline in interest rates over the past four decades through 2022 exposed shortcomings in both life insurer product design (e.g., high minimum interest rate guarantees; lapse supported products) and liability reserving standards (e.g., lack of guardrails on actuarial assumptions; ALM scenario tests that reflected outdated interest rate conditions). Many life insurers were forced to strengthen reserves repeatedly for actuarial assumption deficiencies; retained rather than deployed capital; and allocated more greatly to private and structured credit and alternatives – often through reinsurance but sometimes directly – to fund minimum interest rate and other policyholder guarantees. Following the 2008 financial crisis, new entrants into the life sector willingly deployed capital to back those reinsurance agreements, attracted by the (i) low capital charges required to support the associated investment portfolios, (ii) favorable ceding commissions that cedants were willing to pay given their ALM challenges, and (iii) appeal of stable funding provided by those agreements after alternate sources, such as prime brokers, diminished due to post-crisis banking regulation reforms.

‘First wave’ regulatory reforms sought holistic overhaul of liability reserving standards

The same reserving and ALM challenges also motivated regulators to reform reserving standards through the NAIC’s Principles-Based Reserving (“PBR”) initiatives, including VM-20/Life, VM-21/Variable Annuity and the upcoming VM-22/Fixed Annuity implementation. These reserving standards replaced outmoded formulaic rules with standards that, by-and-large, consist of discounted forward looking

projections of cash flows subject to newly introduced guardrails to actuarial assumptions. Recently, the NAIC also elected to modernize the economic scenario generator (GOES) that backs PBR and C3 Phase I, part of a holistic reform of liability standards – notably executed through individual initiatives so as to accommodate regulator and industry bandwidth. Collectively, these crucial reforms will ensure that lessons from the liability-driven systemic shocks of the past are enshrined in prospective, right-sized liability reserving standards.

‘Second wave’ reforms now rightly focus on investment risk

As these liability-related initiatives progressed, regulators have recognized the need to reform the frameworks governing investment risk – arising from the recognition of unearned spread in reserves (AG53) and shortcomings in the RBC C1 asset risk charges. In particular, the increased prevalence of lower rated structured securities like CLOs and other ABS on insurer balance sheets justifies a tailored approach to capital charges, given that the tail risk profile of structured securities – both in loss potential and correlation of loss with other investments – differs overtly from that of corporate bonds, whose factors are currently used for determining the required capital for structured securities.

Rising interest rates alleviates industry impact of investment risk reforms

The justifiable increase in capital charges for lower rated structured securities that we expect to result from the current reform initiatives would have been a challenge for many insurers to absorb in a low interest rate environment, where yields on more traditional senior credit investments would have been inadequate to fund their previously written minimum interest rate guarantees. However, fortunately for regulators and industry alike, these initiatives have coincided with a sharp rise in risk free interest rates that enables insurers to fund their guarantees with a broader set of credit instruments than was feasible during the era of near-zero short-term rates. This means that insurers can now manage their legacy liabilities without the need for significantly increasing allocations to lower rated structured securities that potentially threaten acute insolvencies of individual insurers (along with life insurance industry and regulator credibility).

Pragmatically, a period of sustained higher interest rates means that regulators have far more latitude to establish more prudent and appropriate capital charges and concentration factors – and likely shifts in some insurer investment portfolios – without impairing industry solvency ratios.

Supplement RBC C1 capital charges with concentration factors

This section outlines why we believe concentration factors are necessary to maintain life insurer balance sheet resilience in light of the substantial risks posed by large allocations of lower rated ABS, namely, (a) their “cliff loss” potential, (b) their high correlation of losses, and (c) the uncertainty inherent in using models to estimate losses in the tail. *See Appendix for details about and rationale for this proposal.*

Regulator and stakeholder focus of investment risk RBC reform has thus far been on C1 capital charges. **While important, higher capital charges alone are insufficient to address regulator concerns**

about the potential for deep insolvencies among life insurers with concentrated positions in lower rated structured securities. The reason for the inadequacy is inherent in the structure of these securities:

- **Cliff loss potential:** Lower rated tranches may lose nearly 100% of their value in a severe stress scenario, as cumulative losses erode the credit enhancement of a lower rated tranche.
- **High correlation of losses:** Lower rated tranches that are susceptible to losing all their value will do so at a time when equivalently-rated tranches in other securities – backed by collateral of a similar risk profile - also experience a near total loss. This reveals a paradox of collateral diversity – more diverse collateral *within* a given structured security actually creates more correlated performance *across* securities with similar collateral types and security terms.

These two features – demonstrated by historical data for several classes of ABS – make the loss profile of an investment in, say, BBB-rated CLOs closely resemble an investment in a single security with the very real potential to lose virtually all its value.

That capital charges alone are inadequate for addressing ABS investment risk is demonstrated through an example:

Assume an insurer has \$100 of assets and \$8 of capital. Assume also that this insurer holds 15% of its portfolio in lower rated CLOs (for purpose of this example, BBB rated), for which the average C1 charge today is 1%. Further suppose that the existing reform initiatives result in CAL RBC being increased five-fold to 5%. In a stress scenario sufficiently severe to breach BBB-rated CLO tranches, **the extreme correlation of losses among equivalently-rated CLO tranches means that almost all the BBB tranches will lose their full value.**

A capital charge of 5% is grossly inadequate to cushion the loss of 100%² on these assets – and results in a capital shortfall of 14.25% (95% of 15%) of the insurer’s total investment exposure. De facto regulatory allowance of this outcome means losses in a single asset class representing 15% of that insurer’s investment exposures will eliminate all its capital and more – leaving no capital to absorb any losses on all other investments or risks of that insurer, in an economic environment that is, by definition, a severe corporate credit loss event.

By contrast, if, due to the application of a concentration risk charge, the insurer was limited to holding, say, 2% of its balance sheet in BBB-rated CLOs - the resulting 1.9% (95% of 2%) shortfall in the same stress scenario would be of concern but would not result in an acute insolvency, thereby leaving most of the insurer’s capital in place to support other risks.

Accordingly, we recommend that the NAIC adopt a system of concentration factors that distinguishes among ABS collateral types, given the highest loss correlation among ABS will occur - and has previously occurred - for securities backed by collateral with a similar risk profile. Provisionally, we

² Simplification for the purpose of this illustration, intended to capture the binary nature of lower rated structured ABS outcomes in a tail scenario.

propose applying separate concentration factors to lower rated structured security types that have collateral based upon (i) corporate credit, (ii) residential real estate, (iii) commercial real estate and (iv) all other ABS, once holdings of these securities exceed a predetermined threshold or limit. We note that adoption of concentration factors by the NAIC is not a novel concept – they already exist for single equity and other asset exposures.

The graphic below illustrates the hypothetical structure of a concentration factor framework:

Collateral type	Corporate credit	Residential real estate	Commercial real estate	...	Aggregate limit
Limit % GA (lower rated tranches)	x%	x%	x%	x%	yy%
Types of securities	CLOs, CFOs, CDOs	NA RMBS	CMBS	All other (credit card rec., auto finance, cell phone towers)	Total <u>lower rated tranches</u> limit

Within this framework, holdings of lower rated securities for each collateral type are subject to a limit (set at a level dictated by regulator tolerance for the overall loss to the insurer’s General Account attributable to a loss in the particular ABS class), such that:

- Lower rated holdings below the limit draw the RBC C-1 capital charges in place for those securities; and
- Any lower rated holdings above the limit are subject to an additional concentration factor.

Moreover, while lower rated ABS losses are not necessarily as correlated *across* collateral type as they are *within* collateral type, **the positive correlations observed among collateral losses justify consideration of an aggregate limit on lower rated ABS** to protect against a large set of deep insolvencies in a very severe tail scenario, where all lower rated ABS collateral may experience significant losses.

Continue to prioritize SVO CLO modeling to inform translation of CRP ratings to tail-oriented ABS capital charges

We support the E Committee position that the most pragmatic means for setting appropriate capital charges for private credit is to rely primarily on the outputs of CRPs – subject to governance of ratings robustness and harmonization of material variations in methods employed across CRPs. We also believe the SVO is the appropriate body to oversee this enhanced governance and should be provided the additional tools and resources it needs to carry out this function.³

However, we further argue that a comprehensive modeling effort – such as the SVO CLO modeling initiative currently underway – is necessary to inform the translation of a CRP rating (which usually estimates probability of default or “expected loss”) into a tail loss measure appropriate for a capital

³ We agree with the American Council of Life Insurers and other commenters that the SVO should retain its current ability to perform individualized credit assessments.

charge. This undertaking may ultimately result in the much discussed “mapping of ratings” of CRP ratings to NAIC ratings – but will inform the important question of “how large a mapping adjustment” relative to corporate bond mappings is warranted.

The table below outlines the critical gaps addressed by a translation of CRP ratings into tail loss measures, which include core elements such as the risk metric to be calibrated and the risk factors and characteristics to be considered. We support use of a Conditional Tail Expectation measure for the risk metric, and consideration of correlation of losses of the lower rated ABS both with other lower rated ABS backed by similar collateral as well as with other common industry investment exposures.

CRP ratings and tail risk measures: commonalities and differences in considerations for establishing appropriate ABS capital charges

Methods	CRP rating		Capital charge
Target Metric	Probability of Default (PD) or Expected loss (EL = PD x LGD)		Tail loss (e.g., Conditional Tail Expectation)
Probability of default (PD)	Considered		Considered
Loss given default (LGD)	Historical LGD (non-stress period), if considered at all		<u>Stressed</u> LGD (higher loss in adverse climate)
Correlation (ρ)	Collateral loss ⁽¹⁾	Considered	Considered
	Intra-sector loss ⁽²⁾	Not considered	Necessary
	Inter-sector loss ⁽³⁾	Not considered	Necessary

(1) Measure of correlation within the specific security collateral, i.e., relationship within the loss profile between loan 1 and loan 2 in a given CLO.

(2) Measure of correlation across securities with common collateral, i.e., relationship within the loss profile between CLO 1 and CLO 2.

(3) Measure of correlation across securities of different types, i.e., relationship in the loss profile between CLO 1 and CMBS 1.

Without the backing of a model to determine an appropriate RBC C1 charge for the risk posed by a class of lower rated structured securities, a CRP-based rating system for ABS will lack robust calibration. For the calibration of the C1 bond factors, historical loss data from the last 40 years was available from

multiple credit stress environments, and so CRP outputs were able to serve as a sorting mechanism for calibrating a tail loss metric (in this case, 96%-ile VaR) appropriate for capital. CLOs and most other ABS have a significantly shorter history during which severe credit stresses have been absent; accordingly, a model will be required to capture tail losses for these securities. Moreover, we expect the same adjustments noted in the table above for CLOs to apply roughly equally for other ABS, enabling regulators to apply the mapping developed for CLOs to all types of ABS.

We commend the NAIC on its work on these important issues to date, including the thoughtful, transparent and iterative process through which regulators have engaged with external stakeholders. We would be delighted to further discuss the concepts presented in this letter as regulators continue to refine the framework for regulation of insurer investments.

Sincerely,



Aaron Sarfatti
Chief Risk & Strategy Officer

Appendix – Rationale for concentration factors

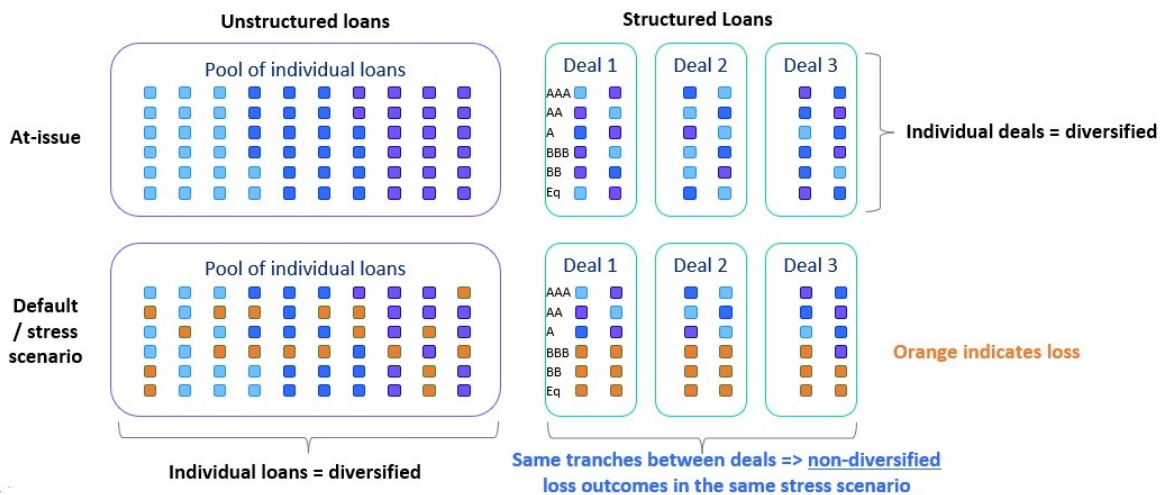
Lower rated structured securities of the same rating and underlying collateral demonstrate an ultra-high correlation of losses in a severe stress that fully distinguish them from traditional bonds.

While any two similar loans (say, leveraged loans) in a stress scenario will be subject to the same structural risk factors (i.e., higher interest rates and declining GDP), their loss correlation will remain well below 100% because a large share of their financial outcomes is based on idiosyncratic factors – company sector, strategy, geographic footprint, etc.

By contrast, two lower rated ABS tranches of a similar rating and which draw from a similar collateral pool are likely to experience ultra-high (near 100%) correlation of losses. This is because the contractual rules governing the security's structure, most notably pooling of risk across large numbers of loans, diversify away the aforementioned idiosyncratic factors that affect individual loan performance. The result is relatively homogenous structures whose losses are heavily determined by the systematic risks factors that affect all lower rated ABS of a given type (say, CLO) in the same way.

These effects are demonstrated in the following illustration, which shows how the performance of tranches across individual deals is apt to be highly similar in a stress environment given the common risk pooling, attachment points for tranches, and other security characteristics.

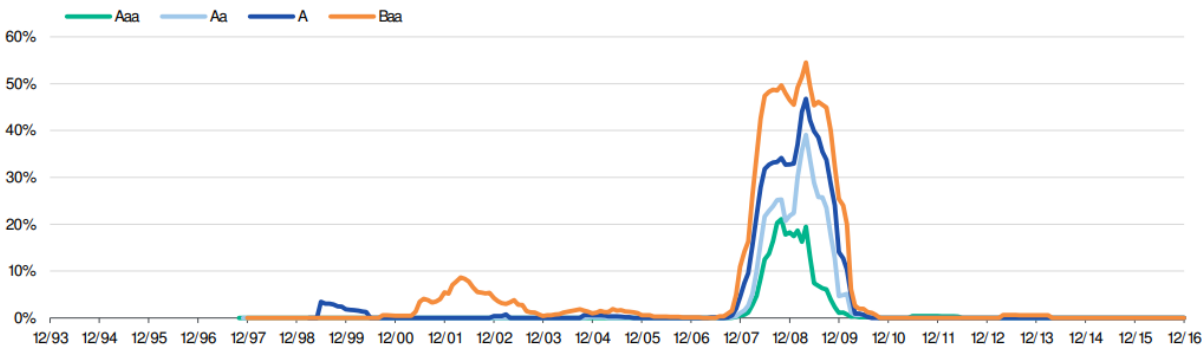
Expectation in a stress environment is that the same rated tranches will default in tandem across multiple deals which have common collateral
 Contrast of diversification effect across multiple CLO securities vs. multiple standalone securities



Historical data supports the theoretical outcomes predicted above for various ABS. Below is an exhibit of the impairments for global CDOs (excluding CLOs) between 1993 and 2016. This exhibit includes all securities within the CDO asset class – and demonstrates the high correlation of losses driven by systematic risk factors: no or very low losses prior to the financial crisis, followed by profound

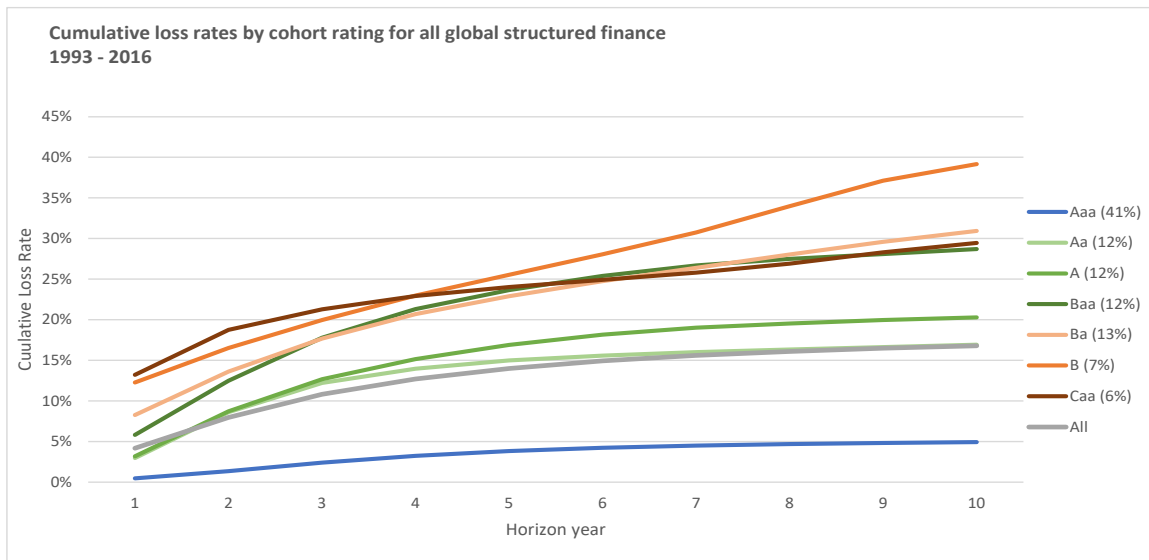
losses across tranches experienced during and shortly after the crisis. Numerous other ABS asset classes exhibit similar “no loss followed by profound correlated losses” characteristics.⁴

Trailing 12-month Impairment Rates for Global CDOs ex CLOs by Cohort Rating (Aaa, Aa, A, Baa)



That CLOs have not previously experienced profound and correlated losses is simply because the risk factors that would significantly impact CLO performance – stagflation characterized by high short term interest rates and weak corporate earnings – have not transpired since the inception of the asset class.

Historical losses by tranche assessed in the Moody’s report “Impairment and Loss Rates of Structured Finance Securities: 1993-2016” are greater than the losses observed in corporate bonds. The following chart shows the observed losses by cohort rating. The “All” is effectively the average loss of all collateral in structured deals over the 10-year horizon. Higher rated tranches show the benefit of substantial credit enhancement. Lower rated tranches show larger historical losses with amounts increasing as the degree of credit enhancement decreases with lower ratings. This effect is amplified when looking specifically at assets that experienced stress during the crisis, e.g., RMBS. Note that this chart provides average losses across all structured securities.



⁴ Source: Moody’s Investor Service. “Impairment and Loss Rates of Structured Finance Securities: 1993-2016.” June 15, 2017

Further, there can be significant structural factors that drive correlation of collateral in structured deals. In the example of CLOs, deals in a given year have had 30-40% of collateral overlap. What this means is that sampling two CLO deals, which typically have 100-200 issuers in each of them (with limits of about 1% per issuer), will demonstrate that there are about 30-80 of the same names across the two deals. The similarity or sameness of collateral is in large part a driver of the “paradox of diversification”.

In summary, the general drivers of concentration risk for lower rated structured assets which underly the need for a concentration factor are:

- Directly overlapping collateral;
- Highly correlated collateral (where the more diversified the collateral pool is, the more likely its aggregate performance will converge with that of collateral pools backing similar securities that experience the same stress factors); and
- Similarity of structures (tranche size, diversification / ratings requirements, management requirements, term).

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October 9, 2023

Superintendent Beth Dwyer, Chair

Financial Condition E Committee

National Association of Insurance Commissioners (NAIC)

Via email ddaveline@naic.org

Re: Holistic Framework for Regulation of Insurer Investments

Dear Superintendent Beth Dwyer:

The American Council of Life Insurers (ACLI) and its members appreciate the opportunity to submit the following comments on the Holistic Framework for Regulation of Insurer Investments (“Framework”). We support and appreciate the use of a holistic and principle-based approach that contains a focus on stakeholder engagement that we believe will ultimately lead to better outcomes, industry understanding, and compliance. As more specific details surrounding potential changes are contemplated and proposed, ACLI and its members will continue to collaborate with the NAIC to provide specific feedback and discuss implications of the proposed changes at that time.

General Observations

In recognition of the ongoing evolution in the securities marketplace and corresponding utilization by the insurance and reinsurance sectors of complex, structured, and private assets, the NAIC seeks to update its approach to the regulation of insurer investments to support life insurers long-term obligations. The Framework also asks and seeks to answer the important question: What is the most effective use of regulatory resources in a modern environment of insurance regulation for investments?

ACLI appreciates and supports a more comprehensive and holistic approach to the regulation of insurer investments as they continue to evolve. As NAIC looks to a holistic approach, we support ensuring that appropriate resources at the Securities Valuations Office (SVO) are in place to accommodate both existing and future needs of the regulators. Given the significant complexity around these issues, a critical component of a holistic approach must include an open and

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The American Council of Life Insurers (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

transparent process. One way of enhancing openness and transparency is through the creation of a consistent process for feedback from regulators, industry, and stakeholders to review the issues identified in the Framework and provide detailed feedback on specific proposals. We have appreciated when the NAIC has employed such a strategy in other situations, including the principle-based bond project and think a similar approach should be a part of the Framework. Stakeholder engagement, discussion, and collaboration such as this invites a common understanding of the issues and broad buy-in for proposed initiatives and solutions.

The NAIC has been clear that this holistic approach will not pause its current work. As a result, ACLI believes it is critical that work already in process continues to be coordinated across all workstreams with the holistic approach in mind.

The Framework

RELIANCE ON CREDIT RATING PROVIDERS (CRPs)

ACLI strongly supports the need to reduce or eliminate the “blind reliance” on CRPs while retaining the ability to utilize CRPs under a strong due diligence framework. Ideally, a holistic process would identify and address regulators’ and stakeholders’ concerns, while balancing the industry and capital markets need for transparency and due process. CRPs fill an important role in the marketplace, and it would be impractical, if not impossible, for the SVO to effectively replicate the capabilities of the CRPs on a large scale. We believe a system of better checks and balances is needed and will improve the overall regulatory oversight. We provided further detail on our suggestions to address this reliance in our July 14, 2023, letter to the Valuation of Securities Task Force (VoSTF), attached as Appendix I.

We further believe that a “vigorous process with consequences” should highlight where reliance on a CRP rating methodology is either “fit for purpose” or not “fit for purpose” for assigning NAIC Designations. The need for transparency in this process cannot be overstated – all parties must have visibility into the outcomes and understanding of the regulator’s expectations. In both situations – fit for purpose and not fit for purpose – the process should make SVO discretion rare, particularly given the strong CRP due diligence process to be implemented.

REGULATORY DISCRETION

ACLI supports the NAIC retaining the SVO’s ability to continue performing individualized credit assessments for unrated securities, as it exists today. We recognize that regulators may want to give the SVO additional latitude to challenge agency ratings deemed unfit for purpose. However, we believe that it is important to have transparency, due process, and a form of independent appeal.

Regulatory discretion should be exercised only under well-documented and governed parameters. Such discretion should be used as the exception and not the rule and must include a transparent and timely independent appeal process. Governance optimization as described above should work to achieve the limited use of regulatory discretion. Transparency when exercising regulatory discretion is critical so capital markets are not inappropriately disrupted or left “guessing” why a CRP rating was overridden. Without delineating why the CRP rating was overridden, particularly if the change impacts other similarly structured securities, the NAIC’s stated goal of uniformity and consistency will not be achieved. Discretion like this causes significant uncertainty for insurers and inappropriately disrupts capital markets that must react to the change in regulatory positioning.

It would also be inappropriate for CRP ratings to be overridden without a timely and independent appeals process that is available to impacted insurers and includes regulators. Including regulators in the independent review and appeal process is important because they are best positioned to consider all views and set policy consistently across the states. These discussions will ultimately benefit all stakeholders by promoting a deeper understanding of how investments are viewed by the SVO, capital market participants, insurers, regulators, and rating agencies.

Our July 14, 2023, letter to the VoSTF (Appendix I) includes more detailed recommendations to promote transparency and an independent appeals process. We look forward to working collaboratively with regulators and staff to address these issues.

ENHANCE SVO PORTFOLIO RISK ANALYSIS

ACLI supports the idea of further developing the SVO's portfolio risk analysis infrastructure and corresponding personnel who could perform both company-specific risk analytics at the request of regulators, and industry-wide risk analytics for use in macroprudential efforts, if that serves regulators' needs.

To ensure such a function serves identified needs, it must be efficiently developed and implemented. ACLI recommends regulators provide specific direction on what enhancements they believe are necessary to improve portfolio risk analysis. While we recognize enhancements may be necessary, dialogue and transparency with industry is critical to define the scope and implications of increasing the SVO's tools and personnel. While we support the Framework as appropriate and necessary, more definition on this item would be appreciated. ACLI would welcome participation in such a discussion.

ENHANCED STRUCTURED ASSET MODELING CAPABILITIES

ACLI supports additional structured asset modeling capabilities in support of the CRP due diligence function and in line with both Items 1 and 3 of the Framework. We agree that the SVO will need additional resources as mentioned in the Framework to reasonably enhance these capabilities. As noted previously, ACLI would recommend that regulators provide meaningful direction, specificity to these modeling capabilities to ensure they serve the needs of regulators, and CRP due diligence. Providing specificity and direction around these goals will make it easier to ensure that the process ultimately achieves regulators' desired outcomes. Again, supporting the SVO is a worthy goal and one that ACLI endorses, but if it duplicates rather than enhances existing work, it may not achieve its designed purpose.

POLICY ADVISOR AT SVO

We generally support providing regulators with more resources, but there is a need for additional understanding for all parties of what is envisioned for the next step. There is also a critical need for transparency on this item.

BROAD INVESTMENT WORKING GROUP

ACLI supports the creation of a working group that has a view towards investment strategies and

scenarios. Ideally, this group would focus on the big picture and would have clear goals to understand and measure progress with an eye towards ensuring that the cost of compliance is appropriately aligned with the benefit to regulators. We especially want to emphasize the need for confidentiality, structured similarly to Financial Analysis Working Group (FAWG) and Valuation Analysis Working Group (VAWG) where appropriate, but also the need for both regulator and industry transparency and understanding.

REWORKING VOSTF AND EMPOWERING SVO TO RAISE ISSUES

We agree that it makes sense to reduce the size of VoSTF and rename it to clearly identify the work of the group moving forward. ACLI also supports empowering the SVO itself to raise issues to the appropriate NAIC group, such as Life Actuarial Task Force (LATF), Statutory Accounting Principles Working Group (SAPWG), etc. This helps ensure that investment issues receive a true holistic review and regulators are not operating with a limited purview, as any regulatory changes in this area will almost certainly have an impact on the overall regulatory framework. We believe the process and transparency will promote a broader understanding, and better industry compliance overall.

IMPACTS ON LATF WORKSTREAMS

ACLI supports the use of actuaries that have expertise in securities valuations or other investment specific background to support Actuarial Guideline 53 (AG 53) type reviews. While such investment actuaries would not be as well versed in asset adequacy testing (AAT), they can bring greater understanding to the assets underpinning company AAT, particularly for AG 53 requirements. We fully support the SVO providing insight, analytics, and validation of assets to facilitate the Valuation Analysis (E) Working Group (VAWG) and individual regulators' review of company Actuarial Opinions. Greater understanding of asset assumptions enables regulators to have robust dialogues with companies to understand the rationale behind their Opinions.

RISK BASED CAPITAL FOR INVESTMENTS

CONSISTENCY ACROSS ASSET CLASSES

ACLI believes that the C-1 capital framework should be based upon consistent levels of stress across asset classes. As such, ACLI supports the proposed guideline that changes in RBC factors "should consider consistency across classes". We recommend including a guideline to specifically address the need for transparency in methodologies used to calculate credit risk consistently across asset classes.

ADDRESSING INCENTIVES FOR PARTICULAR STRUCTURES

As the NAIC contemplates creating new avenues for developing capital charges to new forms of investments or changing existing charges, we recommend embedding guidelines in the Framework to address the need for transparency and a robust development and modification process. The process should be iterative, analytically rigorous, and informed by data where available. We recommend the guideline also emphasize the need to allow stakeholders a reasonable amount of time to offer constructive feedback on proposals, as well as the need to provide opportunities for meaningful dialogue between regulators and industry.

ACLI appreciates the opportunity to comment and stands ready to work with the NAIC as it considers this holistic approach.

Sincerely,

Carrie Haughawout

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October 4, 2023

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Re: Framework for Regulation of Insurer Investments – A Holistic Review

Dear Superintendent Dwyer and Task Force Members,

It seems fitting that at the most recent national meeting the presentation and discussion of this Framework followed the excellent presentation by Jacqueline Friedland of OSFI demonstrating how significant advances can be made in insurance regulation. It is very encouraging that the Committee is becoming engaged and is focusing its efforts by aggressively considering ways to improve the regulation of insurer investments in this changing financial landscape.

I fully support the underlying concept in the Framework that regulators need appropriate tools as they review insurer investments. The Framework has too many excellent elements to comment on in a single letter so this letter focuses on how just a few of these can best be implemented.

As background, there are three levels of analysis of investment securities:

- Individual security
- Portfolio
- Enterprise (e.g. asset liability analysis)

Individual Security Analysis

The NAIC presently has the responsibility for analyzing bond-like assets one-by-one. The result of this is an NAIC Designation which translates directly into RBC factors (either C-1 or R-1) and this work is performed by the Investment Analysis Office. The Valuation of Securities Task Force is presently considering a proposal intended to reduce reliance on rating agency ratings. One concern of some regulators is that the NAIC is relying blindly on the rating agencies which provide the overwhelming majority of NAIC Designations.

I have written very recently to the VOS/TF raising what I believe are significant questions that are yet to be answered about how the proposal could be implemented. Given that the anticipated time

frame for implementation is two to three years in the future and that it would require the NAIC to develop many new capabilities I have recommended that the task force take a step back and take a broader look at the overall situation.

Rather than focusing on the narrow question of how to reduce reliance on rating agencies I have proposed that the task force address this question instead: **How can the NAIC optimally determine RBC C-1 and R-1 factors for debt instruments?**

This is a much more important question and considering it can produce far superior results. There should be no preconceived notions. It should not even be assumed that there needs to be any reliance on rating agencies at all, as unlikely as that may seem, and the IAO itself could have a vastly different role as well. This is completely consistent with the with the thinking of the Committee that new technologies for modern risk analysis should be explored and utilized when appropriate.

Summary: I recommend that this Committee support a consulting project to answer the fundamental question of how to optimally develop these risk measures before work proceeds on a proposal that may or may not be determined to be relevant.

Portfolio and Enterprise-Level Analysis of Insurer Investments

SVO Proposal #3 essentially recommends that the SVO develop industry-wide risk analytics. This seems reasonable provided its costs can be justified. As well as insurance departments already perform, they themselves need to be able to look beyond just their own jurisdictions in order to be better aware of national and even global trends. The NAIC is ideally suited to do this on their behalf.

Care should be taken, however, not to duplicate existing resources if they cannot be proven produce better results. Regulators already have these tools:

- Risk-Based Capital
- Statutory Reserves
- ORSA
- Liquidity Stress Testing
- Cash Flow Testing (AG 53)
- Others

The single-asset analysis, as performed by the SVO today, is as different from portfolio analysis as brain surgery is from heart surgery. They simply require different skills. The NAIC has not demonstrated that it possesses capabilities beyond asset-by-asset analysis and the Framework is clear that significant resources would need to be added to accomplish this. The same is true of

enterprise-level analysis (ALM) which also requires its own skill sets, specifically including actuarial knowledge.

For individual company examinations it should be recognized that while examiners may not themselves have in-house the complete suites of analytic tools necessary to evaluate every portfolio and enterprise, by no means does that indicate that there any deficiencies or shortcomings in their examinations of insurers. On a case-by-case basis, as they determine necessary, examiners retain investment and other specialists to support them in their examinations. These are private sector enterprises, most often are selected after public requests for proposals, and the costs are borne by the company being examined. This practice allows regulators a choice of specialists so they can assign them based on their skills to best meet the specific situation of the insurer being examined.

Proposal #3 could be read to imply that the NAIC itself should be doing the portfolio and enterprise analysis work now being done by the 56 departments of insurance. Hopefully this would be a misinterpretation.

Given its present capabilities it may be better for the NAIC to be a standard setter rather than a builder of the same portfolio and ALM capabilities that are already being provided to regulators as needed by private sector competitors. It also should be noted that in years past the Capital Markets Bureau offered portfolio analysis systems but that effort did not result in significant success.

When it comes to developing expanded capabilities there is always the question of funding. Given that less than 1½% of the NAIC's budget comes from its members, it is clear that for the NAIC to deliver expanded resources it would likely put itself in the position of essentially selling goods and services. Rather than delivering company-specific risk analytics itself the NAIC could provide vital assistance to insurance departments by setting standards and assisting them in obtaining the services they themselves determine they need based on NAIC guidelines and recommendations.

To achieve many of the desirable objectives in the Framework it is clear, however, that the NAIC will still certainly need to significantly expand its capabilities however they may be funded.

NAIC Structure

It is a welcome comment that the VOS/TF could probably perform better if it were organized somewhat differently. This is only one of only two Task Forces without any entities reporting to it whereas in the past there were as many as three. Working Groups could be re-established, reporting to the VOS/TF, responsible for tracking developments both in asset design in the financial markets and investment risk assessment technologies. The SVO derives its authority from its procedures manual which is approved by the VOS/TF. In recognition of this another working group could be charged to oversee the performance of SVO so the regulators would be better positioned to monitor the work they have directed staff to perform.

As the SVO itself is reconsidered, regardless of whatever specific functions it will be assigned and what it will be called, there should be a clear split between the SVO as an operating unit (which today produces Designations) and the staff/advisory function. The SEC itself is extremely strict with its NRSROs: analysts must be completely isolated from financial matters that are managed by “business development” people who negotiate with issuers.

In this instance the staff supporting the VOS/TF should be completely separated from the analysts producing Designations. They should have different reporting lines, accountabilities and job descriptions. At present the staff members who support the VOS/TF as it considers what to require of insurance companies are the same individuals who lead groups that book the revenue received from new activities. A better business practice would be to clearly separate these two functions.

Consulting Engagements

Identifying a consultant to assist with determining the optimal way to determine C-1 and R-1 factors should be relatively easy. The consultant would primarily need to evaluate the full range of analytic techniques, including advanced technologies that could be used to determine C-1 and R-1 factors. Some familiarity with the NAIC structure and how these factors would be used would be required.

Evaluations of elements of this Framework itself will require a comprehensive and much deeper understanding of the needs of departments of insurance as well as detailed knowledge of available resources already available, some of which are listed above on page two of this letter. The NAIC itself is probably unique and a consultant would need a clear understanding of its organization and capacities. So for the first engagement it should be relatively easy to identify qualified consultants whereas consultants evaluating elements of this Framework will certainly require a much broader knowledge base and skill set.

Summary

This Framework has great potential for the NAIC to continue its leadership, enabling departments of insurance to enhance their capabilities in an increasingly complex investment environment. Hopefully immediate action can begin to determine how RBC C-1 and R-1 factors can be optimally developed and as this has significant potential. This should also be relatively easy so there is no reason for delay. As to expanding portfolio and entity-level capabilities and the other concepts in this Framework I am sure that there will be many thoughtful comments presented to the Committee so it can continue this serious work.



Copies: Dan Daveline



October 9, 2023

VIA ELECTRONIC SUBMISSION

Director Elizabeth Kelleher Dwyer
Chair, Financial Condition (E) Committee
Commissioner Nathan Houdek
Vice-Chair, Financial Condition (E) Committee
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Framework for Regulation of Insurer Investments – A Holistic Review

Dear Members of the Financial Condition (E) Committee:

The American Investment Council (“AIC”)¹ appreciates the opportunity to comment on the draft *Framework for Regulation of Insurer Investments – A Holistic Review*² (“Framework Memo”) that was exposed during the Financial Condition (E) Committee’s August 15, 2023 meeting. We agree that a comprehensive, methodological and holistic review of the myriad of recent investment-related initiatives undertaken by various National Association of Insurance Commissioners (“NAIC”) working groups and task forces is necessary. We commend the E Committee for recognizing the need to conduct a holistic review of those initiatives. However, we remain concerned that the Framework Memo leaves open the possibility that the NAIC Securities Valuation Office (“SVO”)³ will begin financially modeling collateralized loan obligations (“CLO”) for purposes of risk-based capital (“RBC”) treatment. We understand that the E Committee has indicated that the CLO modeling work will continue, and respectfully suggest that decision be re-considered in light of the factors we raise below.

¹ The American Investment Council, based in Washington, D.C., 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. In this effort, the AIC develops, analyzes, and distributes information about private equity and private credit industries and their contributions to the US and global economy. Established in 2007 and formerly known as the Private Equity Growth Capital Council, the AIC’s members include the world’s leading private equity and private credit firms which have experience with the investment needs of insurance companies. As such, our members are committed to growing and strengthening the companies in which, or on whose behalf, they invest, to helping secure the retirement of millions of pension holders and to helping ensure the protection of insurance policyholders by investing insurance company general accounts in appropriate, risk-adjusted investment strategies. For further information about the AIC and its members, please visit our website at <http://www.investmentcouncil.org>.

² The Framework Memo is available at: <https://content.naic.org/sites/default/files/inline-files/Framework%20for%20Investments%20Exposed%20by%20E%20Committee.pdf>.

³ Except where otherwise noted, references in this letter to the SVO also refer to the NAIC Investment Analysis Office and/or the NAIC Structured Securities Group, as applicable.

As explained below, the NAIC’s current plans to begin financially modeling CLOs in January 2024 is inconsistent with the E Committee’s observations, as set out in the Framework Memo, and recent presentations by the American Academy of Actuaries (“Academy”) to the NAIC on this topic. This timeline also relies on what we believe is a flawed CLO modeling methodology.

In light of these concerns, we respectfully request that the E Committee revisit its current plans and timeline for requiring the financial modeling of CLOs. More broadly, we respectfully encourage you, as members of the E Committee, to continue to actively supervise the “intensive level of coordination” that is required with respect to the “highly technical,” and interrelated accounting, risk assessment, and capital activities of the E Committee’s investment-related subordinate committees. We are hopeful that the Framework Memo will support a more methodical and transparent approach to assessing those interconnected workstreams.

While the focus of this letter is to express our concern with the financial modeling of CLOs and its current timeline for completion, we also want to take the opportunity to note our concerns with (i) the proposed amendments to the *Policies and Procedures Manual of the NAIC Investment Analysis Office* (“IAO”) that would provide the SVO discretion to adjust NAIC Designations that are assigned through the NAIC Filing Exempt (“FE”) process and mapped to credit rating provider (“CRP”) ratings (“FE Proposal”), and (ii) the NAIC’s action to impose a 45% RBC charge beginning in 2024 on asset backed security residuals (“Residuals Charge”). With respect to the FE Proposal, we appreciate the Framework Memo’s acknowledgement that various stakeholders have raised a number of valid concerns related to these issues, and its directive to the Valuation of Securities (E) Task Force (“VOSTF”) to continue deliberating and to incorporate stakeholders’ constructive feedback.⁴ We also appreciate the NAIC’s willingness to engage with stakeholders on the Residuals Charge, but we remain concerned by the decision to impose a 45% charge without first conducting a full analysis or providing a clear path to develop and analyze independent tail risk or performance data.⁵ We will continue to engage with the NAIC on these issues.

I. The Framework Should Terminate the SSG CLO Modeling Workstream or Should at Least Delay the Development and Implementation of the CLO RBC Framework Until further Analysis and Resources are Provided

As you are aware, in 2022, the Risk-Based Capital Investment Risk and Evaluation (E) Working Group (“RBCIRE”) engaged the Academy to assist in the development of RBC factors for CLOs. Since that time, the project has expanded to include the development of RBC factors for all structured securities. To date, the Academy has given two public presentations to the

⁴ AIC echoes comments submitted by many stakeholders – including regulators, trade associations, insurers, and members of the U.S. House of Representatives – that raise a number of valid concerns regarding the expanded scope of the SVO, the ability of such a mechanism to ensure consistency across asset classes and risks, and the potential for market uncertainty and increased illiquidity. More fundamentally, we still lack a clear understanding of why the current system is considered inadequate.

⁵ Notwithstanding the compromise that was reached at the 2023 NAIC Spring National Meeting – which effectively gave interested parties until June 2024 to provide evidence that a 45% RBC charge is not appropriate – the Residuals Charge adoption process seems to have been rushed and goes against the principles enumerated in the Framework Memo. We continue to believe that a measured, fact-driven process – which has yet to be conducted by regulators or interested parties and may take longer than the allotted time to complete – is necessary.

RBCIRE: one, during the 2022 Fall National Meeting, that questioned the propriety of the CLO project and noted that a measured, deliberative process should not be sacrificed in the name of expediency;⁶ and a second, during the 2023 Summer National Meeting, that provided an overview of (i) an Academy-developed flowchart to determine whether an asset class should be modeled, and (ii) a number of Academy-supported “Candidate Principles” for use in guiding the development of RBC factors for structured securities.⁷

The Academy’s presentations raise significant questions as to whether it is prudent to direct the SVO to financially model individual CLO investments, as the NAIC is scheduled to begin doing in January 2024. While we appreciate that, as a technical matter, the Academy’s focus is on RBC factors, as the Framework Memo itself states, insurer asset modeling and risk-assessment are inextricably linked, and there appears to be no comprehensive framework for coordinating or governing those functions. *As such, we respectfully submit that CLO modeling should not continue as initially scheduled in light of the Academy’s valid concerns and recommendations and in the absence of an agreement on foundational principles to govern the CLO RBC framework.*

We also believe the plan for the SSG to begin CLO modeling in January 2024 is inconsistent with the principles and observations set out in the Framework Memo:

- The Framework Memo indicates that VOSTF will review the output of CLO/RMBS/CMBS modeling in conjunction with the Academy and RBCIRE to determine if (i) NAIC designations, (ii) dynamic ad hoc modeling/stress capabilities or (iii) a combination of both, are the most valuable use of SSG resources. *The NAIC should not continue development of the CLO methodology or begin requiring the financial modeling of individual CLO investments before such determination is made.*
- The Framework Memo acknowledges, and we agree, that finding the right balance between separate NAIC working groups when assessing risk and capital “needs to be an iterative process of developing proposals, soliciting feedback, and adjusting or replacing proposals in response.” *It will be extremely challenging for the SVO to develop an effective CLO model when the RBCIRE is just getting started on the long-term RBC factors for CLOs.*
- The Framework Memo retains the ability of the SVO to model structured assets in support of its other functions (e.g., the CRP due diligence function), but recognizes the critical need for model governance. *We agree, and as such, the NAIC should not implement a new financial model in the absence of a model governance policy and related controls.*
- The Framework Memo argues extensively for the need to expand the staffing and resources of the SVO, including the need to enhance the SVO’s structured asset modeling and model validation capabilities. *We are concerned that the SVO will not be able to effectively take on the significant responsibility of developing and validating financial models for CLOs and other structured securities without the staffing and tools to properly do so. Moreover,*

⁶ See American Academy of Actuaries, C1 Work Group (C1WG) Presentation to the RBCIRE on CLOs - Status Update (December 14, 2022), available at: https://www.actuary.org/sites/default/files/2022-12/C1_Presentation_CLOs.pdf.

⁷ See American Academy of Actuaries, Principles for Structured Securities RBC (August 13, 2023), available at: https://www.actuary.org/sites/default/files/2023-08/Life_Presentation_Principles_for_Structured_Securities_RBC.pdf.

the NAIC’s limited resources would be better served being used to develop a strong due diligence function over CRPs that would include CLO ratings, rather than have the SVO begin to model CLOs.

- The Framework Memo proposes to reduce/eliminate “blind” reliance on CRPs but retain overall utilization of CRPs with the implementation of a strong due diligence framework. *Implementation of a strong due diligence function would eliminate any perceived need for the NAIC to conduct its own modeling of CLOs. In addition, NAIC modeling of CLOs would potentially and unnecessarily result in a lack of capital parity between CLOs and other investments and would divert important resources from the due diligence function.*
- The Framework Memo correctly acknowledges that the “project to review RBC factors for investments remains in its infancy,” while also recognizing the importance of considering “market impacts and consistency across asset classes” before implementing changes to RBC factors. *Accordingly, we agree and respectfully submit that the NAIC should assess the impact those changes will have on the RBC for other structured securities before implementing new RBC factors for CLOs.*

Implementing this fundamental change to the CLO RBC framework without first addressing these critical issues could have serious unknown consequences, unnecessarily depress insurers’ RBC, and deprive insurers of a vital capital markets tool during a time of increasing uncertainty in the broader financial markets. This fundamental change could also have a chilling effect on the capital markets themselves. Fewer insurer investments in CLOs would remove vital sources of capital for a significant number of corporate borrowers who rely on the private credit markets to operate their businesses. In fact, it was reported during the VOSTF’s August 14 meeting that the NAIC’s *mere consideration* of the broader changes to the investment framework for structured securities, and the uncertainty so associated, is already having a chilling effect on insurers’ access to capital markets.⁸ Moreover, CLOs “do not present a material risk” to current industry solvency.⁹ In fact, the issue perceived as being the most pressing regulatory concern was addressed by the NAIC’s adoption of new RBC factors for structured securities’ residual tranches during the 2023 Summer National Meeting. ***In light of these considerations, we ask that you eliminate the proposed plan for SVO financial modeling of CLOs, or at least delay it until a proper framework and governing policies have been adopted and implemented by the NAIC Membership.***

⁸ See Lease-Backed Securities Working Group (John Garrison) comments to VOSTF during its August 14, 2023 discussion of proposed changes to the IAO *Policies and Procedures Manual* to authorize SVO discretion over NAIC Designations assigned through the FE Process, available at: https://content.naic.org/sites/default/files/national_meeting/VOSTF%208.14.23%20Minutes_final.pdf.

⁹ See Academy Presentation to the RBCIRE on December 14, 2022, available at: <https://content.naic.org/sites/default/files/inline-files/Att%20C%20AAA%20C1WG%20Presentation%20to%20RBCIRE%20WG%20on%20CLOs%20vF.pdf>. See also the NAIC Capital Markets Bureau’s own analysis, which concluded that “U.S. insurer investments in CLOs remain an insignificant risk” (see NAIC Capital Markets, Special Report, *Collateralized Loan Obligation Stress Testing U.S. Insurers’ Year End 2021 Exposure*, January 5, 2023, available at: <https://content.naic.org/sites/default/files/capital-markets-special-reports-clo-stressed-analysis-ye2021.pdf>).

II. The Proposed CLO Modeling Methodology is Incomplete and Flawed

As you are aware, VOSTF and the SSG have established a CLO Modeling Ad Hoc Technical Group (“Ad Hoc Group”) that is developing a CLO modeling methodology for use by the SSG when CLOs become a financially modeled security in January 2024.¹⁰ Although the AIC is not a member of the Ad Hoc Working Group, we have attended all public Ad Hoc Group meetings and have submitted multiple comment letters to VOSTF and the SSG detailing why (i) it is neither necessary nor appropriate to subject CLOs to a new NAIC financial modeling process,¹¹ (ii) the modeling development process has made it impossible to assess the full model and the interplay between each input,¹² and (iii) the current iteration of the model is flawed.¹³ With respect to the draft CLO methodology, our specific concerns include that:

- The SSG has neither the resources nor expertise to develop a model that is fit for purpose (a sentiment that is consistent with the Framework Memo);
- The methodology fails to account for the benefits of CLO active management and other qualitative factors that are unique to CLOs (a concern also raised by the Academy in its January 2023 presentation);
- A zero purchase discount assumption is inconsistent with real-world evidence; and
- A zero prepayment assumption contradicts real-world evidence.

Our prior letters to VOSTF also flag a number of other material concerns.¹⁴

Notwithstanding our significant concerns with the methodology’s development and inputs and the lack of expertise and resources noted in the Framework Memo, the NAIC has not delayed the January 2024 implementation date. Further, the SSG has just (in the last week) released draft modeling scenarios for public comment, and no stakeholder or regulator has had the opportunity to assess the full CLO methodology with scenarios and probabilities. ***Given the foundational***

¹⁰ During the 2023 Spring National Meeting, E Committee voted to amend the *IAO Purposes and Procedures Manual* to include CLOs as a financially modeled security under the responsibility of the SSG which effectively makes CLOs ineligible to use CRP ratings to determine an NAIC designation. The amendment is effective as of January 1, 2024 and insurers are required to first report financially modeled NAIC designations for CLOs in their year-end 2024 financial statement filings.

¹¹ See our letter to VOSTF dated July 12, 2023 titled *CLO Modeling Ad Hoc Technical Group Assessment of Pre-Payment and Discount Assumptions in Potential CLO Financial Model* (“July 12 Letter”), available at: <https://www.investmentcouncil.org/wp-content/uploads/2023/07/AIC-CLO-Ad-Hoc-Group-Letter-Regarding-Pre-Pay-and-Purchase-Discount-Assumptions-1.pdf>.

¹² *Id.*

¹³ See our letter to VOSTF dated July 15, 2022 titled *Comments regarding the IAO Issue Paper on the Risk Assessment of Structured Securities – CLOs* (“July 15 Letter”), available at: <https://www.investmentcouncil.org/wp-content/uploads/2022/12/AIC-NAIC-CLO-Issue-Paper-Comment-Letter-Dated-July-15-2022.pdf>.

¹⁴ Additional issues include: (i) that modeling should not be undertaken as an indirect means to alter RBC treatment of insurer investments, (ii) that it is inappropriate to use existing bond factors that force capital charge equivalence between CLOs and corporate bonds; (iii) the general approach for residential mortgage backed securities and commercial mortgage backed securities is not suitable for CLOs; (iv) it seems illogical to conclude that CRP ratings can be relied upon with respect to underlying collateral, but are flawed with respect to CLO ratings, (v) why the Moody’s CLO methodology appears to have been given priority over other CRP methodologies; and (vi) that the SSG has not quantitatively justified its stress thesis that underpins the draft CLO modeling methodology. See our July 12, and July 15 Letters.

nature of this modeling, we are concerned that a rushed process to meet a year-end timeline will result in a flawed methodology that cannot be used as the template to reliably model other structured securities in the future.

In light of these concerns, AIC has engaged FTI Consulting (“FTI”) to prepare an assessment of the SSG’s CLO methodology, which we expect to share with E Committee as soon as FTI’s report is finalized.¹⁵ However, it is impossible for FTI to conduct a comprehensive analysis of the modeling methodology when the draft methodology is incomplete.¹⁶ At this early stage, FTI has already found that, contrary to the SSG’s published findings,¹⁷ CRP CLO methodologies do take pre-payment and purchase discount assumptions into account in a material way when it is reasonable to do so.¹⁸ Despite this, and a July 2023 SSG report that there are “significant benefits” to including those assumptions in the methodology, the SSG is moving forward with a “no pre-pay/no discount” model based, in part, on the SSG’s high-level CRP methodology analysis and on the basis that the assumptions would add complexity to the model. As we previously noted to the SSG, added complexity does not justify a CLO model that fails to account for CLO prepay and discount features, among others.

III. Conclusion

For the reasons outlined above, we respectfully request that you delay the proposed financial modeling of CLOs, until a proper framework and governing policies have been adopted and implemented by the NAIC Membership. We look forward to continuing to work with you on all of these important issues.

Sincerely,

/s/ Rebekah Goshorn Jurata
General Counsel
American Investment Council

¹⁵ In the interest of time, FTI may make certain modeling assumptions or issue an abbreviated report that considers only what is known as of a certain date. We expect to offer the report to VOSTF and the SSG as well.

¹⁶ While we appreciate that modeling methodology inputs are often developed in piecemeal, the current timeline makes it highly unlikely that interested parties will be able to conduct a fulsome assessment of the modeling methodology prior to its implementation. In comparison, nationally recognized statistical rating organization (“NRSRO”) methodologies are published for public comment and scrutinized by public markets. NRSRO guidelines typically account for substantial notice and comment periods, and require the NRSRO to provide a substantial level of granular information regarding proposed changes to financial models and the underlying basis for the proposed changes.

¹⁷ See NAIC SSG *Prepay / Discount Methodology* (July 14, 2023), available at: <https://content.naic.org/sites/default/files/industry-ssg-clo-CLO-Methodology-Update-7.14.23.pdf>.

¹⁸ We recently shared FTI’s CRP prepay and discount findings with the SSG and VOSTF leadership, and would be happy to share that with the E Committee as well.



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Chair, Financial Condition (E) Committee
National Association of Insurance Commissioners

Via Electronic Submission

October 9, 2023

**Comment letter on Proposed Framework for Regulation of Insurer Investments -
A Holistic Review**

Dear Director Dwyer,

The Alternative Credit Council (“ACC”)¹, the private credit affiliate of the Alternative Investment Management Association Ltd (“AIMA”) whose members manage in excess of \$ 1 trillion in private credit strategies, welcomes the opportunity to respond to the proposed Framework for Regulation of Insurer Investments – A Holistic Review (“Framework for Investments”) recently issued by the Financial Condition Committee (“E Committee”) of the National Association of Insurance Commissioners (“NAIC”). The ACC supports the E Committee’s initiative to holistically review the multiple workstreams currently underway at the NAIC in response to the shift in insurance investments towards private credit and asset-backed securities (“ABS”). We also appreciate the E Committee’s statement that the workstreams are not meant to be punitive or to discourage innovation in insurance investment strategies.

From our perspective as a global trade association, we have worked with regulators around the globe as the private credit marketplace has developed over the last several decades. A wide range

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 as well 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.

Alternative Credit Council (ACC)



of institutional investors, including public and pension funds, endowments, and sovereign wealth funds, have increased their allocation to private credit and ABS since the NAIC established its current risk-based capital framework in the early 1990s. It is only natural that the insurance industry would participate in a few, but not all, of the alternative asset classes that, over time, have proven that they make sense for their long-term asset-liability management strategies. It is important to note, however, that insurers have had a long and successful history of investing in private credit and other forms of alternative credit in the U.S.² The NAIC has already established appropriate, customized accounting treatment, valuation methodologies, and risk-based capital charges for some of the most common forms of alternative investments, including real estate, residential mortgage-backed securities (“RMBS”), and commercial mortgage-backed securities (“CMBS”). These were established by the NAIC using a thorough, fact-based, and transparent process that provided clarity and certainty that facilitated insurance investments and encouraged responsible growth in these asset classes.³

We are hopeful that the E Committee’s proposed Framework for Investments will ensure a similar, well-coordinated, and fact-driven process to determine the appropriate accounting treatment, valuation, and capital charges for the additional types of asset-backed securities (“ABS”) that are now commonplace in U.S. financial markets and that align with the asset-liability driven investment strategies of insurers consistent with their enterprise-wide risk management frameworks.

We believe greater coordination and fact-finding are particularly necessary in two areas. First, we are very concerned about efforts to remove exempt filing status before any significant progress is made on developing a governance framework for credit rating providers (“CRPs”). Removing filing exempt status would add significant additional costs, time delays, and uncertainty that would negatively impact the insurance investment manager’s ability to negotiate and complete ABS deals. In our view, renewing efforts to develop a robust due diligence regime for CRPs would better address regulatory concerns about “outlier” ratings and have fewer adverse side effects than the extensive amount of additional time and expense that would be incurred if the Securities Valuation Office (“SVO”) must provide the designation for every single security in certain asset classes. Second, we are concerned about the effort to promulgate a CLO modeling framework before greater consideration is given to the work underway at the American Academy of Actuaries to develop a framework for how to evaluate all ABS that could also be applied to CLOs. We are not asking for work to stop in these areas but rather that additional consideration be given to all the implications arising from the work of other groups, including the Statutory Accounting Principles Working Group (“SAPWG”), before any policy changes are finalized.

² For additional information about the history of alternative investments in the U.S. and other regions, including insurance investments in real estate, infrastructure, and mortgage securities, see Preqin, “The Past Present and Future of the Alternative Assets Industry,” and Helmut Gründl et al., “The Evolution of Insurer Portfolio Investment Strategies for Long-Term Investing,” *Organization for Economic Cooperation and Development Journal*, 2016.

³ The Chartered Financial Analyst (“CFA”) Institute in the U.S. defines the term alternative investments as follows: “Alternative investments” is a label for a disparate group of investments that are distinguished from long-only, publicly traded investments in stocks, bonds, and cash (often referred to as traditional investments). The terms “traditional” and “alternative” should not imply that alternatives are necessarily uncommon or that they are relatively recent additions to the investment universe. Alternative investments include such assets as real estate and commodities, which are arguably two of the oldest types of investments.” *Introduction to Alternative Investments*, CFA Institute. Available at: <https://www.cfainstitute.org/en/membership/professional-development/refresher-readings/introduction-alternative-investments> (Accessed: 15 September 2023).

The E Committee’s proposed regulatory enhancements are divided into two sections: investment risk assessment and risk-based capital for investments. The proposals in these two sections reflect the E Committee’s holistic assessment of the various NAIC workstreams and their recommendations on how to enhance and better coordinate those efforts. The ACC appreciates the E Committee’s issuance of this holistic review, and below are specific reactions and suggestions on each of its specific recommendations.

I. Investment Risk Assessment

The seven recommendations in the investment risk assessment section address potential steps to modernize the SVO and the Valuation of Securities Task Force (“VOSTF”). While we support the goal of modernizing the SVO and strengthening its ability to provide additional analytic support to the VOSTF and other NAIC groups, we do not believe it is feasible or even desirable for it to replace the role of CRPs. Given the tens of thousands of securities that insurers invest in, if the NAIC eliminates or even significantly reduces the scope of exempt filings, the SVO would have to massively expand its staff to provide the kind of analysis, monitoring and reporting that CRPs currently provide for the investment teams of insurers.

An even greater reason is that there is an important regulatory benefit in having multiple CRPs--each with its own particular set of economic assumptions, models, and other analytic tools—that provide a differentiated but still realistic spectrum of market views and risk assessments. This diversity of market views, which may occasionally result in outlier assessments, provides a vital market signal for individual securities and, as a whole, results in a spectrum of views that is valuable for the diversification of risk across the industry. However, we recognize that there should be minimum standards that CRPs should meet to be authorized and accredited by the NAIC. These standards should focus on determining if the CRP has the appropriate governance, internal controls, appropriate staff levels, and rules to mitigate potential conflicts of interest rather than imposing a single, unified set of modeling and economic assumptions.

Recommendation 1: Reduce or eliminate “blind” reliance upon CRPs. ACC strongly supports the E Committee’s recommendation to reduce blind reliance upon CRPs, but the retention of overall utilization of CRPs with the implementation of a strong due diligence framework. This due diligence framework should include strengthening insurance investors’ own internal credit risk management capabilities in line with the investment risk management requirements in the NAIC’s Financial Condition Examiners Handbook.⁴ The investment management departments of insurers, often with the support of outside investment advisors, should undertake their own credit analysis in line with each insurer’s investment strategy and risk controls consistent with their asset-liability and overall risk management and control frameworks.

We also support the creation of a due diligence framework for CRPs that would focus on the overall capabilities, governance, and management of each CRP and avoid imposing a single risk and economic model. The SVO would have an important role in reviewing the credit risk assessment capabilities of CRPs using clear quantitative and qualitative parameters. We encourage the NAIC to hire an outside consultant who could develop an appropriate set of such parameters, and we

⁴ See Section 2, NAIC Financial Condition Examiners Handbook, 2023.

would recommend that, as part of that process, they survey the quantitative and qualitative criteria used by other regulators in the U.S. and abroad.

We oppose authorizing the SVO to notch a CRP's ratings as that would, in effect, impose a single credit perspective on the entire industry based on a single, SVO-specific model and assumptions. However, if the SVO has concerns about an outlier rating, it can flag that security for review by the lead insurance regulator. The criteria for flagging a security should be based on specific criteria (including quantitative criteria) to be established through a public exposure process and cannot involve material policy discretion on the part of NAIC employees. Once flagged, the affected insurance company and its outside investment adviser (if applicable) should have the right to engage directly with the state regulator to provide any necessary documentation in support of their reliance on the rating. The final authority should rest with the state supervisors, with NAIC staff acting as a technical resource.

Recommendation 2: Retain SVO's ability to perform individualized credit assessments. We support retaining the SVO's current ability to perform credit assessments under well-documented and governed parameters. For the reasons discussed above and in further detail with respect to Recommendation 3 below, we would not support a significant expansion of this authority given the requisite staff that would take.

Recommendations 3: Enhance the SVO's portfolio risk capability. We are concerned about recent SVO proposals to modify the definition of an NAIC designation and to address other non-payment risks. These proposals would greatly expand the ability of the SVO to second guess and potentially notch ratings provided by approved CRPs. Our concern is based on the danger that the adoption by the SVO of a single credit risk analytics tool would lead to the imposition of a single credit view on the entire industry. Instead, we believe a better course would be to develop a CRP authorization framework that avoids inappropriate outlier risk ratings but does not supplant that with a univocal view of credit risk. These proposals also appear to conflate credit risk with portfolio and other risks, such as volatility, liquidity, and prepayment risk, which are already addressed appropriately in other parts of the NAIC's risk-based capital framework. The SVO's proposed ability to challenge CRP ratings is undermined by the fact that their assessment is limited to the probability of default without additional analysis of potential loss given default and the likelihood of recovery.

We support the views of the June 29, 2023 joint trade association letter requesting clarification of what new authorities the SVO should have and believe that the Capital Adequacy Task Force should be included in the holistic review process.⁵ More broadly, insurance investment portfolio risk encompasses a wide variety of non-credit risks—such as market, liquidity, concentration, interest rate and reinvestment risk, among others—that must be considered in light of an insurer's overall risk management framework and hedging strategies. Regulatory supervision in these areas is best addressed in the context of each supervisor's overall financial and risk management oversight processes.

Recommendation 4: Enhance the SVO's structured asset modeling capabilities. We support a greater CRP due diligence function for structured asset modeling along the lines articulated above.

⁵ See pages 65-71 of the August 14, 2023 Valuation of Securities Task Force Meeting Materials for the June 29, 2023 Joint Trades Comment Letter from the ACLI, PPIA, NASVA, and SFA.

We are concerned that the CLO modeling process as it currently stands does not correspond with sound market practice with respect to original issue discount, prepayment, and reinvestment as an appropriate risk management tool. One possible enhancement could be to bring in outside consultants more familiar with the wide variety of structured securities that are now commonplace in financial markets and insurance investment portfolios.

Recommendation 5: Build out a broad SVO policy advisory function. This would represent a significant expansion of the SVOs' mandate beyond its core mission of individual asset valuation from a credit perspective. Providing market analysis or policy advisory functions should remain with the current NAIC entities elsewhere in the NAIC's Capital Markets Bureau and elsewhere that are responsible for those functions. Given the revenue that is generated by SVO services, there may be a conflict or at least the appearance of a conflict if individual designation functions are combined with formal policymaking rather than providing technical advice.

Recommendation 6: Establish a broad investment working group under the E committee. We support this recommendation as it would allow for greater integration and communication between the separate working groups on accounting, valuation, and capital charges. As mentioned above, we believe that it is important for the NAIC to add staff with market private credit and structured securities experience beyond commercial and residential mortgage-backed securities. For this working group to be successful, it will be important for it to include subject matter experts with significant market experience in a broad range of structured securities markets. In addition, it would be helpful for that working group to either include or regularly consult with dedicated investment specialists with experience in structured securities from an insurance investment perspective.

Recommendation 7: Rename SVO and reduce the size of VOSTF. We have no comment on this proposal.

Regarding the proposed impact of the proposed Framework on Investments on current initiatives, we support the reprioritization by the VOSTF of developing a CRP due diligence framework. In our view, this is a preferable alternative to having the SVO review and notch CRP designations, even under a very limited set of circumstances.

II. Risk-Based Capital for Investments

This section of the E Committee framework makes two recommendations, both of which we generally support.

Recommendation 1: Changes to capital charges for ABS should consider market impact and consistency across asset classes. We strongly support the principle of "equal capital for equal risk" and appreciate the E Committee's indication that should be the goal to the highest degree possible. Along those lines, we are in favor of further study of the principles-based approach to establishing capital charges to structured securities contained in the August 13 presentation by the American Academy of Actuaries ("AAA") to the NAIC's Risk-Based Capital Investment Risk and Evaluation Working Group ("RBC-IRE Working Group").⁶ That presentation provides a structured securities modeling flow chart that helps distinguish which asset classes could most easily be assigned

⁶ American Academy of Actuaries, "Principles for Structured Securities RBC," August 13, 2023.

existing or new C-1 capital charges and outlines seven different approaches on how to establish specific capital charges for each type of structured security. In our view, it will be very important for the NAIC staff to engage extensively with ABS investors and other market experts in each of the relevant asset classes to discern which of the seven options is most appropriate.

Recommendation 2: The RBC-IRE should address where inconsistencies in treatment across asset classes incentivize a particular legal form. We agree with this principle but feel it is important to point out that securitized asset pools have a wide range of meaningful risk enhancement features that make it inappropriate to directly compare their level of risk to the risk of holding a single similar asset. We believe that the well-understood risk-mitigating benefits of diversification and active management of a large pool of assets, well-recognized by the NAIC in the context of corporate bond capital charges, need to be taken more into account based on the characteristics of each type of ABS.

In summary, we support the overall goal of the Framework for Investments to better integrate and coordinate the multiple NAIC workstreams that are changing the accounting treatment, valuation methodology, and capital charges for a range of ABS. We do not support wholesale changes to the exempt filing process but do support the ability of the SVO to increase its supervision of the governance of CRPs to ensure their ratings accurately reflect the level of credit risk for each type of ABS. We also support the principle of “equal capital for equal risk” when modernizing capital charges for ABS. In determining equal risk, the NAIC’s recognition of risk diversification and other mitigation techniques for corporate bonds should also be applied to the development of ABS capital charges. For the Framework for Investments to achieve its goals of modernizing its regulatory framework for ABS without negatively impacting markets or discouraging innovation, it is critical for each of the NAIC working groups to engage more with investment management specialists and other ABS market experts to examine the varying levels of risk and risk mitigation features of each type of ABS. AIMA stands ready to engage with the relevant NAIC staff to provide market insights about the wide range of ABS risks and risk mitigation from a global perspective.

If you have any questions, please contact me or Joe Engelhard, Senior Counsel, US Policy and Regulation, at jengelhard@aima.org or 202-304-0311.

Sincerely,

Yours sincerely,



Jiří Król

Deputy CEO, Global Head of Government Affairs

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July 14, 2023

Ms. Carrie Mears, Chair
Valuation of Securities Task Force (VOSTF)
National Association of Insurance Commissioners (NAIC)
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Practices & Procedures (P&P) Manual Amendment Authorizing the Procedures for the Securities Valuation Office's (SVO's) Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears:

The undersigned (ACLI, PPIA, NASVA, SFA, MBA, and CREFC) appreciate the opportunity to comment on the exposure referred to above that was released for comment by the VOSTF on May 15, 2023. We generally like to provide constructive comments on VOSTF exposures and provide support wherever possible. Regarding this exposure, the undersigned have concerns with the proposal and believe additional transparency is warranted. We also recommend changes that are necessary to avoid significant unintended consequences.

Prelude

As discussed at the NAIC Spring National meeting, the undersigned recognize that VOSTF seeks additional information on certain types of insurer investments, with the SVO acting as the “eyes and ears” for Regulators. Further, we recognize that some Regulators may want to grant the SVO some latitude in challenging rating agency ratings if they are deemed not fit for NAIC purposes (“not fit for purpose”). The undersigned stated at the NAIC Spring National meeting, and this was further supported by Texas Regulator, Jamie Walker, that full transparency is warranted for both the NAIC (including the SVO) and the insurance industry, but that is not present in this proposal.

The undersigned appreciate the opportunity to comment and would like to highlight some significant, specific concerns with the exposure. In recent years, the NAIC has made several changes to increase reporting regarding insurer investments, including requiring rating rationale reports as part of the filing exemption (FE) process. As outlined in greater detail below we recommend that any additional changes to the FE process first identify specific ways that NRSRO methodologies are not fit for purpose for a given asset. We also recommend that the NAIC/SVO be transparent about their specific concerns that would warrant such significant changes. Given the magnitude of the potential impacts of this exposure, we also recommend that Regulators convene to study the issue in depth like the study commissioned by the VOSTF in 2008 (referred to in our Subscript S letter dated June 29, 2023). In the interest of providing constructive feedback, the undersigned outline additional transparency and oversight measures below that can mitigate our concerns and help minimize downstream impacts of the proposed exposure. The

undersigned believe it is in the best interest of all parties – Regulators, NAIC staff, insurance companies, rating agencies, and capital markets participants – to have complete procedural transparency.

Concerns

- 1) The exposure currently places the right to challenge a rating or methodology, and the ability to make a final decision on such rating or methodology, solely with NAIC staff and potentially with just one regulator. There is no requirement for oversight from VOSTF, or another sub-group of regulators, to ensure consistency of process or to provide an independent view, should NAIC staff and insurers disagree. This poses due process problems, as well as potential extra-territorial application of one state regulator’s decision over insurers domiciled in other states.
- 2) In the exposure a ratings challenge from NAIC staff starts with staff’s view on a designation, having only had access to the Credit Rating Provider (CRP) rating and rationale and to Schedule D information. NAIC staff would lack access to critical information provided in a full security filing when they first determine their proposed designation. Practically speaking, the insurer would then need to informally file the security for a more thorough review from NAIC staff, should the insurer wish to engage in a fully informed dialogue about the security with the SVO or SSG. The exposure treats this subsequent filing and dialogue as a ratings appeal, rather than recognizing that NAIC Designation filings and appeals are separate processes.
- 3) Should the VOSTF proceed with this proposal, the undersigned believe that there must be a separate appeal process in place, with oversight from an independent party, to ensure due process for insurers. The exposure provides limited transparency to insurers (and to their capital markets counterparties) regarding the SVO’s/SSG’s rationale supporting a CRP ratings challenge. The only envisaged disclosure is for a challenged rating to be flagged in the NAIC Automated Valuation Service (AVS+). However, there is no requirement for NAIC staff to provide public disclosure regarding why they are uncomfortable with a rating. Instead, such information can only be obtained with a phone call between the filing insurer and the SVO analyst. This is problematic, because other insurers who hold the same security (and other interested capital markets participants) may not be privy to some of the one-off, undocumented discussions. Lack of consistent, public disclosure of the NAIC’s concerns leaves room for guessing and misinformation within the capital markets. This could result in market uncertainty and increased illiquidity. The current exposure has already had a negative effect on capital markets. Several transactions have been put on hold, as insurance company investors are sidelined from certain investments, due to the lack of transparency in the current exposure. To date, NAIC staff has provided only limited examples of types of transactions they are concerned about. The lack of further clarity regarding NAIC staff’s scope and method of review has created risk-based capital uncertainty for portfolio investments (both current and future). Insurers have a strong need to understand what the NAIC’s concerns are with a given rating—especially when NAIC staff are deeming a rating methodology as unfit for regulatory purposes.
- 4) The exposure does not require staff to publicly report aggregate statistics for ratings challenges. Staff are only required to provide an annual report at VOSTF’s request, and even then, such a report would not be shared publicly.

Collectively, the issues highlighted above serve to create a process that, if implemented, would lack transparency, sufficient checks and balances, and the opportunity for insurers (and ratings agencies) to present their data, information, and ratings rationales in a fair, open forum. For example, assume there is an Asset-Backed Security (ABS) where the rating agency rating assumes 10% appreciation in the underlying collateral, but the SVO assumes 0% appreciation and believes their approach is more fit for purpose. The proposed exposure, where any single security rating is challenged based on a methodology concern, would cause several significant problems:

- a. One state, working with the SVO, could dictate NAIC Designations for companies in other states where the same security is held.
- b. Further, such a security would not be in isolation. The ratings challenge would presumably apply to all similarly situated, rated securities. The challenge would create significant market uncertainty, as it would be unclear to industry and interested parties whether the SVO's concern applied to just:
 - i. One CRP's rating methodology, or other CRPs' methodologies as well (i.e., other rating agency methodologies may also assume collateral appreciation, but at different levels).
 - ii. That particular legal structure or type of ABS,
 - iii. A subset of that particular ABS type,
 - iv. A specific, unique structural feature or anomaly in that ABS, specifically (or that would also potentially apply to other ABS as well), or
 - v. A general matter of difference in professional judgment of the particular analyst.

Changing any particular security rating within AVS+ would create problems and would not achieve the stated goals of consistency, uniformity, and appropriateness necessary to achieve the NAIC's financial solvency objectives. Ultimately, this would create significant capital markets disruption. The undersigned would like to recommend some changes that we believe would help strike the right balance between the NAIC's need for ratings oversight and with industry's and capital markets' need for transparency and due process.

Suggested Changes to Improve Transparency

Should the VOSTF choose to proceed, we believe a robust and transparent process is warranted. The process should make clear whether a rating is challenged due to (1) a CRP's rating methodology being deemed unfit for purpose, or (2) as a matter of professional judgment (we believe the latter would be relatively rare). The SVO should publicly identify rating agency methodologies that they do not believe are fit for the NAIC's purpose and provide analytical support for such view on each respective CRP methodology in question. Whenever the SVO challenges a rating based on differences in professional judgment, it should provide insight on its own approach for assigning a designation to that security. More specifically, the undersigned's proposed solution includes the following:

- 1) Whenever a CRP rating is challenged in AVS+, not only should the security's rating be flagged, but there should also be an area in the system that provides a written rationale for why the rating is being challenged. The AVS+ system should include a field that carries a single category description for ease of use in future reporting (e.g., methodology not fit for NAIC purposes, or professional judgment). However, that alone is not a sufficiently transparent explanation. There should also be an attached report or link to a publicly available rationale where the SVO analyst highlights:

- a. Key factors considered in the SVO analysis, and the methodology utilized;
 - b. A rationale as to why the CRP's methodology is not fit for purpose (if applicable) or where the SVO analyst's view differs materially from the CRP (if a difference in professional judgment), and
 - c. The scope of the population of securities for which the change applies.
- 2) When NAIC staff challenges a CRP methodology as being unfit for purpose, these challenges should be disclosed publicly and brought to the VOSTF for approval prior to any ratings change. This should include the rating methodology or methodologies (if multiple rating agencies) deemed not fit for purpose, along with a robust rationale, as well as what securities are impacted. Impacted insurers and the relevant CRPs can then present their analyses, including relevant data and security information, models (if applicable) and rationale publicly to VOSTF, and VOSTF can serve as the ultimate arbiter after hearing views from both sides. Benefits of a public discussion include:
 - a. Prevents one regulator and the SVO from unilaterally making regulatory decisions that potentially impact other state regulators, other insurers, and other similar securities;
 - b. Provides transparency to the Capital Adequacy Task Force (CATF), as it is CATF's responsibility to determine appropriate RBC charges and model factors;
 - c. Ensures all enacted changes are in line with the stated goals of consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives;
 - d. Aligns the VOSTF's stated goal of engaging further with the CRPs as a consumer of ratings to gain a better understanding of their process, methodologies, and regulatory oversight.
 - e. Provides appropriate checks and balances, affording due process for insurers and transparency to all stakeholders.
- 3) In the case of differences in professional judgment (which we believe would be relatively rare, especially considering the proposed three-notch threshold for a ratings challenge), the SVO/SSG should be required to perform a full security filing review and disclose to the insurers the SVO's or SSG's own applicable methodology, laying out the key considerations and rationale that NAIC staff considers for similar securities.

If the SVO and impacted insurers are unable to reach agreement on an appropriate designation during the initial challenge process, then it is important for the insurer to have some method of appeal beyond NAIC staff to provide appropriate independent review and ensure consistency to the designation process. The undersigned would not expect insurers to appeal every ratings challenge (nor would it be practical for VOSTF to hear to every such appeal), but there are expected to be key instances where insurers feel strongly that an additional third-party's viewpoint (beyond the SVO/SSG and the original CRP) is needed and helpful. Ultimately, such discussions may help Regulators as well, as it would help them develop a deeper understanding of how investments are viewed by insurers, capital markets participants, and the rating agencies, as well as by the SVO. More discussion is merited on whether the appropriate appeals board should be the VOSTF or some subset thereof. However, the appeals process should include people who are willing to independently consider all views, and who can set policy across all states consistently.

- 4) As a best practice, all SVO designation methodologies, and a description of the NAIC's process of reviewing and approving these methodologies, should be posted publicly on the NAIC's website. We recognize that the SVO and SSG will not have models or methodologies covering the full bond population. Indeed, no CRP can rate the full bond population, given the sophisticated data gathering, modeling, analytical software and other resources required to rate certain types of securities. However, posting methodologies publicly would highlight areas where the SVO/SSG do not have designation methodologies in place, such as ABS or (currently) Collateralized Loan Obligations (CLOs), and help ensure that those methodologies which do exist are consistently applied, providing transparency to insurers and to capital markets.

- 5) The undersigned believe industry should be provided with an overall assessment of how this ratings challenge program progresses and is enforced. Aggregated statistics, shared publicly each quarter, would help both Regulators and industry alike to understand the scope of the issues and how the program is progressing. NAIC staff should provide quarterly reports for both VOSTF and the public, highlighting the following for securities challenged:
 - a. Number of ratings challenged, for each challenge type;
 - b. Number and dollar-amount of CUSIPs challenged;
 - c. Outcome of SVO/SSG challenges:
 - i. Percentage of CRP ratings affirmed vs. percentage of SVO designation overrides;
 - ii. Number of challenges appealed to VOSTF and percentage of appeals where NAIC staff's recommendation to overturn a rating the was affirmed by Regulators vs. percentage of appeals where the original CRP ratings were affirmed;
 - d. Average number of notches that ratings were reduced, both on an incident- and dollar-weighted basis.

Further Considerations

The undersigned suspect one concern VOSTF may have with our proposal centers around confidentiality associated with private ratings. However, we think confidentiality concerns are manageable. Federal law requires that NRSROs disclose and maintain their methodologies publicly, and rating methodologies can be found directly on CRP websites. Any questions on such methodologies can be answered through discussions with CRP analysts. Therefore, for situations where NAIC staff is challenging a methodology as not fit for purpose, staff should be able to discuss the methodology that the CRP employed and discuss where the NAIC takes issue with that methodology, without disclosing non-public information. When NAIC staff is challenging a rating based on differences in professional opinion, the underlying CRP rating can be expressed in terms of an NAIC-equivalent designation (as opposed to disclosing the CRP rating directly), and the details of the issuer or structure can be genericized enough to mask the specific security, yet still provide key insights into the reason and rationale for ratings challenges. In fact, the SVO has successfully done this with some limited examples in the past.

The only downside the undersigned see in such approach is additional effort required of the SVO/SSG, but the benefits are many. Enhanced transparency is generally good for any system, but here, it is imperative for insurers to understand what types of investments or ratings methodologies concern the NAIC to limit

negative downstream consequences for insurers. This also is necessary to limit capital markets disruption and prevent both investment bankers and insurers from arbitrarily rejecting established private placement debt types as a viable option for insurers' portfolios. Absent more transparency, the market could potentially deem the entire privately-rated debt universe as problematic when Regulators and the SVO have only expressed concerns with a targeted subset of that universe. Insurers need to understand what is and is not problematic, and why, as well as how, the SVO or SSG might view certain types of securities. Further, without transparency, the public debt market (particularly the 144A space) could also experience significant disruption, which could cause unnecessary negative impacts to insurers' investments in such instruments. Any reasonable cost associated with providing transparency and oversight, as outlined in our solution above, would be supported by industry. It is likely minimal in relation to the significant benefits that transparency affords to all stakeholders.

Conclusion

The undersigned stand ready to discuss these ideas further with Regulators and with the SVO/SSG; we are willing to begin discussions immediately. We ask that adoption of the exposure be postponed until the significant philosophical and procedural issues highlighted above can be resolved.

Given the magnitude of this proposed change, and the potential effect on insurers and capital markets, the undersigned believe that this process may be best suited for a comprehensive study by Regulators across disciplines. A working group could be established with members from the NAIC's CATF, Risk-based Capital Investment Risk and Evaluation Working Group, Life Actuarial Task Force, and VOSTF, to holistically address what we understand the broader regulatory concern to be: Whether the NAIC investment risk-based capital regime has kept pace with market innovation. This approach could be patterned after the previously mentioned study commissioned by the VOSTF in 2008 that met extensively over an approximately eight-month time period to define and evaluate perceived shortcomings and issue a formal report. In this instance, a report should have specific recommendations that address defined problems holistically and transparently. The following are some of the issues that the working group could consider:

- Define areas of concern raised by the SVO and by some Regulators with as much precision as possible to properly scope the project;
- Identify whether there are any investment types with significantly different risk characteristics which may warrant additional investment RBC factors (as was suggested by Moody's Analytics at the time of development of current investment RBC factors);
- Identify additional asset classes, if any, where modeling may be appropriate, such as with CLOs; and
- Evaluate any input from the VOSTF Ad Hoc Rating Agency Review group.

Lastly, we also think it is important to recognize that credit analysis is both an art and a science; differences of professional opinion are unavoidable. No one organization (whether an insurer, a CRP or the SVO/SSG) has a monopoly on perfect accuracy when assessing risk. An institution's ability to assess credit risk will inevitably be shaped by unique organizational experiences, risk tolerances, and resources or tools brought to bear in the risk assessment process. Furthermore, each CRP (and NAIC staff) has certain areas of relative strength and expertise and areas where their resourcing and expertise is weaker. Therefore, in addition to defining the concerns with as much precision as possible at the outset, ongoing transparency is key to any process. Industry is, and has been, committed to transparency, as evidenced by our willingness to

submit ratings rationale reports and provide transaction documents upon NAIC staff's request. We ask for the same level of transparency from the NAIC.

The current exposure grants the SVO significant unilateral powers, with very little transparency, and without sufficient due process or checks and balances. This proposal, if adopted, would be materially disruptive to the insurance industry. Rather, the undersigned propose that the identified concerns with reliance on CRP ratings be addressed in a holistic way, backed by disciplined and rigorous analysis, with output that is transparent to all parties. This would address Regulator concerns without creating undue market disruption and the other shortcomings that the undersigned have identified in this letter.

The undersigned stand ready to assist in this process in a meaningful way, but we believe that is best done transparently and through collaboration. We believe Regulators understand the importance of transparency and would like to achieve a transparent outcome as well. We appreciate the opportunity to participate in this ongoing process.

Sincerely,



Mike Monahan
ACLI

Tracey Lindsey

Tracey Lindsey
NASVA

John Petchler

John Petchler
on behalf of PPIA Board of Directors



Lisa Pendergast
CRE Finance Council



Michael Bright
SFA



Mike Flood
Mortgage Bankers Association

cc: Charles Therriault, Director, Securities Valuation Office
Eric Kolchinsky, Director, Structured Securities Group

The American Council of Life Insurers (“ACLI”) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI’s member companies are dedicated to protecting consumers’ financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI’s 280 member companies represent 94 percent of industry assets in the United States. For more information, visit www.acli.com.

The Private Placement Investors Association (“PPIA”) is a business association of insurance companies, other institutional investors, and affiliates thereof, that are active investors in the primary market for privately placed debt instruments. The association exists to provide a discussion forum for private debt investors; to facilitate the development of industry best practices; to promote interest in the primary market for privately placed debt instruments; and to increase accessibility to capital for issuers of privately placed debt instruments. The PPIA serves 66 member companies and works with regulators, NASVA, the ACLI, the American College of Investment Counsel, and the investment banking community to efficiently implement changes within the private placement marketplace. For more information, visit www.usppia.com.

The National Association of Securities Valuation Analysts (“NASVA”) is an association of insurance company representatives who interact with the NAIC Securities Valuation Office (“SVO”) to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC’s ISIS electronic security filing system, and commenting on year-end processes.

The Structured Finance Association is the leading securitization trade association representing over 370 member companies from all sectors of the securitization market. Our core mission is to support a robust and liquid securitization market and help its members and public policymakers grow credit availability and the real economy in a responsible manner. SFA provides an inclusive forum for securitization professionals to collaborate and, as industry leaders, drive necessary changes, advocate for the securitization community, share best practices and innovative ideas, and offers professional development for industry members through conferences and other programs. For more information, visit www.structuredfinance.org.

MBA is a national association representing the real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation’s residential and commercial real estate markets. Its membership of more than 2,200 companies includes all elements of real estate finance: independent mortgage banks, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies, credit unions, and others in the mortgage lending field.

CREFC comprises over 400 institutional members representing U.S. commercial and multifamily real estate investors, lenders, and service providers – a market with over \$5 trillion of commercial real estate (“CRE”) debt outstanding. Our principal functions include setting market standards, supporting CRE-related debt liquidity, facilitating the free and open flow of market information, and education at all levels. One of our core missions is to foster the efficient and sustainable operation of CRE securitizations. To this end, we have worked closely with policymakers to educate and inform legislative and regulatory actions to help optimize market standards and regulations.



October 9, 2023

Dan Daveline
Director, Financial Regulatory Services
NAIC
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197
ddaveline@naic.org

Re: Proposed E Committee Framework for Regulation of Insurer Investments

Dear Mr. Daveline:

On behalf of Athene Holding (“Athene”), we write in support of the NAIC Financial Condition (E) Committee’s (E Committee) recently proposed Framework for Regulation of Insurer Investments – A Holistic Review (the “Framework”). The Framework provides for a thoughtful, comprehensive approach for addressing the most important challenges confronting US insurance regulators – efficiently adjusting the current capital framework to account for both a rapidly evolving life insurance sector and the need to remedy the ongoing retirement/protection crisis in this country. In undertaking a principles-based examination of the NAIC’s existing risk-based capital (“RBC”) system, the NAIC has opened the door to creating a consistent, fair, and rational RBC framework. In doing so, it will provide stability to insurers’ investment activities and foster a vibrant and competitive life insurance market that can meet the extensive and unmet retirement and protection needs of US consumers. We support both the Framework and the objectives it embodies.

Framework Proposals

The Framework identifies two broad regulatory enhancements: to modernize investment risk oversight, and to create a consistent approach in calculating C1 capital across a diverse set of asset classes and structures. We are supportive of these recommendations and write to provide our perspective on several related topics.

Proposal A. Investment Risk Assessment

Regulators, Credit Rating Providers (“CRP”), the NAIC’s SVO Securities Valuation Office (“SVO”), and Structured Securities Group (“SSG”) each have distinct and critical roles in the risk assessment and oversight of insurer investment portfolios. Separation of duties and clear role delineation is a crucial aspect of the ongoing transition, and the Framework appropriately recognizes this as a foundational question. In that regard, we fully support the Framework’s balance of reducing “blind reliance” on CRPs, while avoiding replicating the significant capabilities of CRPs. As recognized in the Framework, “state regulators should not develop frameworks that prioritize using such resources in reperforming functions

that can otherwise be satisfied using available market mechanisms, leaving no capacity for more impactful and macro-level risk assessment and analysis.”

The clear benefits and efficiencies of CRP ratings should be leveraged in any regulatory solution. CRPs bring considerable expertise, resources, and continual improvement in methodologies and analysis, and are subject to significant existing regulatory obligations.¹ As noted in the Framework, it would be both inefficient and extraordinarily costly for the NAIC to attempt to replicate the extensive resources that CRPs bring to bear. With that said, as suggested by the Framework, any concerns regarding “blind” reliance on CRPs can be addressed through a combination of regulatory due diligence, portfolio analysis, increased insurer stress testing and other regulatory tools. Given these overarching principles, we do not believe there is a compelling need for the SVO to perform individual security designations, except where it may have historically performed such role. We acknowledge that there may be circumstances as contemplated by the Framework where this may be a practical necessity, for example, when an issuer chooses not to pursue a CRP rating.

In this regard, we generally support the principles-based approach outlined by the American Academy of Actuaries (the “Academy”) in its Principles for Structured Securities RBC presentation to the Investment Risk and Evaluation Working Group. Similar to the observation in the Framework that SVO modeling for individual designations would be rarely necessary, the Academy Principles provide “a principles-based approach to RBC for structured securities [that] will allow regulators flexibility in adapting to new structures as they emerge in the marketplace.” The Academy Principles present a “Modeling Flowchart” that provides a practical construct for application of “equal capital for equal risk” in ensuring consistent decision-making around C1 capital. The flowchart would be used to determine whether (a) an asset class needs to be modeled and (b) whether securities within an asset class need to be modeled individually to determine C-1 factors. Where the flowchart demonstrated a need for an asset class to be modeled, there would be a principles-based approach to derivation of C-1 factors.

We encourage the E Committee to incorporate the Academy’s flowchart and related Principles into the Framework, particularly with regard to the pending workstream around CLO modeling. The Academy’s approach demonstrates the practical application of “equal capital for equal risk”, and if implemented, would free up SVO and NAIC resources to focus on other pending and emerging issues arising under the Framework’s implementation. The Academy has already provided the NAIC a reasonable roadmap deciding the appropriate role of the SVO/SSG in determining credit risk, and will help it reach immediate resolution on the pending question of whether CRPs should continue to model CLOs.

We further support the Framework’s revised mandate for the SVO/SSG so that its resources are focused on portfolio and market risk analysis, enhanced asset modeling, and a broader policy advisory function, all of which would provide NAIC members with critical data and support to make ongoing and informed decisions related to implementation of the Framework and proper oversight of insurers.

¹ For example, CRPs are subject to oversight by the SEC and must comply with specific requirements aimed at improving the reliability and transparency of ratings, including certification and disclosure requirements regarding their rating methodologies, conflicts of interest, and internal controls.

Similarly, we agree that a neutral third-party consultant(s) would likely be helpful to developing the structure needed for implementation and “key guidance on policy related issues, assess market impacts and provide recommendations.” The Academy, as noted by the Framework, is already serving in this role on the risk-based capital and reserving initiatives and its well-reasoned and expert-informed recommendations show the value of such an approach.

To the extent that regulators intend for designations to encompass additional or different risks than CRP ratings are designed to cover, a transparent process should be undertaken to precisely identify quantitative and/or qualitative “gaps” between ratings and regulatory objectives, as well as potential solutions to address such gaps. Such a process, which we believe is ongoing and envisioned by the Framework, would be informative to regulators, industry, and CRPs alike. The ultimate challenge is constructing a solution that is feasible, takes advantage of CRP resources and expertise, and yet provides regulators with tools for the identification and oversight of portfolio risks that arise within the industry.

Proposal B: Risk Based Capital for Investments

Perhaps one of the most important concepts identified in the Framework is the need for any updated capital regime to have the goal of creating “consistent standards to the highest degree practicable.” Currently there is a concerning lack of consistency in how C1 capital is calculated across a diverse set of asset classes and structures. Capital charges have been determined over time through multiple statistical risk measures, tolerances and data sets, and designations are determined through multiple different parties and methods. While RBC was originally designed primarily as a metric for detecting troubled companies, its impact on insurers’ asset allocations and on capital markets is indisputable.

We fully support the goal of achieving “equal capital for equal risk.” We believe this principle can be achieved over time with individual principles-based decisions that align to an overarching goal of framework consistency and integrity. For example, we believe the bond project is a highly successful example of this type of ambition in action – it should be extrapolated to the asset framework more broadly. We offer some practical suggestions for application of “equal capital for equal risk” as part the Framework’s implementation.

- The methods for determining capital charges for material asset classes should be inventoried, including underlying assumptions and stress tolerances and methods, across asset classes and used to form a view about the overall health and consistency of capital charges across asset classes.²
- Any new capital factors should be developed using a similar process used for the C-1 bond factors. Similar to that process, we recommend an objective, third party should be engaged to perform

² See, e.g., Academy standards on model risk management: American Academy of Actuaries guidelines on Model Risk Management (Academy Guidelines), Principle Based Reserving (PBR) governance rules in the Valuation Manual discuss assumption-setting, Federal Reserve SR 11-7.

the necessary analysis, perform field testing, and promulgate appropriate charges to ensure “equal capital for equal risk” across different asset classes.

- The NAIC and relevant working groups should develop a thorough understanding of CRP models and methodologies for material asset classes. The relationship between CRP ratings and C-1 capital charges should be clearly defined, and capital charges should be developed to account for such defined relationship.
- Consistency should be a primary objective regarding modeling methods and assumptions. Sensitivity testing could be added as a guardrail for stress levels and scenarios that are beyond the severity of the base RBC model.
- The anticipated impact on both policyholders and capital markets, in terms of expected costs and benefits, should be part of the holistic review and development of the final framework revisions, including through a macroprudential lens.
- Modeling processes should be subject to formal and transparent model governance and validation processes and embedded permanently in NAIC manuals and guidelines in respect of RBC changes.

Impact on Current Capital Workstreams

During the NAIC’s Summer National Meeting, E Committee Chair, Superintendent Beth Dwyer, noted that current task force and working group workstreams would continue,³ pending deliberation and adoption of the Framework. The Framework serves as an opportunity to provide a consistent and holistic lens to capital-related initiatives. Should some existing projects move forward prior to the adoption of the Framework, the NAIC may miss an opportunity to stage, and even rethink, these initiatives in a thoughtful and holistic manner. To manage this risk, we recommend that:

- As noted above, near-term adoption of the Framework as well as incorporation of the Academy’s Principles would lead to a determination that individual modeling of CLOs is not required because sufficient data to model CLOs already exist and they possess identifiable attributes that can be used to sort the assets into risk buckets.⁴ Following this approach, designations would rely on CRP ratings for CLOs, using newly developed capital factors, with greater CRP oversight by NAIC members supported by analytics from the SVO.
- E Committee should also revisit the role of existing working groups, task forces and ad hoc groups currently engaged on Framework-related issues and determine how to facilitate an overarching workstream providing for coordination, transparency, and inclusivity.

³ In particular, (i) IRE review of residuals and other structured securities charges; (ii) VOSTF proposal around CRP challenge right; and, (iii) VOSTF-led SVO/SSG Modeling of CLOs.

⁴ “For example, CLOs would likely have an answer of ‘yes’ because most CLOs are rated by CRPs and those ratings can reasonably sort each individual CLO security into a risk bucket”. Academy Presentation, Page 10.



Again, we welcome and support the Framework and would encourage NAIC members to move forward with its swift adoption and implementation.

Sincerely,

A handwritten signature in black ink, appearing to read "John L. Golden".

John L. Golden
Global Head of Insurance
Regulation Partner, Apollo and
Executive Vice President,
Athene

Amnon Levy
Bridgeway Analytics
Amnon.Levy@BridgewayAnalytics.com

October 2, 2023

Superintendent Elizabeth Dwyer, Chair
Financial Condition (E) Committee
National Association of Insurance Commissioners
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Framework for Regulation of Insurer Investments – A Holistic Review

Dear Superintendent Dwyer,

We are grateful for the opportunity to comment on the above-mentioned proposal that envisions a modernization of the NAIC's investment risk oversight framework to align with insurers' shifting investments towards more complex strategies. The proposed framework represents impeccable foresight, commendable reflection, and an incredible opportunity to initiate a much-needed update that will lay a foundation for the U.S. insurance industry at a time of relative financial stability, allowing for thoughtful design.

By deliberately leveraging resources efficiently, the redesign can be approached to balance prudence and cost-efficiency while incorporating lessons learned from history and from other frameworks.^{1,2} Thus, we are confident that the U.S. insurance regulatory framework can be adapted to benefit policyholders and insurers. To this end, we propose an action plan for regulators to consider:

1. **Principles.** Regulators should agree on principles for investment risk oversight (**PIRO**).
2. **Roles and responsibilities.** Agree on mandates with deliberate considerations for potential conflicts of interest that tie back to PIRO along with immediate priorities.
3. **Designation oversight.** A step toward the aspirational vision that also addresses the need for stop-gap measures.
4. **Design an investment risk oversight framework.** Build an investment risk oversight framework that rests on PIRO.
5. **Feasibility assessment and costing.** Engage with external consultants and vendors to map out the needed data, tools, and subject expertise required to achieve oversight that addresses desired standards.

Our report, [Investment Risk Oversight](#), Attachment 1 to this letter, frames the inherent challenges with investment risk oversight, including data and transparency limitations, complexity, and potential conflicts of interest. With

¹ [Efforts to Reform NAIC Investment Guidelines: Lessons Learned from History](#) and references therein provide useful points of reference of past revisions to guidelines and unintended consequences for investment strategy and capital markets more broadly.

² [Benchmarking the Treatment of CLOs](#) provides a useful comparison of the treatment of structured assets and corporate credit across jurisdictions, including the NAIC, Solvency II, Basel II, and the Bermuda Monetary Authority, and the implications for investment strategy and capital markets more broadly.

these considerations, along with feedback from members of the industry, regulators, and other members of the community, we arrived at supervisory roles and responsibilities as well as candidate PIRO:

1. **Clarity.** Ensuring each component of the framework has a well-articulated objective and definition.
2. **Consistency.** Ensuring different types of investments are handled objectively and consistently across the framework.
3. **Governance.** Ensuring ongoing governance across the framework, including a model risk management framework with defined standards.

We also commend the E-Committee for focusing on how the NAIC, and the Securities Valuation Office specifically, should evolve to cost-effectively support regulators with data and tools needed for modern supervision. To this end, we share [Overseeing Designations and the Prudent Use of Agency Ratings](#) in Attachment 2 to this letter. This second report also received invaluable guidance on feasibility and cost-effectiveness from current and former senior quantitative staff from several rating agencies. It applies PIRO in the context of the designation process, and it arrives at three key features of their oversight:

1. **Credit Assessments.** We formalize the concept of Credit Assessments (e.g., agency ratings) and Credit Assessment Providers with consistent standards required for their qualification in the designation process.
2. **Quantitative oversight.** We introduce principles and a quantitative mechanism to compare Credit Assessments that deliberately consider conflicts of interest and data limitations, and are designed to help NAIC staff provide transparency over Credit Assessments that are overly favorable or overly punitive in the context of their use in statutory accounting and RBC.
3. **Insurers are the first line of defense against excess risk-taking.** We propose placing the onus on insurers to demonstrate their use of Credit Assessments in business applications beyond regulatory compliance, demonstrating their genuine belief that the risk assessment is prudent and accurate, avoiding flagrant misuse of ratings.

Ultimately, we hope the reports will help achieve the goal of providing regulators with the tools needed to assess insurers' investment risks without undue burden, acknowledging that policyholders will bear the cost of any regulatory framework. As such, it is critical to assess the efficacy of any proposed changes; we believe this is best achieved with a quantitative and principle-driven approach.

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.

Attachment 1:
Investment Risk Oversight



Investment Risk Oversight

October 2023

Synopsis:

Following the Global Financial Crisis (GFC), insurers faced a low-yield environment, prompting a significant shift towards higher-yielding alternative assets. This transition encompassed various strategies, such as private debt and equity placements, structured products, and cost-effective investment vehicles, including custom-designed, non-SEC registered funds tailored to their specific requirements. Up to the present, regulations have been tactically modified to evolving market dynamics. An August 2023 memo from the Financial Condition (E) Committee proposes a comprehensive reassessment of the regulatory framework for insurers' investments. This initiative acknowledges the imperative to modernize the existing structure to better align with contemporary needs.

This report builds on the memo's aspirational vision to modernize the NAIC's oversight of investment risk and to use available resources cost-effectively, aiming to achieve the principle of "Equal Capital for Equal Risk." Given the complexities involved with the needed depth and breadth of tools with considerations for the broad set of capital markets, statutory accounting, RBC, etc., this report introduces candidate core principles for investment risk oversight:

1. **Clarity** – ensuring each component of the framework has a well-articulated objective and definition.
2. **Consistency** – ensuring different types of investments are handled objectively and consistently across the framework.
3. **Governance** – ensuring ongoing governance across the framework, including a model risk management framework with defined standards.

This report also introduced supervisory roles and responsibilities for insurers, NAIC staff, regulators, and external consultants, with deliberate considerations for potential conflicts of interest that tie back to the core principles.

By deliberately leveraging resources efficiently and approaching the redesign to balance prudence and cost-efficiency while incorporating lessons learned from initiatives such as CCAR and Solvency II, we are confident that the U.S. insurance regulatory framework can be adapted to benefit policyholders and insurers.

**We hope you find this resource helpful
It is consistent with our goal of bringing value to our community**

About the Authors

Amnon Levy is the CEO of Bridgeway Analytics and led the redesign of the C-1 factors on behalf of the NAIC and ACLI in 2021.

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Craig Peters is an independent consultant who has played various Model Risk Management (MRM) roles, including Head of MRM at Moody's Analytics, Head of Model Validation at Bank of the West, and Head of Controller Modelers at Goldman Sachs.

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.

Asset Regulatory Treatment (ART)

STANDARDS & SYSTEM is Bridgeway Analytics' machine learning-assisted platform that efficiently and effectively organizes insurers' current and proposed investment guidelines including NAIC and state rules. Users are kept current and provided timely notifications on changes and their impacts, overcoming challenges with navigating the multitude of complex regulations across jurisdictions that use disparate language, with varied rulemaking processes. The platform is used by insurers' investment, risk, compliance, legal, government affairs, accounting, and reporting functions, as well as their regulators.

- **ART System** provides users access to codified state investment guidelines in a searchable and understandable format.
- **ART Newsreels** alert users of the changes to the investment landscape, including NAIC and state investment guidelines, packaging, and delivering what matters most through timely, concise, and clear messaging.
- **ART Chronicles** are a centralized repository of recent and possible future changes to the landscape, including NAIC and state investment guidelines. Our Chronicles consolidate Newsreels in a distilled and easy-to-navigate format.
- **ART Heatmaps** provide a visualization of the varying investment limits that govern asset classes across states.
- **ART Investment Classification** assists with the classification of assets, which includes requirements under the proposed principles-based bond definition which consists of possible heightened reporting requirements.

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1 Executive Summary

Insurers have shifted their investment strategy since the post-Great Financial Crisis (GFC) onset of the low-yield era toward higher-yielding alternative assets. These assets include private placements of debt and equity, structured products, and lower-cost, efficient investment vehicles, often bespoke private, non-SEC registered funds designed to address insurers' unique needs.¹ Part of this trend is due to the changing landscape in banking, where post-GFC regulation has resulted in classes of transactions being more capital-efficient for insurers than banks.² In many respects, the illiquid nature of this lending is a much better match to the illiquid nature of life insurance policies than for bank deposits. This symbiosis has spurred significant economic benefits; however, it has created a need for insurance regulators to realign the rules to the new investment landscape.

To date, regulators and the NAIC have responded to these shifting trends by tactically refining the rules to the new landscape, leaving essential elements of the framework disjointed. The E-Committee has taken notice, and its August 15, 2023, meeting included deliberations over a [memo](#) outlining a holistic rethink of how insurers' investments are regulated.

This report builds on the memo's aspirational vision to modernize the NAIC's oversight of investment risk, which outlines a shift in strategy whereby the NAIC would prioritize resources to establish a robust and effective governance structure. It highlights the need for the NAIC to provide due diligence over rating agencies to reduce/eliminate "blind" reliance on their ratings and de-emphasize its role in assigning NAIC-derived designations. At the most basic level, the memo explores the most effective use of regulatory resources in the modern environment of insurance regulation for investments, with aspirations of achieving the principle of "Equal Capital for Equal Risk."

Core to the investment risk oversight framework is the tension between keeping policies affordable by allowing insurers to invest in higher-yielding instruments while protecting policyholders from the risk of insolvency. When designing an update to the framework, this trade-off must be top of mind, providing guardrails and certainty for insurers and transparency for regulators. Various jurisdictions have chosen different balances with significant macroeconomic impacts – from the scope of property policies, the affordability of retirement savings, and the availability of capital.

To address this tension, this report identifies the core components of the traditional 'three-legged' stool of the NAIC's investment risk framework (i.e., accounting, risk assessment, and capital): classification, designation, and Risk Based Capital (RBC) as well as reserving that play key roles in investment oversight for life companies. We then outline some of the challenges associated with investment risk oversight:

1. **Heterogeneous characteristics and multiple risk factors** resulting from the myriad and growing forms of asset classes whose performance is impacted by a complex set of risk factors that can be unique.
2. **Lack of transparency** resulting from increasingly opaque private or complex assets.
3. **Difficulties with quantifying risk, including those of rare events**, resulting from challenges with their measurement, both in terms of accessing comparable data across asset classes and paucity of data associated with rare events such as credit defaults.

Given the complexities involved with tools that consider nuances with capital markets, statutory accounting, RBC, etc., we introduce candidate core **Principles for Investment Risk Oversight (PIRO)**:

1. **Clarity** – ensuring each component of the framework has a well-articulated objective and definition.
2. **Consistency** – ensuring different types of investments are handled objectively and consistently across the framework.

¹ Amnon Levy, Bill Poutsiaka, and Scott White, [Trends in the Ownership Structure of U.S. Insurers and the Evolving Regulatory Landscape](#). Insurance AUM Journal, Q3 2023.

² See Michael Schwert, Does borrowing from banks cost more than borrowing from the market?, Journal of Finance, 2020.

-
3. **Governance** – ensuring ongoing governance across the framework, including a model risk management framework with defined standards.

We introduce supervisory roles and responsibilities for insurers, NAIC staff, regulators, and external consultants, with deliberate considerations for potential conflicts of interest that tie back to PIRO.

We propose concrete next steps for regulators to consider, building a plan toward a long-term aspirational vision that, in the process, addresses considerations for stop-gap interim measures that include:

1. **Principles.** Regulators should agree on principles for investment risk oversight.
2. **Roles and responsibilities.** Agree on mandates and immediate priorities.
3. **Designation oversight.** A step toward the aspirational vision that addresses the need for stop-gap measures.
4. **Design an investment risk oversight framework** that builds off PIRO.
5. **Feasibility assessment and costing.** Engage with external consultants and vendors to map out the needed data, tools, and subject matter expertise required to achieve oversight that addresses desired standards.

The report concludes with optimism, highlighting that the seemingly overwhelming task of overseeing investment risk can be managed cost-effectively by deliberately leveraging resources efficiently (e.g., rating agencies with prudent oversight).

2 Statutory Accounting and RBC Investment Risk Toolbox

The investment risk framework sits on top of statutory accounting and RBC frameworks, which provide regulators with a toolbox to help them assess insurers' solvency. This section describes the components of the traditional 'three-legged stool' of the NAIC's investment risk framework (i.e., accounting, risk assessment, and capital) referenced in the E-Committee memo, along with reserving that, in some circumstances, can consider investment risk. *Figure 1* provides a schematic for key components of the 'Investment risk toolbox,' acknowledging other tools available to regulators, such as liquidity stress tests, that we abstract from in this report.

The process of building out the toolbox begins with the **classification and reporting** of investments that have been and continue to be revised toward principles-based approaches in response to increases in more complex strategies that include investments with blended characteristics (e.g., debt with equity-like performance features). Bonds receive designations that ultimately result in favorable capital treatment, for example, and in the case of structured assets, can require demonstration of sufficient subordination, a process that the revised investment risk oversight framework should oversee.

Designation assignments provide a rank order of credit risk; they are ordinal. They are defined in the [Purposes and Procedures Manual](#), with revisions currently being deliberated and discussed in our report [What's Next for the rules governing insurers' investments](#). Designations rely heavily on agency ratings and determine the degree to which a bond is treated favorably or punitively, primarily in the calculation of Risk Based Capital (RBC) but also when used in reserves. They are also relevant in adhering to state investment limits and other guidelines, such as those that govern securities lending. The designation process involves ongoing monitoring of individual counterparties and their credit quality. The [United States SEC](#), which oversees rating agencies, requires a description of credit ratings to be published. For example, [Moody's Rating Symbols and Definitions](#) describes credit ratings as opinions of ordinal, horizon-free credit risk and, as such, do not target specific default rates or expected loss rates. By their nature of rank ordering credit risk across the credit spectrum (e.g., with Moody's Aa 10-year historic corporate default rates in the order of 50 bps), ratings consider extreme tail events.³ They don't describe a cardinal level of risk as is the case with, say, C-1 bond factors that measure expected tail loss from

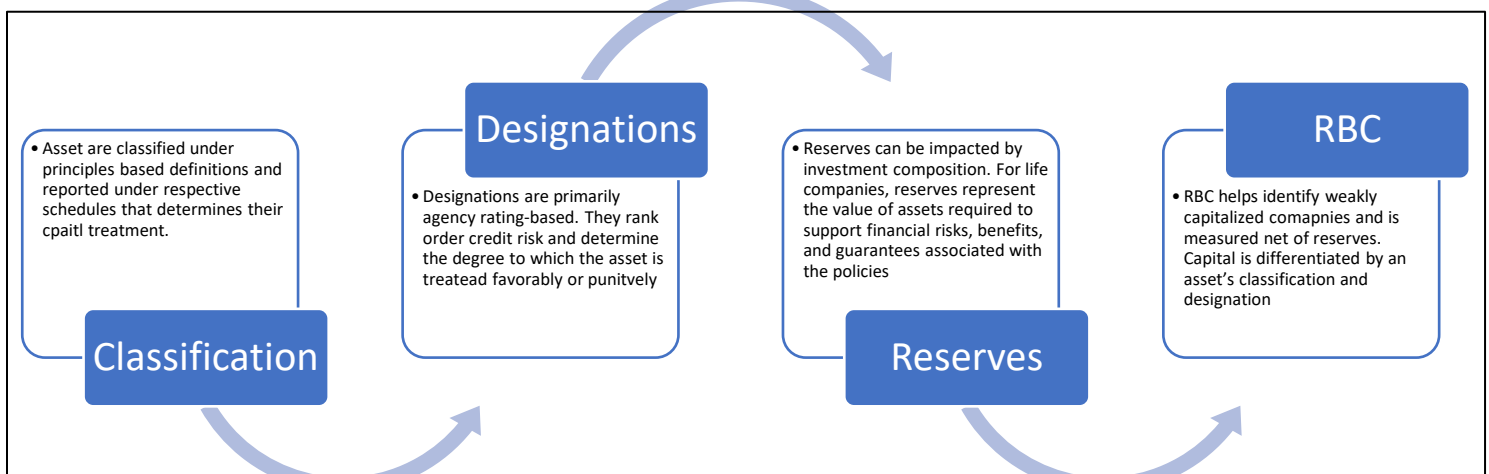
³ See, for example, [Revisions to the RBC C-1 Bond Factors Prepared for the NAIC and ACLI](#).

credit events across the credit spectrum. The E-Committee memo specifically highlights the need for the NAIC to provide due diligence over rating agencies to reduce/eliminate “blind” reliance on their ratings and de-emphasize its role in assigning NAIC-derived designations. We propose principles to address this need in our report, [Overseeing Designations and the Prudent Use of Agency Ratings](#), which include adherence to the overarching principles outlined in this report.

For life companies, **reserves** represent the value of assets required to support financial risks, benefits, and guarantees associated with the policies. They are being updated to consider the nature of complex assets more explicitly for life companies, as an example, which is now analyzed in Asset Adequacy Testing (AAT) under Actuarial Guideline (AG) 53. The additional complexity of assets presents two distinct challenges for regulators: (1) understanding the likelihood of promised cashflows materializing, allowing for payments to policyholders in the context of asset-liability management (ALM), and (2) understanding market liquidity and its implications for solvency. What we propose seeks to support oversight on both these fronts as well as overseeing investment risk in reserves more broadly, including, for example, consistent credit risk modeling and the use of designations.

RBC helps identify weakly capitalized companies and, when applicable, is measured net of reserves. It establishes a minimum threshold below which regulators can take control of an insurer. It is often described as a blunt tool. An investment’s classification and designation determine its capital charge. It is being revised to determine risks more granularly, initially to address potential capital arbitrage for structured assets and investment vehicles. Designations are ordinal and rank order risk and feed into RBC, which is cardinal and assigns a level of capital. Designations don’t describe a quantitative level of risk as with, say, C-1 bond factors that measure expected tail loss from credit events across the credit spectrum. The C-1 bond framework specifies a target probability (96%) along with a horizon of 10 years and considers various offsets, including those within the statutory accounting framework.

Figure 1: Investment risk oversight



3 The Challenges with Investment Risk Oversight

Insurers' investment trends have heightened the need for the NAIC and regulators to access subject matter experts and better tools to aid in their efforts to oversee investment risks, to which the E-Committee memo calls attention. Investment risk oversight involves identifying and assessing the various risks associated with a broad set of investment activities, with each asset class presenting a distinct and unique set of challenges and multiple stakeholders, such as rating agencies and insurers, possibly facing conflicts of interest. These challenges must be deliberately considered when designing principles for oversight and laying out supervisory roles and responsibilities. The challenges are broad but not insurmountable:

-
1. **Heterogeneous characteristics and multiple risk factors.** Insurers participate in broad swathes of capital markets that cater to varying funding needs of the market segments they service. Identifying and assessing investment risks, even for seemingly similar assets, can require specialist knowledge and skills. Take, for example, a typical vanilla floating-rate loan and a fixed-rate bond with similar terms and counterparties of similar characteristics. Various features must be identified and quantified when assessing credit risk, such as expected recovery in the event of default, that are often difficult to disentangle and attribute. As the scope of asset classes expands, so do nuances. Acknowledging the increased heterogeneity in investment composition, the NAIC has embarked on efforts to increase granularity with virtually every aspect of its toolbox.

Identifying and measuring differentiated risks is also increasingly challenged by insurer's increasingly complex investments. Variation in premia across assets of seemingly similar profiles muddles an assessment of variation in their risks. Progress has been made with the regulatory toolbox measuring differentiated risks. Premiums for illiquidity and other risks of complex assets, including structured assets in Asset Adequacy Testing through Actuarial Guideline 53, but the efforts are in a formative stage.

2. **Lack of transparency.** A natural byproduct of insurers' increased footprint in private and more complex assets, including a spectrum of SEC- and non-SEC registered investment vehicles, has resulted in less transparent portfolio holdings. There is an important distinction to the source of opacity that can result from lack of disclosure or complexity:

- a. **Disclosure.** Private assets, equity or residual interests under Schedule BA, or debt under Schedule D have been flagged by NAIC staff and regulators as opaque. Concerns have been raised with privately rated bonds, in particular given their de facto favorable regulatory treatment. While Private letter ratings (PLRs) provide a rationale, they are not standardized and cannot be analyzed in mass. This is a significant and growing issue, with well over 8000 PLRs accounting for nearly 6% of admitted assets reported under Schedule D in 2022, compared with 4.1% in 2021. In 2022, four companies were reporting more than 30% of their admitted assets in bonds with private ratings
- b. **Complexity.** More complex assets, including structured assets and investment vehicles that contain non-vanilla instruments, often require subject matter expertise to assess their risk, regardless of the level of disclosure and data quality.

3. **Difficulties with quantifying risk.** Several factors challenge quantifying risks across asset classes:

- a. **Non-comparable data across asset classes** results in limitations to easy comparably
 - i. **Disclosure.** Capital markets span multiple jurisdictions (e.g., equity interests in a member of the S&P 500 that is SEC-registered vs. a small non-SEC registered private firm), and each has its own set of regulations and standards with variations in disclosure and risks that result in challenges with comparably assessing risks. Reporting requirements differ across market segments, which includes considerations for audited standardized financial statement data that can be analyzed in mass.
 - ii. **Market data.** Variations in available market data across asset classes can lead to a lack of comparability. This is tied to the degree to which price data reflect transaction prices that are representative of the prices that will manifest in practice.
 - iii. **Accounting standards.** Variations in statutory accounting treatment (e.g., bonds are generally reported under amortized cost, while public equity is at fair value) can result in imprecise comparability.
- b. **Challenges to quantifying the risk of rare events.** Discussed extensively in [Assessment of the Proposed Revisions to the RBC C-1 Bond Factors](#), substantial practical challenges exist with categorizing and measuring credit and other tail risks across assets. [Overseeing Designations and the Prudent Use of Agency Ratings](#) discusses approaches to overcome challenges with overseeing Credit Assessments, which we define more formally below, such as agency ratings, parts of which can be used to address other challenges with investment risk oversight more broadly, including:
 - i. Measures of default risk, an inherently remote event, cannot be assessed robustly given the dearth of default data.
 - ii. Level-setting risk across asset classes is challenging because different risk factors impact different credit segments (e.g., corporate vs. municipal).

-
- iii. Controlling for variation in methods and standards across Credit Assessment Providers whose methods necessarily involve subjectivity.
 - iv. Avoiding conflicts of interest driven by rating agencies' commercial incentives and insurers' desire to, all else equal, minimize capital.

We now explore principles and supervisory roles and responsibilities for overseeing investment risk that deliberately address these challenges.

4 Investment Risk Oversight

Investment risk oversight involves a governance framework along with a supervisory function. The governance framework outlines the overarching structure of investment risk oversight through a set of principles that guide both regulators and practitioners. Supervision includes specific operational roles and responsibilities, including overseeing and monitoring day-to-day activities and performance. This section proposes PIRO along with roles and responsibilities for investment risk supervision. The principles deliberately consider the challenges with investment risk oversight and balance varying stakeholder interests:

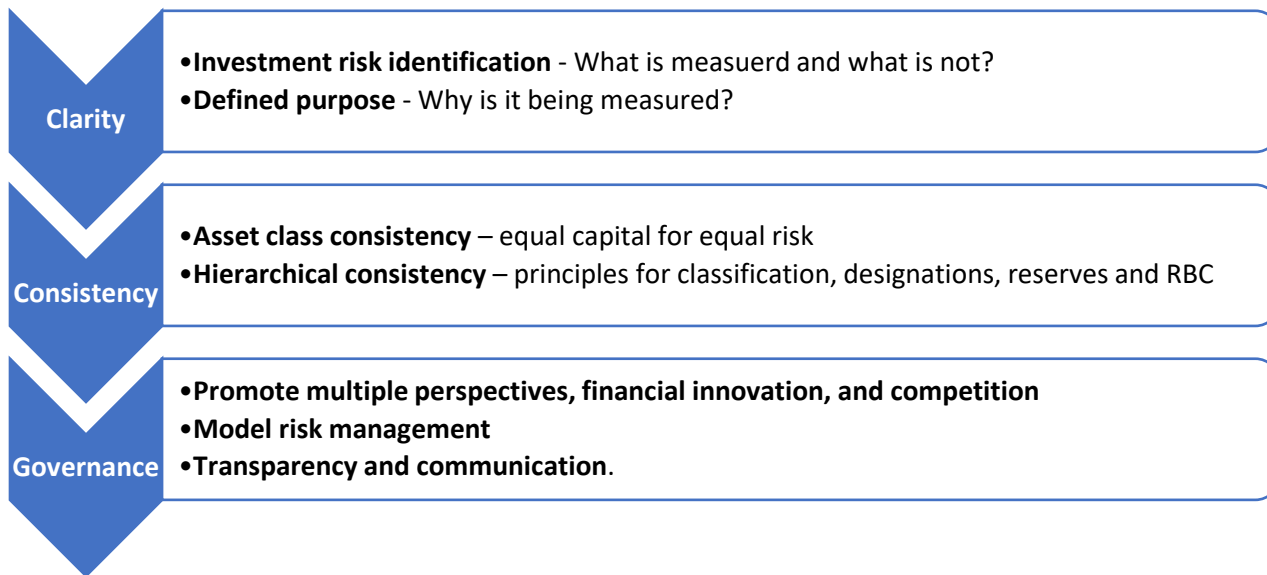
1. **Insurers** need a predictable and understandable regulatory framework that equates treatment with economic risks. In addition, sensitivities to the wide spectrum of investment strategies across insurance segments (e.g., life vs. property and casualty) and varying complexity, sophistication, and entity size require consideration. While a key goal should be to protect policyholders, there must be a deliberate avoidance of undue burden, allowing insurers to comply efficiently and effectively. This is critical to ensuring policyholders are best served. Conflict of interests, whereby insurers are incented to choose measures that present themselves as overly financially secure by, say, 'shopping for ratings' and using overly favorable agency ratings to obfuscate the risks of their credit portfolio, need to be acknowledged and deliberately considered.
2. **Regulators** need tools that will help identify weakly capitalized companies and the ability to identify insurers' chosen methodologies that are questionable without undue burden. The tools should not, a priori, bias any insurance segment and should promote competition and new entrants.
3. **Policyholders** need access to affordable and reliable coverage. The link between investment guidelines and policy coverage should be understood. For example, more punitive treatment of long-dated investments, a feature prevalent in many jurisdictions (e.g., Solvency II), will lead to more expensive long-dated life and annuities.⁴

4.1 Principles for Investment Risk Oversight (PIRO)

We now lay out PIRO, which has three core principles summarized in *Figure 2*, subsequent to which further details are provided.

⁴ See our report, [Benchmarking the treatment of CLOs](#).

Figure 2: Principles for risk oversight



The approach detailed by the American Academy of Actuaries for Principles for Structured Securities RBC presentation included in the Risk Based Capital Investment Risk and Evaluation (E) Working Group 2023 Summer Meeting [Agenda & Materials](#) demonstrates the spirit of these principles applied to the case of RBC for Asset Backed Securities. However, we prefer risk measures to be consistent across all asset classes. We believe this framework supports the Academy’s work, and below, we outline a broader application of our thinking.

4.1.1 Clarity of purpose

Ensuring stakeholders understand the purpose and rationale behind each component of the framework is vital to ensure that the system is understandable and predictable. This needs to cover two key areas:

1. **Investment risk identification** – a clear articulation of risks that are intended to be measured or not. This is a nuanced issue under the current framework that lacks a comprehensive inventory, and with significant variation in the extent to which different risks are captured within the statutory accounting and RBC frameworks. In many cases the exclusion of a risk is intentional (e.g., life RBC does not generally capture spread risk for bonds), and in other cases it is a byproduct of convenience (e.g., C-1 factors are measured in excess of reserves for which low quality credit holdings are generally not used).
2. **Defined purpose** – a clear articulation of the risk measure’s intended use within the framework, with the possibility of an identified risk, referenced in Principle 1, being measured through multiple lenses.
 - **Classification** is used to differentiate the treatment of investments, including capital and reserves, and is determined by SAP reporting guidelines. Classification is a risk measure and may require analytic and documented justification.⁵
 - **Designations** rank order credit risk of instruments that qualify as bonds with guidance provided under [SSAP No. 26](#), [SSAP No. 43](#), and references therein.⁶
 - **Reserves** can include investment risk. For life companies, reserves represent the value of assets required to support financial risks, benefits, and guarantees associated with the policies described in the NAIC

⁵ Several notable characteristics that impact reporting include those that allow investments to qualify as: (1) a bond issued by an Issuer Credit Obligation (ICO) or an Asset Backed Security (ABS) under [SSAP No. 26](#), [SSAP No. 43](#), and references therein, and (2) an equity interest in an ICO or residual interest of an ABS (with [revisions to clarify the scope of residual interests](#) currently being deliberated).

⁶ NAIC designations are defined in the [Purposes and Procedures Manual](#), with revisions that are currently being deliberated and discussed in our report [What’s next for the rules that govern insurers’ investments](#).

[Valuation Manual](#). There is significant variation in the extent to which investment risk impacts reserving across insurance entity types and lines of business. This leads to downstream challenges and possible imprecision in the treatment of reserves in RBC.

- **Risk Based Capital (RBC)** helps identify weakly capitalized companies and ensures an adequate margin of safety is available to support policyholders. As a practical matter, RBC generally measures portfolio tail loss with considerations for their treatment under statutory accounting, including offsets related to the likes of reserves. The varying treatment across asset cases is notable, with tail risk not currently well defined; it could represent a target probability or conditional tail expectation (CTE).

4.1.2 Consistency of approach

The framework should aspire to equate the treatment of assets with their risks and apply principles consistently, not a priory biasing specific business models or strategies.

1. **Asset class consistency** – an aspiration for models to equal treatment for equal risk.
 - a. **Classification** should adhere to consistent standards across asset classes, including reporting under the principles-based bond definition and reporting of residual interests.
 - b. **Designations** should aspire to rank order credit risk across asset classes consistently.
 - c. **Reserves** should consistently treat investment risks, including credit, across asset classes. The same confidence level (e.g., CTE-70) should be used for all asset classes and designation buckets. This includes considerations with Asset Adequacy Testing (AAT) and Actuarial Guidance (AG) 53.
 - d. **RBC** should represent the same confidence level (e.g., CTE-90) over the same, say, 10-year horizon for all asset classes.
2. **Hierarchical consistency** - principles should flow down the waterfall of risk measures: Classification, Designations, Reserves, and RBC.

4.1.3 Governance

Insurers and regulators should hold themselves and each other to the highest governance standards, ensuring rules are followed and boundaries respected.

1. **Promote multiple perspectives, financial innovation, and competition** - avoid mechanistically relying on any single model or statistic and ensure that no single point of failure will lead to systemic events. Fundamental to prudent risk management is the need for measuring risks from multiple perspectives, with incumbent opinions not de facto being favored.
2. **Model risk management** - including governance and validation to control model risk arising from model use. Valuable points of reference include standards outlined in the following:
 - a. [American Academy of Actuaries guidelines on Model Risk Management](#) (Academy Guidelines).
 - b. Principle Based Reserving (PBR) governance rules in the [Valuation Manual](#) discuss assumption-setting
 - c. [Federal Reserve SR 11-7](#)
3. **Transparency and communication.**
 - a. **Initiatives and processes, including underlying methodologies**, should include
 - i. Clear objectives, boundaries, and limitations
 - ii. Stakeholders, along with their roles and responsibilities
 - iii. Assessment of implications and impact analysis
 - iv. A periodic assessment of the overall performance of the oversight process, including making changes or enhancements as warranted.
 - b. **Public communication**, including potential changes to guidelines, should consider possible reactions from capital markets. Proposed changes should speak to downstream implications as part of adhering to the principles of clarity of purpose and defined purpose.

4.2 Investment Risk Supervision- Roles and Responsibilities

In this Section, we map out the roles and responsibilities, inspired, in part, by the spirit of the frameworks outlined in the Academy Guidelines and Federal Reserve SR 11-7 that focus narrowly on model risk management that we apply in the context of investment risk oversight. While regulators can assign roles and responsibilities in several ways, resources must be used efficiently, which is fundamental to addressing the need outlined in the E-Committee memo. A fundamental challenge to the current framework is the desire for, say, RBC to help regulators identify weakly capitalized companies with risk measures, such as agency ratings, that are often chosen by the insurers themselves or other participants in capital markets, with no mechanism of incenting a robust choice. In addition, as discussed in [Overseeing Designations and the Prudent Use of Agency Ratings](#), rating agencies are incented to provide overly favorable ratings as a way of increasing market share. This section maps out the core incentives and potential conflicts of interest, followed by articulated roles and responsibilities that can help address those concerns.

1. **Insurers** should ultimately be responsible for defending the models and parameters they use, including an agency rating. To align insurers' incentives, they must demonstrate business use of their models and chosen parameters, including the use of an agency rating, beyond regulatory compliance, demonstrating their genuine belief that the risk assessment is prudent and accurate, avoiding flagrant misrepresenting risk. As a corollary, different insurers might report different ratings for the same asset, as would be the case if an internal process of one insurer, but not another, deems an agency rating appropriate for use.
2. **NAIC staff should oversee the investment risk framework and adhere to PIRO**, including model risk management processes:
 - a. **Oversee a governance framework over model risk that includes:**
 - i. A monitoring and reporting framework that provides transparency on model performance.
 - ii. Have a particular focus on the use of agency ratings and reduce/eliminate "blind" reliance on rating agencies but retain overall utilization of rating agencies by implementing a strong due diligence framework that includes assessment of agency rating performance.
 - b. **Oversee risk analytics tools** for purposes that include:
 - i. Company-specific risk analytics at the request of regulators and utilize regulatory discretion when needed under well-documented and governed parameters. This "backstop" should be embedded in the regulatory regime but ideally would be rarely used if other governance is optimized. This includes bond reporting under the principles-based bond definition and designations.
 - ii. Have a particular focus on structured asset modeling capabilities to support due diligence, validation, and stress testing.
 - iii. Identification of industry-wide risks for use in macroprudential and emerging risk detection.
 - iv. Investment-related support to risk-based capital and reserving teams, understanding the key functions of asset-liability management and resulting portfolio impacts.
 - c. **Oversee a policy advisory function** that can consider and recommend future policy changes to regulators under a holistic lens, considering input from all impacted processes.
2. **Regulators**
 - a. Should set the tone and ensure the investment risk oversight framework is integrated into the NAIC's overall strategy and decision-making processes.
 - b. Should be provided with the tools that will help identify weakly capitalized companies and the ability to identify insurers' chosen methodologies that are questionable without undue burden.
3. **Rating agencies** should be utilized with an oversight framework that deliberately addresses potential conflicts of interest that would lead them to provide overly favorable ratings.
4. **External consultants** should be used when needed and cost-effective, acknowledging limits to internal NAIC expertise, data, and tools. External consultants should adhere to PIRO, including model governance processes, and be leveraged for purposes that include:

-
- a. Ongoing guidance on the design and implementation of new initiatives.
 - b. Stop gap resources given needed expertise
 - c. Ongoing external audit.

5 What Immediate Next Steps Should the NAIC Consider Taking?

Regulators should consider parallel tracks, building a plan toward a long-term aspirational vision that, in the process, addresses considerations for stop-gap interim measures.

1. **Principles.** Regulators should agree on principles for investment risk oversight. That should provide a foundation for the aspirational framework and priorities.
2. **Roles and responsibilities.** Agree on mandates and immediate priorities. External consultants should be used for needed subject matter expertise.
3. **Designation oversight. A step toward the aspirational vision that addresses the need for a stop-gap measure.** Inventory and assess the effort needed to achieve appropriate standards for the asset classes of most significant concern. Given the lack of market oversight, we suspect that privately rated credit is likely most concerning. Since corporate credit is reasonably uniform and understood, compared to, say, feeder notes, start with privately rated corporate credit.
4. **Build guidelines for an investment risk oversight framework incorporating the PIRO.** Do so iteratively by first assessing what can be measured before suggesting NAIC staff have the authority to take specific action. In the case of designations, for example, initiate a program to demonstrate which mechanisms can legitimately be used in identifying overly favorable ratings and, in doing so, publish data and reports that would provide regulators transparency over misuse of agency ratings. Once the data and systems are in place that allow for the identification of overly favorable ratings, it will be more natural to explore the mechanisms by which the NAIC can manage agency ratings.
5. **Feasibility assessment and costing – much-needed partnerships.**
 - a. Engage with external consultants and vendors to map out the needed data, tools, and subject expertise required to achieve a level of oversight that is viewed as addressing standards.
 - b. Prioritize inventoried assets of greatest concern.
6. **Prepare to answer the following question:**

Are regulators and the industry prepared to make significant investments in the needed infrastructure and prepared for a heightened level of disclosure and development of methodologies required to achieve an appropriate investment risk oversight framework?

6 What Are We Optimistic About?

By deliberately leveraging resources efficiently (e.g., rating agencies with prudent oversight), the seemingly overwhelming task of overseeing investment risk can be managed cost-effectively. Lessons learned from expensive regulatory initiatives, including CCAR and Solvency II, can provide important guidance on governance and the effectiveness of various mechanisms, and we are confident that the U.S. insurance regulatory framework can be adapted in a way that benefits both policyholders and insurers.

We are also optimistic that by applying principles that ensure Clarity, Consistency, and Governance for all of the tools used in insurance supervision, the system will be both easier to implement, easier to supervise, and more robust. In the same way that the transition from CLO 1.0 to 2.0 was a boon to the industry, resulting in an expansion of the asset class, we believe that the increased transparency and higher standards will help to expand the insurance capital base, ensuring the long-term viability of this crucial industry.

We are optimistic that NAIC's communal approach to policy design will have regulators and industry come together to solve the most critical issues.

Bridgeway Analytics and its product suite ART provide opinions related to the business implications of regulations and accounting standards. While Bridgeway Analytics aspires to provide accurate and timely information, the nature of distilling information to what we deem as most relevant and the evolving and subjective nature of the rules implies that the data represents our opinion of the rules and not the rules themselves. Users of ART agree to consult their legal, compliance, and accounting professionals before applying any data generated by or resulting from the use of the data in business processes. Bridgeway Analytics does not guarantee the accuracy, adequacy, completeness, timeliness, or availability of data and/or content, and is not responsible for errors or omissions (negligent or otherwise), regardless of the cause, and is not liable for any damages, costs, expenses, legal fees, or losses (including lost income or lost profit and opportunity costs) in connection with any use of the data and/or content.

Attachment 2:
Overseeing Designations and the Prudent
Use of Agency Ratings



Overseeing Designations and the Prudent Use of Agency Ratings

September 2023

Synopsis:

The post-Global Financial Crisis (GFC) low-yield environment had insurers move more heavily toward higher-yielding alternative assets. These included strategies using private placements of debt and equity, structured products, and lower-cost, efficient investment vehicles, often bespoke private, non-SEC registered funds designed to address insurers' unique needs. To date, the changes to investment guidelines have tactically responded to changing market conditions. The Financial Condition (E) Committee August 2023 [memo](#) outlines a holistic rethink of how insurers' investments are regulated, recognizing the need to modernize the framework.

This report addresses one aspect of the proposal by outlining candidate principles along with roles and responsibilities for overseeing designations and a mechanism that would allow for the prudent use of rating agencies – without mechanist reliance on such ratings or wholesale outsourcing of risk analysis to the NAIC. The mechanisms we propose to oversee designations deliberately consider the efficient use of resources, including NAIC staff, rating agencies, and other external solution providers. They also deliberately address challenges in credit risk measures and assessing their performance, including:

- Measures of default risk, an inherently remote event, cannot be assessed robustly given the dearth of default data.
- Level-setting risk across asset classes is challenging because different risk factors impact different credit segments (e.g., corporate vs. municipal).
- Controlling for variation in methods and standards across Credit Assessment Providers whose methods necessarily involve subjectivity.
- Avoiding conflicts of interest driven by rating agencies' commercial incentives and insurers' desire to, all else equal, minimize capital.

**We hope you find this resource helpful
It is consistent with our goal of bringing value to our community**

About the Authors

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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.

Asset Regulatory Treatment (ART)

STANDARDS & SYSTEM is Bridgeway Analytics' machine learning-assisted platform that efficiently and effectively organizes insurers' current and proposed investment guidelines including NAIC and state rules. Users are kept current and provided timely notifications on changes and their impacts, overcoming challenges with navigating the multitude of complex regulations across jurisdictions that use disparate language with varied rulemaking processes. The platform is used by insurers' investment, risk, compliance, legal, government affairs, accounting, and reporting functions, as well as their regulators.

- **ART System** provides users access to codified state investment guidelines in a searchable and understandable format.
- **ART Newsreels** alert users of the changes to the investment landscape, including NAIC and state investment guidelines, packaging, and delivering what matters most through timely, concise, and clear messaging.
- **ART Chronicles** are a centralized repository of recent and possible future changes to the landscape, including NAIC and state investment guidelines. Our Chronicles consolidate Newsreels in a distilled and easy-to-navigate format.
- **ART Heatmaps** provide a visualization of the varying investment limits that govern asset classes across states.
- **ART Investment Classification** assists with the classification of assets, which includes requirements under the proposed principles-based bond definition which consists of possible heightened reporting requirements.

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1 Executive Summary

The post-Global Financial Crisis (GFC) low-yield environment had insurers move more heavily toward higher-yielding alternative assets. These included strategies using private placements of debt and equity, structured products, and lower-cost, efficient investment vehicles, often bespoke private, non-SEC registered funds designed to address insurers' unique needs.¹ To date, the approach of regulators and the NAIC to changes in investment guidelines has been a collection of piecemeal responses. While the updates have tactically responded to changing market conditions, several commentators, ourselves included, have noted that this process has left essential elements of the framework disjointed. The E-Committee has taken notice, and its August 15, 2023, meeting included deliberations over a [memo](#) outlining a holistic rethink of how insurers' investments are regulated.

This report addresses one aspect of the memo's proposal by outlining principles for overseeing designations, including a mechanism that would allow for the prudent use of rating agencies or what the NAIC calls Credit Rating Providers (CRPs). We build on the memo's vision in which the Securities Valuation Office (SVO) of the NAIC would de-emphasize and reduce its role in assigning NAIC-derived designations. Instead, the NAIC would prioritize resources to establish a robust and effective governance structure for due diligence over rating agencies and reduce/eliminate "blind" reliance on their ratings. We begin by outlining the four challenges of overseeing credit risk measures, including agency ratings, and assessing their performance:

- Measures of default risk, an inherently remote event, cannot be assessed robustly given the dearth of default data.
- Level-setting risk across asset classes is challenging because different risk factors impact different credit segments (e.g., corporate vs. municipal).
- Controlling for variation in methods and standards across Credit Assessment Providers whose methods necessarily involve subjectivity.
- Avoiding conflicts of interest driven by rating agencies' commercial incentives and insurers' desire to, all else equal, minimize capital.²

When designing solutions to these issues, it is critical to ensure that the resulting system is efficient and does not place any undue burden on insurers, which would, of course, increase premium costs. This includes efficiently using NAIC staff, rating agencies, and other external solution providers. The mechanisms we propose to oversee designations deliberately address these challenges, building off the proposed principles for investment risk oversight (PIRO) and proposed roles and responsibilities outlined in our report, [Investment Risk Oversight](#).

We introduce the concept of a Credit Assessment Provider (CAP), which can be a rating agency, an insurer, or possibly the NAIC. A Credit Assessment (CA), such as agency credit ratings or an insurer's internal rating, can qualify to be used in assigning designations. Qualification standards are uniform across all CAPs and involve heightened governance, reporting, and performance evaluations. Key to the framework is its objective of proper evaluations providing transparency on the relative prudence of CAs, resulting in the likelihood for discretion over CAs minimal – minimizing uncertainty in insurers' capital charges. We propose three sets of principles to oversee designations:

1. **Adherence to PIRO**, ensuring hierarchical consistency, and with a particular focus on ensuring CAs adhere to Model Risk Management standards, including governance and validation to control risks arising from model use.
2. **Competitive and reliable CAs** with principles that include
 - a. **CAs must adhere to NAIC qualifying standards** beyond those imposed by the SEC and PIRO to be used for designations that include a quantitative review. Only providers assessed for a specific asset class may provide ratings for that class. Each CAP would provide CAs for a set of synthetic portfolios of fixed-income

¹ Amnon Levy, Bill Poutsiaka, and Scott White, [Trends in the Ownership Structure of U.S. Insurers and the Evolving Regulatory Landscape](#). Insurance AUM Journal, Q3 2023.

² For an interesting discussion on this issue, see [The Debasement of Ratings: What's Wrong and How We Can Fix It](#).

assets. This would create asset-class-specific benchmarks that can be used to compare the level of prudence across qualifying CAPs.

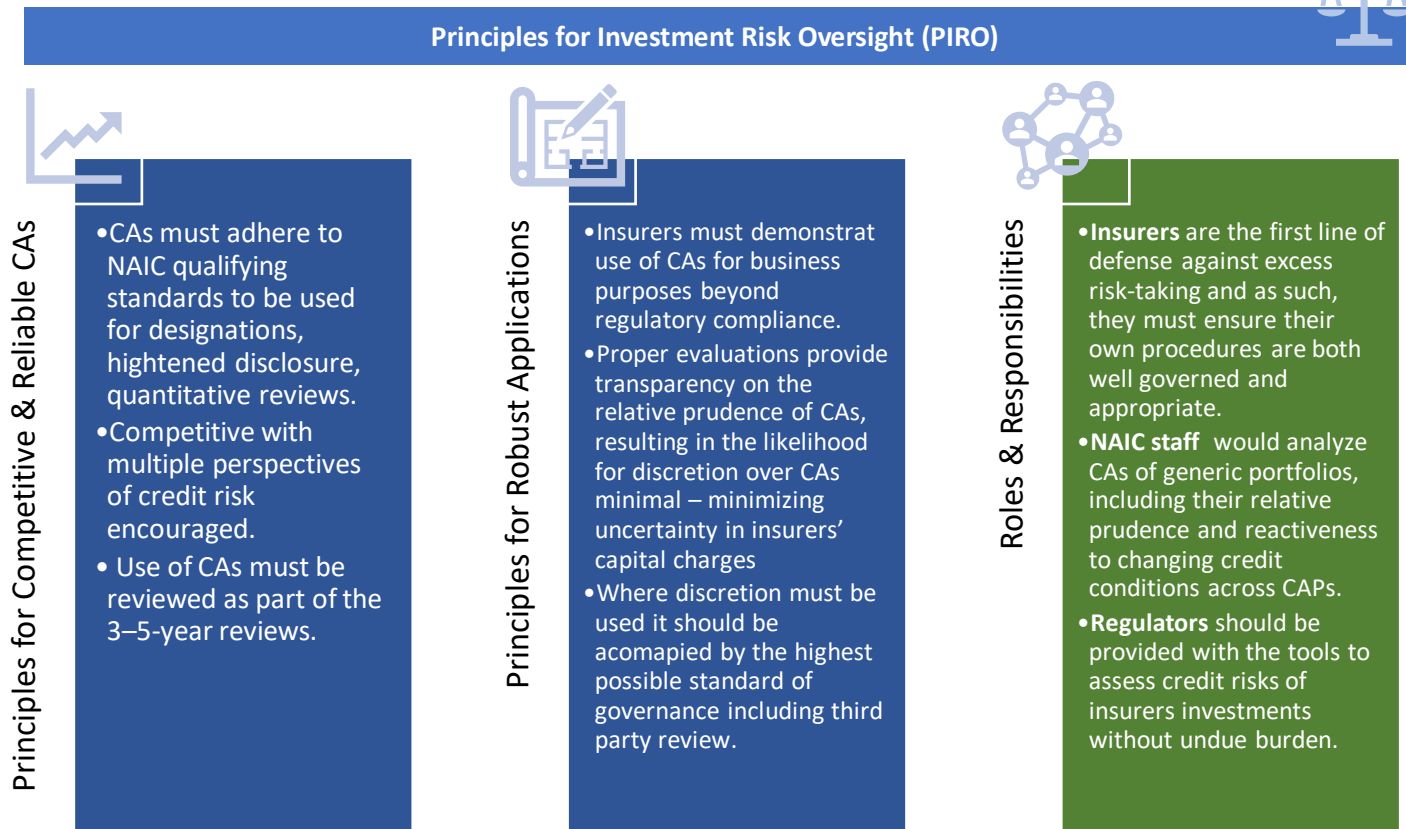
- b. **Multiple perspectives of credit risk are encouraged**, and mechanistic reliance on a single ubiquitous model in the designation process should be avoided when possible. Agency credit ratings and insurer internal ratings are the first choice for CAs with NAIC-assigned designation used in very limited circumstances, as outlined in the E-committee memo, but with sensitivities of avoiding possible undue burden by removing the SVO as a cost-efficient CAP for some instruments.
 - c. **Use of CAs should be audited as part of 3–5-year reviews**, requiring insurers to demonstrate that CAs are used for business purposes and adhere to model risk management standards.
3. **Robust applications of CAs** that include
- a. **Onus on insurers to ultimately defend the use of CA** in business applications beyond regulatory compliance, demonstrating their genuine belief that the risk assessment is prudent and accurate, avoiding flagrant misuse of ratings. This should not be interpreted to suggest that insurers would need to defend, say, an agency’s methodologies, which have important subjective elements, and with some agencies, not providing a sufficient level of disclosure to reproduce fully. Rather, using an agency rating is aligned with benchmarks and appropriately audited. Investment suitability should be a key consideration, with insurers needing to understand and articulate the risks in their portfolios
 - b. **NAIC staff should provide regulators with the tools and transparency** needed to assess the appropriateness of agency rating use without undue burden. Proper evaluations will provide transparency on the relative prudence of CAs, resulting in the likelihood of discretion over CAs minimal – minimizing uncertainty in insurers’ capital charges. Where discretion must be used, it should be accompanied by the highest possible standard of governance, including third-party review.

In addition, we outline **roles and responsibilities**:

- **Insurers** are the first line of defense against excess risk-taking, and as such, they must ensure their own procedures are both well-governed and appropriate.
- **NAIC staff** should provide risk analysis to better support supervision. In that regard, they would analyze the CAs of generic portfolios, including their relative prudence and reactivity to changing credit conditions across CAPs. Compiled statistics shared publicly each quarter will provide transparency on CAs that are overly favorable or overly punitive in the context of their application within the statutory accounting and RBC frameworks.
- **Regulators** should be provided with the tools to assess credit risks of insurers’ investments without undue burden.

We summarize the core elements of our proposed approach in *Figure 1* below.

Figure 1: Core Elements of the Bridgeway Analytics Proposal



We suggest that regulators consider parallel tracks, building a plan toward a long-term aspirational vision that, in the process, addresses considerations for stop-gap interim measures that include:

1. **Develop principles for investment risk oversight.**
2. **Develop principles for designation oversight.**
3. **Focus on governance.** Regulators should vet and agree on frameworks that oversee:
 - a. Qualifying standards, reviewing CA performance, and designation assignment.
 - b. Reporting that will provide transparency over CA performance.
4. **Designation oversight. A step toward the aspirational vision that addresses the need for a stop-gap measure.**

This report should be read in the context of several related NAIC initiatives, including proposals to update the definition of a designation and to extend NAIC staff discretion over designations, which we discuss extensively in [What’s Next for the Rules that Govern Insurers’ Investments](#). The rest of this report is organized as follows: We begin by describing key tools used by the NAIC and regulators to oversee investment risk and explore the role of designations and what they measure. We then explore fundamental challenges with overseeing CA performance. We deliberately address those challenges with principles, and roles and responsibilities for designation oversight and prudent use of agency ratings.

2 The Role of Designations

Designations provide a rank order of credit risk; they are ordinal. They are defined in the [Purposes and Procedures Manual](#), with revisions currently being deliberated and discussed in our report [What’s next for the rules governing insurers’ investments](#). While the primary use of designations is in capital allocation, *Figure 2* provides a schematic for where

designations fit into the ‘Investment risk toolbox’ within the traditional ‘three-legged stool’ of the NAIC’s investment risk framework (i.e., accounting, risk assessment, and capital) referenced in the E-Committee memo.

The process of building out the toolbox begins with the **classification and reporting** of investments that have been and continue to be revised toward principles-based approaches in response to increases in more complex strategies that include investments with blended characteristics (e.g., debt with equity-like performance features). Bonds receive designations that ultimately result in favorable capital treatment, for example, and can require a need to demonstrate sufficient subordination, a process that the revised investment risk oversight framework should oversee.

Designation assignments rely heavily on agency ratings and determine the degree to which a bond is treated favorably or punitively, primarily in the calculation of Risk Based Capital (RBC) but also when used in reserves. They are also relevant in adhering to state investment limits and other guidelines, such as those that govern securities lending. The designation process involves ongoing monitoring of individual counterparties and their credit quality. The [United States SEC](#), which oversees rating agencies, requires a description of credit ratings to be published. For example, [Moody’s Rating Symbols and Definitions](#) describes credit ratings as opinions of ordinal, horizon-free credit risk and, as such, do not target specific default rates or expected loss rates. By their nature of rank ordering credit risk across the credit spectrum (e.g., with Moody’s Aa 10-year historic corporate default rates in the order of 50 bps), ratings consider extreme tail events.³ They don’t describe a cardinal level of risk as is the case with, say, C-1 bond factors that measure expected tail loss from credit events across the credit spectrum. The E-Committee memo specifically highlights the need for the NAIC to provide due diligence over rating agencies to reduce/eliminate “blind” reliance on their ratings and de-emphasize its role in assigning NAIC-derived designations. We propose principles to address this need, which include principles outlined in this report.

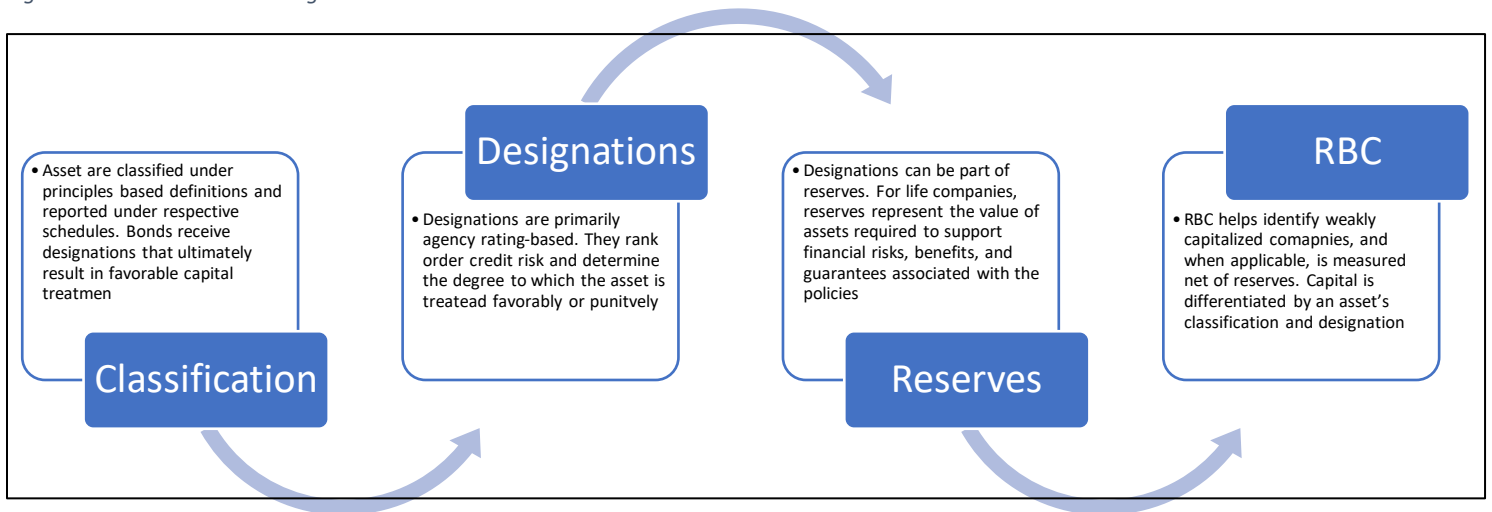
Designations can impact **reserves**. For life companies, reserves represent the value of assets required to support financial risks, benefits, and guarantees associated with the policies. They are being updated to consider the nature of complex assets more explicitly for life companies, as an example, which is now analyzed in Asset Adequacy Testing (AAT) under Actuarial Guideline (AG) 53. Investment risk oversight in this context, which includes the use of designations, should be managed under the same standards.

RBC helps identify weakly capitalized companies and, when applicable, is measured net of reserves.⁴ It establishes a minimum threshold below which regulators can take control of an insurer. It is often described as a blunt tool. In the context of insurers’ investments, capital is differentiated by an asset’s classification and designation. It is being revised to differentiate risks more granularly, initially to address potential capital arbitrage for structured assets and investment vehicles. Designations are ordinal and rank order risk and feed into RBC, which is cardinal and assigns a level of capital. Designations don’t describe a quantitative level of risk as with, say, C-1 bond factors that measure expected tail loss from credit events across the credit spectrum. The C-1 bond framework specifies a target probability (96%) along with a horizon of 10 years and considers various offsets, including those within the statutory accounting framework.

³ See, for example, [Revisions to the RBC C-1 Bond Factors Prepared for the NAIC and ACLI](#).

⁴ While this paper focuses on designations, the American Academy of Actuaries Principles for Structured Securities RBC presentation included in the Risk Based Capital Investment Risk and Evaluation (E) Working Group 2023 Summer Meeting [Agenda & Materials](#) provides a good starting point for thinking about RBC; we would like to see a similar framework expanded to all asset classes.

Figure 2: Investment risk oversight



This report focuses on designing a governance framework for designations that will be used in the RBC and statutory accounting and on the prudent use of agency ratings.

3 Fundamental Challenges with Overseeing Credit Assessments

There are fundamental challenges with assigning CAs that transcend agency ratings and the designation process and impact the broad set of capital market participants. The process of arriving at a CA may include both quantitative models and qualitative factors, including expert judgment. We reference CAPs, including NAIC CRPs, the NAIC, which produces model-based designations, and Insurers, who may have their own internal ratings.⁵ CAPs face the following four challenges in their CA process:

- Measuring default risk, which is an inherently remote event.
- Level-setting risk across asset classes.
- Controlling for variation in methods and standards across CAPs.
- Avoiding conflicts of interest driven by rating agencies' commercial incentives and insurers' desire to, all else equal, minimize capital.

The process of assigning designations should acknowledge these challenges and build on robust and well-governed processes that deliberately address them, as discussed in Section 4 below. In section 5, we lay out a framework for governing designations based on mapping CAs from rating agencies, insurers, and possibly the NAIC, each of which must adhere to the same standards. The four challenges delineated above are discussed in more detail in the remainder of this section.

3.1 Measuring Default Risk, which is a Remote Event

An evaluation of, say, a single asset class, such as corporate or sovereign default rates reported by Moody's or S&P, demonstrates general monotonicity in the rank ordering of ratings and default rates when measured over long periods of time.⁶ That said and discussed extensively in [Revisions to the RBC C-1 Bond Factors Prepared for the NAIC and ACLI](#), the sort of credit invested in by insurers, investment grade in particular, by its very nature exhibits few defaults. For illustration,

⁵ The [Purposes & Procedures Manual of the NAIC Investment Analysis Office](#) describes the NAIC's possible use of any rating organization that has been designated a Nationally Recognized Statistical Rating Organization (NRSRO) by the U.S. Securities and Exchange Commission (SEC) and which continues to be subject to federal regulation.

⁶ See, for example, the Gini And Ratings Performance section of S&P Global's, [Default, Transition, and Recovery: 2021 Annual Global Sovereign Default And Rating Transition Study](#).

there have been six defaults within ten years of being assigned an Aaa by Moody's Investors Service (MIS) rating from 1970 (with all defaults occurring after 1983). Similarly, there have only been five Aa1 defaults from 1983 to 2020 on a global scale. This is coupled with recovery, which can have varying characteristics. For example, in the U.S., between 1970-1989, Getty Oil and Texaco were the two issuers that defaulted within ten years of Aaa MIS rating, and they experienced extremely high recovery (~97% and ~88%).

The NAIC is not alone in its struggles to level-set ratings and rating agency performance. In Europe, the relevant authorities map agency ratings and their own Credit Quality Step scale. They do this predominantly by studying historical data subject to their own [Technical Standards](#).⁷ While this process may result in a mapping where some agencies are notched relative to others, no notching is being applied under the current mapping, and we are aware of only two cases historically where notching occurred. This methodology may be appropriate in the European context, where insurers' investment portfolios are much more homogeneous with a wider set of ratings from overlapping agencies. U.S. insurers' heterogeneous investment portfolios result in a much higher incidence of non-overlapping agency ratings, which, along with the other challenges laid out in this section, limits the applicability of this method in the U.S. context.

This means differentiating between the riskiness of IG instruments requires a procedure that can consistently account for extreme and unusual events. Moreover, simply using default rates to assess the relative favorable or punitive treatment in assigning ratings or designations more broadly is insufficient. Our proposed approach outlined below deliberately addresses these data limitations.

3.2 Level-Setting Risk Across Asset Classes

While aspirational goals of aligning incentives with economic risks are broadly accepted as desirable, there are substantial practical challenges with categorizing and measuring credit risk across assets. As discussed extensively in [Assessment of the Proposed Revisions to the RBC C-1 Bond Factors](#), there are material differences in historical default, migration, and recovery dynamics across asset classes observed historically after controlling for credit quality using agency ratings.⁸ This is coupled with reinforcing challenges, including:

- The variability of shocks across sectors and changes in methodologies employed by rating agencies resulting in the patterns observed in the past possibly not manifesting in the future.
- The inherent challenge of measuring the likelihood of default, which is a remote event, often measured in basis points.

The report provides context, highlighting how municipal bonds, as an example, have experienced substantially lower default rates than global corporates. Between 1970 and 2019, the ten-year cumulative default rate for A-rated global corporates was 2.11%, significantly higher than the 0.1% experienced municipal credits. For speculative-grade credit, the dynamics are similar, with the global corporate default rate at 28.68%, about four times the 7.29% experienced by municipal credit.⁹ To understand the different time-series dynamics, Figure 7 from the study is reproduced below, whereby the twelve-month moving average Moody's rated speculative-grade default rates are presented for corporate alongside municipal bonds.

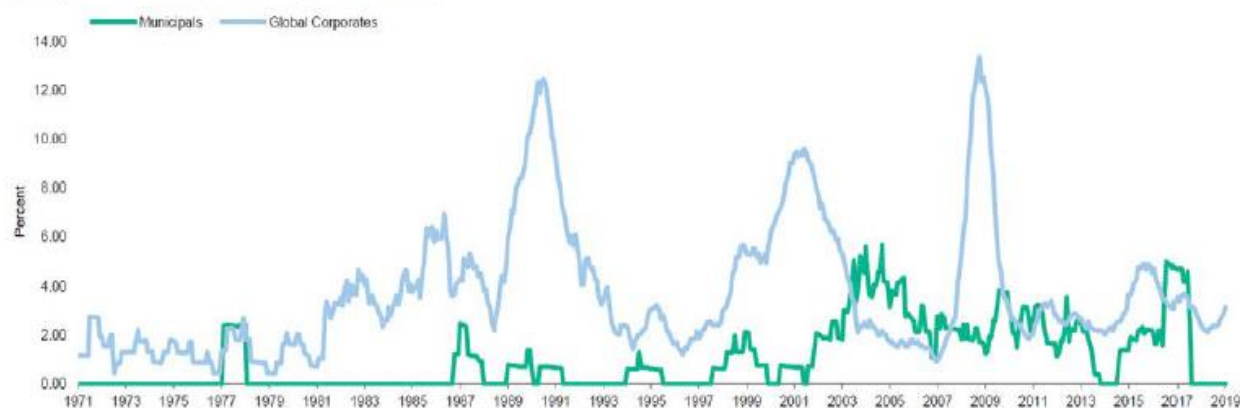
Figure 3: Historical default rate of speculative-grade municipal bonds and global corporates

⁷ The European equivalent of NRSROs is External Credit Assessment Institutions (ECAIs) authorized by the European Securities and Market Authority (ESMA). The mapping between ECAI rating and Credit Quality Steps is produced by the European Supervisory Authorities (ESA) – which includes the insurance regulator EIOPA and so an ECAI is also equivalent to a NAIC approved CRP.

⁸ Another useful reference is Amnon Levy and William Poutsiaka, [The NAIC Alternative to Agency Ratings](#).

⁹ This pattern is noticeable with other agencies, several of which have revised methodologies over the years to address some of these concerns.

Trailing twelve-month speculative-grade default rates



Source: Moody's Investors Service

These observations highlight how different factors impact different asset classes to a different degree over varying economic environments. Corporate and municipal credit markets are mature and well-understood. The observations extend more broadly to other forms of credit, such as structured assets and private placements. They are not limited to credit risk, with different asset classes impacted by liquidity and other risks differently. The challenge of rank ordering and level-setting risk across asset classes is substantial. Importantly, these challenges are not specific to agency ratings and apply to CA from the NAIC and insurers.

3.3 Controlling for Variation in Methods and Standards Across Credit Assessment Providers

Measuring credit risk will always be imperfect, and any quantitative measure has associated with it some uncertainty. As a result, prudent risk management often encourages differing opinions, with leeway often extended for different methods that reach different conclusions on the riskiness of an instrument. This complicating factor results in a potential lack of comparability of CAs across rating agencies, as well as the NAIC, which all use varying methodologies in forming their ratings/designations that are opinions of credit risk. The structure by which rating agencies are governed encourages agencies to have differing opinions.¹⁰ The [United States SEC](#), which oversees rating agencies, by law, is not permitted to regulate the substance of credit ratings or the procedures and methodologies that determine credit ratings. Methodologies include, among other things, the quantitative and qualitative models used to determine credit ratings. Per the SEC, there are no standard or agreed-upon methods to measure the accuracy of credit ratings, in part because of the subjective nature of credit ratings and the lack of performance comparability across different industry sectors.¹¹

3.4 Avoiding Conflicts of Interest Driven by Rating Agencies' Commercial Incentives

The potential lack of comparability across asset classes and across rating agencies is of particular concern, considering the potential for a conflict of interest. While competition between agencies can result in more accurate ratings, the SEC focuses extensively on the risk that credit rating agencies attempt to gain market share by assigning overly favorable ratings.

¹⁰ An interesting discussion related to this matter can be found in the [Report to Congress Credit Rating Standardization Study](#).

¹¹ The [SEC's The ABCs of Credit Ratings](#) notes that defaults and rating changes (or "transitions" of an issuer's or debt instrument's rating from one rating to another) may not be consistent for each rating category across the sectors. For example, default rates for corporate bonds historically have been greater than default rates for municipal bonds with the same credit ratings. Even within an industry sector, transition and default rates may differ over time and in different geographic regions. Inconsistencies in performance can be attributable to changes in business cycles and economic environments that do not impact all obligors equally and at the same time.

The [SEC acknowledges and explains](#) that many credit rating agencies—including the largest agencies—are paid by the obligors they rate or by the issuers of the securities they rate. This creates a potential conflict of interest. The credit rating agency may be influenced to determine more favorable (i.e., higher) ratings than warranted to retain the issuers as clients and obtain new issuer clients. Alternatively, some credit rating agencies are paid by subscribers to their rating services, usually investors. Depending on their holdings and trading positions, investors’ desire for low or high credit ratings may also present a conflict of interest. Under the current framework insurers are incented to improve their capital ratios and have an asset receive the most favorable ratings, creating a selection bias, sometimes referred to as ‘ratings shopping.’ This selection bias manifests whenever agencies have differences of opinion, regardless of whether they invoke their best efforts to assign a prudent rating. NRSROs are required by law to disclose these potential conflicts of interest. NRSROs must also establish, maintain, and enforce written policies and procedures to address and manage these potential conflicts of interest.

4 Principles for Designation Oversight

Our report, [Investment Risk Oversight](#), outlines roles and responsibilities that include those of NAIC staff who should be responsible for overseeing an investment risk governance framework, which includes a particular focus on the prudent use of agency ratings. The E-Committee memo where the NAIC would oversee a strong due diligence framework that includes assessing agency rating performance and reducing/eliminating “blind” reliance on ratings. With the four fundamental challenges top of mind, we propose the following principles that can be used to build this robust due diligence framework for CAs more broadly (i.e., those issued by an agency rating, the NAIC, or an insurer):

1. **Adherence to PIRO**, ensuring hierarchical consistency, and with a particular focus on ensuring CA adheres to Model Risk Management standards, including governance and validation to control risks arising from model use.
2. **Competitive and reliable CAs:**
 - a. **Multiple perspectives of credit risk should be encouraged**, and mechanistic reliance on a single ubiquitous model in the designation process should be avoided when possible. While designations should aspire to consistently rank order credit risk both within and across asset classes, limits to any single measure accurately reflecting credit risk need to be acknowledged.¹²
 - b. **CAs must adhere to NAIC qualifying standards** beyond those imposed by the SEC and PIRO to be used for designations that include a quantitative review. Only providers assessed for a specific asset class may provide ratings for that class.
 - c. **Agency credit ratings and insurer internal ratings are the first choice for CAs** with NAIC-assigned designation used in very limited circumstances, as outlined in the E-committee memo, but also sensitive to avoiding a possible undue burden by removing the SVO as a cost-efficient CAP for some instruments.
 - d. **Use of CAs should be audited as part of 3–5-year reviews**, requiring insurers to demonstrate that CAs are used for business purposes and adhere to model risk management standards.
 - e. **CAs should generally adhere to the same standards**, whether the CA is from rating agencies, the NAIC, or insurers.
 - f. **Incentives should be aligned to ensure rating agencies adhere to performance standards when assigning ratings**, addressing concerns with agencies ‘racing to the bottom’ to gain market share by assigning overly favorable ratings.
 - g. **Oversight should be sensitive to proprietary** elements of CAs and structured to address concerns with:
 - i. The credibility of private ratings, because of a lack of market oversight, given their private nature, which can lead to rating inflation incentives.
 - ii. The Limits to the disclosure requirements placed by the SEC on rating agencies often provide insufficient transparency on their methodologies, with some having proprietary elements.

¹² This need is reinforced by the observation that U.S. insurers are unique in that designations are used for both capital and statutory accounting. In banking, for example, you have GAAP, which assesses solvency with CECL considering future credit loss, and capital requirements that are managed completely differently and provide a different lens.

3. Robust applications of CAs:

- a. **The onus is on insurers to ultimately defend the use of an agency rating in business applications** beyond regulatory compliance, demonstrating their genuine belief that the risk assessment is prudent and accurate, avoiding flagrant misuse of ratings.
- b. **NAIC staff should provide regulators with the tools and transparency** needed to assess the appropriateness of agency rating use without undue burden.

5 Governing Designations and Roles & Responsibilities

We now apply the principles for designation oversight to define standards for CAs to qualify for use in designations. A mechanism for their performance evaluation is proposed that deliberately addresses the four fundamental challenges with oversight. While the proposal embodies the PIRO, we focus narrowly on distinct aspects with overseeing designation and the use of agency ratings. *Section 5.1* focuses on ensuring competitive and accurate CAs by defining appropriate qualifying standards and a mechanism for assessing CA performance, *Sections 5.2* and *5.3* focus on the roles and responsibilities of insurers and NAIC staff and regulators, respectively.

The framework borrows heavily from public comments and proposals, including a letter from the ACLI, NASVA, PPIA Board of Directors, CRE Finance Council, SFA, and Mortgage Bankers Association (ACLI-trades letter) that VOSTF posted as part of the August 14, 2023 meeting [Materials](#).

5.1 Qualifying Standards, Credit Assessment Performance, and Designation Assignments

Consistent standards should be set for all CAs used in the designation process. For agency ratings, NAIC assessments, or insurers' internal assessments to qualify for an asset class, they must adhere to both:

1. SEC standards, in spirit, provide a governance framework for the rating process.
2. Additional standards that address the need for transparency on CA performance, which SEC standards do not provide and are outlined below.

The SEC standards, in spirit, should be adhered to by all CAPs. Outlined in more detail in *Section 8*, the SEC places a broad set of governance and disclosure requirements upon NRSRO methodologies and data. However, the SEC oversight does not have any features that drive equivalence in the meaning of ratings or the average levels of ratings across NRSROs, which we are advocating for.

All qualifying CAPs must adhere to standards beyond those imposed by the SEC and PIRO, allowing NAIC staff to provide transparency on comparability in CAs.

These standards will also provide a basis that will support addressing concerns with the potential for conflicts of interest. As discussed in *Section 3.1*, a broad and reliable quantitative comparison of CA performance across providers, including those of agency ratings, is not possible if one uses, say, realized defaults because they are remote events by their nature. In addition, different credit sectors (e.g., across corporate industries or municipalities) may carry similar ratings while not experiencing similar credit performance, given that different factors impact those sectors. Given the complex and subjective nature of many of the frameworks, a robust analysis of respective methodologies is not possible, which would limit the practicality of such a systematic approach. In addition, the proprietary nature of many elements that enter into, say, the rating process would limit a comparability analysis.

Instead, we propose that the additional standards require the provider to submit CAs of the same generic set of assets. This allows NAIC staff to provide reports with level-set comparisons across providers. This would create asset-class-specific

benchmarks that can be used to compare the level of prudence across qualifying CAPs. CAPs would only have to provide an assessment for the subset of asset classes that they actively rate. In addition, providers would be required to disclose details regarding their discretionary overlay practices (e.g., notching a rating to account for subordination resulting in a lower expected recovery in the event of bankruptcy) to capture practices that may not be seen in the set of generic assets.

Additional standards qualifying CAs to be used in designations:

- 1 For each asset class (e.g., corporate credit), the provider (i.e., rating agency, SVO, or the insurer) must submit an assessment of a generic set of assets (e.g., varying industries and financial ratios). CAPs would maintain a right to appeal the design of generic assets to ensure a fair comparison.*
 - 2 Disclose details related to their discretionary overlay practices, e.g., notching a rating to account for subordination resulting in a lower expected recovery in the event of bankruptcy.*
-

The set of generic assets will be chosen to reflect the distribution of characteristics within each asset class. For example, for corporate credit, a rating agency would provide their credit ratings for a credit portfolio whose synthetic borrowers are represented by varying financial ratios. The ratios would be within the bounds of typical corporate borrowers across the credit spectrum. Other factors that impact the rating would also be considered, including subjective assessments of the management team, reputation, credit enhancements, or subordination. The portfolio would be designed in coordination with rating agencies and insurers to ensure sufficient coverage of the spectrum of borrower characteristics to allow the NAIC to distill summary statistics that provide regulators transparency on relative prudence. Rating agencies would retain the right to appeal the structure of the generic portfolio to ensure the appropriate practicalities are considered.

Reflecting the principle that multiple perspectives of credit risk should be encouraged, qualification would not require that credit receive the same CA from all CAP, but rather that there is not an overt or systematic and significant bias in a particular dimension. That is to say that NAIC staff would provide summary reports on the distribution of CAs from CAPs for regulators to review rather than assessing individual CAs, possibly with some exceptions. In this way, qualification does not require specific quantitative definitions of ratings.

Qualified CA would be used in setting designations as follows:

- Designations are set to the second lowest CA.¹³ CAs can be obtained from qualifying rating agencies, the NAIC's SVO, or an insurer's internal assessment.
- Subject to materiality triggers, the designation may be notched down if only a single CA is obtained, whether from a rating agency, the NAIC, or the insurer's own. The consideration for materiality triggers is included to allow insurers, smaller insurers in particular, to explore asset classes for which they might not have a fully-fledged internal framework.

The exact nature of the materiality triggers needs to be assessed across use cases. For example, for most insurers, any single direct commercial mortgage holding is small, with their overall direct commercial mortgage portfolio constituting a relatively tiny fraction of their overall assets. The spirit of the current framework's treatment of commercial mortgages might be sufficient in such cases, with a single CA implicitly coming from the NAIC's CM capital assignments through characteristics such as loan-to-value ratios of the mortgages. That said, we would not necessarily take for granted that the current model would be the preferred risk measure, given its age and incongruous treatment of other aspects of the RBC and statutory accounting frameworks.

¹³ We propose the second lowest only because it aligns with current practice. Once the NAIC is able to report on CAs of generic portfolios and their relative prudence, it will make sense to revisit this approach.

We now turn to mapping out the NAIC's staff's oversight and reporting that will provide regulators with needed transparency on relative prudence or lax standards across CAPs.

Private Letter Ratings

NAIC Staff and regulators have expressed concern with using private ratings given the lack of credible market oversight. The growing use of private ratings had the concern increase in materiality, resulting in the NAIC requiring private ratings to be supplemented with a justification in the form of a private letter. In practice, this requirement has not assuaged concerns, especially around feeder notes, which have been argued to be used for regulatory arbitrage. It is important to note that private ratings are not in and of themselves nefarious; issuers would want a private rating rather than a public one for many reasons.

- In the corporate space, as bank capital increased for certain lending activities in the aftermath of the financial crisis, insurers have become an essential source of capital for private firms. These firms are a core part of the U.S. economy but do not want the pressure associated with high levels of public disclosure – willing to pay a premium for this privacy.^{14, 15}
- In the structured space, many structured asset classes that are now mainstream began life as private credit, with U.S. insurers as part of the vanguard of investor innovation. Here, private ratings allow this innovation without the distraction of public scrutiny. Once again, this creates a premium that insurers can capture for the benefit of policyholders.

Without the scrutiny of public markets and the associated cost of inappropriate ratings, it is not entirely surprising that regulators are concerned. Our quantitative benchmarking proposal would address these concerns by ensuring private ratings were not overly generous in any particular dimension of risk. However, the use of private ratings in the designation process should be coupled with standardized reporting while retaining their confidential form, requiring:

- Machine readable format of standardized disclosure, varying by asset class, ensuring that data can be analyzed and reviewed at scale by NAIC Staff.
- Disclosure to be sufficient to allow NAIC staff to ensure the private ratings can be benchmarked to a generic portfolio that the agency has rated.

For example, a rating agency would need to provide relevant financial ratios and subjective assessments referenced above in the generic corporate credit portfolio description.

5.2 Insurers: Governance and Audit

[Investment Risk Oversight](#) outlines roles and responsibilities that include those of NAIC staff who should oversee a model risk governance framework. Staff should have a particular focus on reducing/eliminating “blind” reliance on rating agencies but retain overall utilization of rating agencies, with the implementation of a strong due diligence framework that includes assessment of agency rating performance. However, insurers are the first line of defense against excess risk-taking, and as such, they must ensure their own procedures are both well-governed and appropriate. Our proposal aligns with this philosophy by requiring additional governance, disclosure, and regular audits:

- **Onus.** Ultimately, the onus of using a rating should be on the insurer, with the NAIC providing regulators transparency over the relative conservative/lax nature of CAs in designations. This should not be interpreted to suggest that insurers would need to defend, say, an agency's methodologies, which have important subjective elements, and with some agencies, not providing a sufficient level of disclosure to reproduce fully. Rather, using an agency rating is aligned with

¹⁴ See Larry Cordell, Michael R. Roberts & Michael Schwert, [CLO Performance](#), The Journal of Finance, March 2023.

¹⁵ See Michael Schwert, Does borrowing from banks cost more than borrowing from the market?, Journal of Finance, 2020.

benchmarks and appropriately audited, verifying that the synthetic portfolio ratings described in Section 5.1 reflect reality. Investment suitability should be a key consideration, with insurers needing to understand and articulate the risks in their portfolios.

- **Business use.**¹⁶ As a credibility mechanism, the insurer must demonstrate the use of CAs in business applications beyond regulatory compliance, demonstrating their genuine belief that the risk assessment is prudent and accurate, avoiding flagrant misuse of ratings. For example, the same CA must be used in business practices such as pricing models used for origination, if part of the insurer’s business model, or otherwise in investment strategy, as well as in internal risk frameworks such as limits that are placed on portfolio managers or for portfolio rebalancing triggers.
- **Audit.** An insurer’s use of CAs in designations should be audited as part of the 3-5-year reviews.

5.3 Regulators and the NAIC: Oversight and Toolset

As outlined in the E-Committee memo, NAIC staff should provide invaluable risk analysis to support supervision better. In that regard, they would analyze the CAs of the generic portfolios, including their relative prudence and reactivity to changing credit conditions across CAPs, including rating agencies, the NAIC, and insurers. Compiled statistics shared publicly each quarter will provide transparency on CAs that are overly favorable or overly punitive in the context of their application within the Stat and RBC frameworks. Insurers’ CAs used for designations would possibly be reported in a limited capacity to regulators with considerations to proprietary elements. Reports would also cover an analysis of discretionary overlay practices that would be disclosed by CAPs, as discussed above. Key to the framework is its objective of proper evaluations providing transparency on the relative prudence of CAs, resulting in the likelihood for discretion over CAs minimal – minimizing uncertainty in insurers’ capital charges.

While some have advocated for extending NAIC staff some discretion over agency ratings-based designations, the review of CAs requires data and modeling significantly more extensive than what NAIC staff currently have. For example, reviewing privately rated feeder notes, often seen as a primary asset class of concern, would require details on the underlying investments and a modeling framework to assess those investments. While Private Letter Ratings (PLRs), which the SVO requires, might contain some of the needed information, they are likely insufficient to legitimately assess the credit risk of the note. Moreover, the PLR of a note issued by an investment vehicle or corporate entity does not provide the needed data in a form that would allow for a broad review of holdings. Practically, reviews would be manual and would not provide regulators with a general assessment of holdings and the prudent use of agency ratings. As a point of reference, rating agencies employ thousands of analysts, compared to ~35 SVO/SSG staff.

Acknowledging the need for better data and tools to identify rating agencies that are overly favorable or overly punitive in the context of their application within the statutory accounting and RBC frameworks leaves an important question about how to interpret the precision by which the SVO is able to act.

If the data or methodologies are not immediately accessible, how should the SVO execute its notching authority?

An additional dynamic that needs to be approached deliberately is the implications of the process beyond the actions that are taken. A recent comment letter claims that the NAIC’s negative bias towards smaller rating agencies has driven insurance companies to place a moratorium on their use. It argues that this bias has partially resulted in a substantial

¹⁶ Note here that we stop short of the Solvency II required to use specific agencies consistently for specific classes of credits. Such a requirement would disincentivize ‘shopping for ratings.’ However, we believe it is overly restrictive commercially and unnecessary given the other protections in place.

reduction in issues rated by these agencies in the order of 60-90%, depending on the market segment. Although not perfectly comparable given the different footprints (e.g., business outside the U.S.) and different reporting segments, our own analysis suggests at least one large agency has experienced a growth in the number of issues rated over the same period (see [ART Newsreel | August 3, 2023](#)).

Depending on the objectives, the threat of oversight alone might be achieving a potential goal of having insurers shift to more established rating agencies. We feel such a mechanism is imprecise and can introduce instabilities to capital markets, resulting in unintended consequences, and the tactic should be approached more deliberately. In addition, while it is possible to interpret this as prudent regulation, there is a risk of market participants perceiving these actions in ways that raise antitrust complaints, which we have seen already seen by the likes of the letter that members of the U.S. Congress submitted.

There is an inherent challenge with designing a process to manage overly favorable ratings if the data and methodologies needed for identification are not yet available. We advocate first focusing on an oversight and identification framework before exploring a process for discretion. It would allow for a more efficient approach to designing the notching process effectively. Otherwise, the identification of overly favorable ratings remains somewhat hypothetical.

With that said, it is worth acknowledging considerations that should enter into the discretion process that the industry has raised in the latest VOSTF proposal that was outlined in the August 14, 2023 meeting [Materials](#), and discussed in our report, [What's next for the rules that govern insurers' investments](#):

- The need for oversight in the discretion process, including:
 - An independent third party to facilitate checks and balances.
 - Valuation of Securities (E) Task Force (VOSTF) approval to changes in the treatment of ratings, including flagging rating methodologies deemed unfit for regulatory purposes, along with documented rationale and assessment of impacted securities.
 - A method of appeal beyond NAIC staff, allowing for appropriate independent review.
- The need for transparency, including visibility on methodologies employed by the NAIC:
 - Require the NAIC/SVO to publicly identify rating agency methodologies they do not believe fit the NAIC's purpose and provide analytical support for such view on each respective CRP methodology in question.
 - Require a reported assessment of the ratings challenge program, including aggregated statistics, shared publicly each quarter.
- The need for clear scope. The industry pointed to a lack of clarity on the possibility and process, for example, of notching the entire asset class rated by an agency whose methodology the SVO views as overly favorable.
- Unintended consequences and implication of uncertainty with the proposal and process for capital markets. By focusing initially on identifying risks, we are deferring concerns raised related to the current proposals and acknowledging the need for their consideration once the process of designing a mechanism for discretion begins.

6 What Immediate Next Steps Should the NAIC Consider Taking?

Regulators should consider parallel tracks, building a plan toward a long-term aspirational vision that, in the process, addresses considerations for stop-gap interim measures.

1. **Investment Risk Oversight.** Follow the next steps outlined in [Investment Risk Oversight](#), which include:
 - a. **Principles.** Regulators should agree on principles for investment risk oversight. That should provide a foundation for the aspirational framework and priorities.
 - b. **Roles and responsibilities.** Agree on mandates and immediate priorities. External consultants should be used for needed subject matter expertise.
 - c. **Prepare to answer the following question:**

Are regulators and the industry prepared to make significant investments in the needed infrastructure and for a heightened level of disclosure and development of methodologies required to achieve an appropriate investment risk oversight framework?

2. **Principles for designation oversight.** Regulators should agree on principles for designation oversight.
3. **Governance.** Regulators should vet and agree on frameworks that oversee:
 - a. Qualifying standards, reviewing CA performance, and designation assignment.
 - b. Reporting that will provide transparency over CA performance.
4. **Designation oversight. A step toward the aspirational vision that addresses the need for a stop-gap measure.** Inventory and assess the effort needed to achieve appropriate standards for the asset classes of most significant concern. Given the lack of market oversight, we suspect that privately rated credit is likely most concerning. Since corporate credit is reasonably uniform and understood, compared to, say, feeder notes, start with privately rated corporate credit.

7 What Are We Optimistic About?

We are optimistic that the challenges inherent with credit risk measures can be addressed largely by utilizing a principles-based approach for overseeing the use of designations, along with establishing consistent qualifying standards for reviewing CA performance. Identifying overly favorable or overly punitive CAs is at the heart of transparent reporting of CA performance and critical for prudent oversight of rating agencies that can provide the industry with cost-effective solutions. This identification, fortified by regulators' discretion over appropriate and timely responses, will go a long way toward the goal of prudent investment risk oversight and an incredible opportunity to redesign guidelines supporting innovation and long-term growth.

8 Appendix- SEC Oversight of Rating Agencies

The [SEC Office of Credit Ratings](#) oversees requirements that came about with the oversight of rating agencies under Dodd-Frank. To qualify as a Nationally Recognized Statistical Rating Organization (NRSRO), agencies face a range of requirements, including:¹⁷

- NRSROs must have an effective internal control structure governing their policies, procedures, and methodologies for determining credit ratings. The structure must consider 17 specific factors, as well as any other factors applicable to the NRSRO's particular business.¹⁸
- An NRSRO must designate a compliance officer to administer its policies and procedures and ensure compliance with the securities laws.¹⁹
- With each rating action, an NRSRO is required to provide disclosures that include the version of the methodology used to determine the credit rating, a description of the types of data relied on, an assessment of the quality of information considered, an explanation of the potential volatility of the rating, and information on the sensitivity of the rating to the NRSRO's assumptions. These disclosures must be available to the same persons who can receive or access the relevant credit rating.²⁰
- NRSROs are required to make certain public disclosures on Form NRSRO, including information such as performance measurement statistics consisting of transition and default rates for rating classes.²¹
- NRSROs must have standards of training, experience, and competence for their staff that determine ratings.²²

¹⁷ A useful discussion can be found in [The SEC's Office of Credit Ratings and NRSRO Regulation: Past, Present, and Future](#).

¹⁸ See Section 15E(c)(3) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-7(c)(3), and Rule 17g-8(d) of the Securities Exchange Act of 1934, 17 C.F.R. § 240.17g-8(d).

¹⁹ See Section 15E(j) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-7(j).

²⁰ See Rule 17g-7(a) of the Securities Exchange Act of 1934, 17 C.F.R. § 240.17g-7(a).

²¹ Form NRSRO is available at <https://www.sec.gov/about/forms/formnrsro.pdf>.

²² See Rule 17g-9 of the Securities Exchange Act of 1934, 17 C.F.R. § 240.17g-9.

Bridgeway Analytics and its product suite ART provide opinions related to the business implications of regulations and accounting standards. While Bridgeway Analytics aspires to provide accurate and timely information, the nature of distilling information to what we deem as most relevant and the evolving and subjective nature of the rules implies that the data represents our opinion of the rules and not the rules themselves. Users of ART agree to consult their legal, compliance, and accounting professionals before applying any data generated by or resulting from the use of the data in business processes. Bridgeway Analytics does not guarantee the accuracy, adequacy, completeness, timeliness, or availability of data and/or content, and is not responsible for errors or omissions (negligent or otherwise), regardless of the cause, and is not liable for any damages, costs, expenses, legal fees, or losses (including lost income or lost profit and opportunity costs) in connection with any use of the data and/or content.

The Lease-Backed Securities Working Group

October 4, 2023

Financial Condition (E) Committee
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Framework for Regulation of Insurer Investments – A Holistic Review

Dear Superintendent Dwyer and Task Force Members,

This letter, on behalf of the Lease-Backed Securities Working Group, is in response to the comments and suggestions laid out in Attachment 16 to the meeting materials for the E-Committee meeting, **“Framework for Regulation of Insurer Investments - A Holistic Review”** (the “Memo”) at the last NAIC Annual Meeting in Seattle. However, we have also included some additional comments on several of the workstreams already under consideration which were referenced in that memo.

We are wholly supportive of the main concept in the Memo, which is to take a step back from the various proposals that are under way from SAPWG, the VOS Task Force and the SVO to consider some of the broader issues raised by these proposals, and as the Framework states, consider the fundamental question of ***“what is the most effective use of regulatory resources in the modern environment of insurance regulation for investments?”***.

Our perception has been that, to date, the various proposals underway represent a “piece-meal” approach, which has been undertaken with the best intentions, but without considering what impact each of the proposals might have on the others or some of the broader structural and policy implications implicit in these proposals*. We agree wholeheartedly that ***“in order to have a cohesive regulatory framework”*** these separate workstreams ***“require a much more intensive level of coordination”*** -- especially with regard to their potential impact on capital adequacy ratios, before any actions are finally adopted. (*See list of recent proposals at the end of this letter.)

With regard to some of the specific proposals in the Memo:

- 1.) We agree with the importance of retaining a primary reliance on the ratings of NAIC’s approved Credit Rating Providers as currently set forth under “Filing Exemption” in the P&P Manual -- as frankly, the current resources and staffing of the SVO are not adequate to rate the many diverse and complex transactions in the market today.

Moreover, the predictability associated with the Filing Exemption process is a key factor in the functioning of the capital markets. Currently, Filing Exemption assures that all bonds with the exception of structured securities (CLOs, CMBS and RMBS) are ***“entitled to a presumption of convertibility to the equivalent NAIC designation”*** (P&P Manual Section 2). This presumption of convertibility provides the relative confidence that

investors need when purchasing a security, that they can accurately anticipate the risk-based capital factors associated with that purchase. Any uncertainty associated with the assignment of risk-based capital factors is bound to put a damper on markets.

- 2.) We have heard the many concerns about the SVO's "blind" reliance on ratings over the past few years -- particularly for private transactions. A step toward greater visibility was already taken last year, when the SVO first began requiring investors in private securities to submit, in addition to the private rating letter itself, the full CRP rating rationale report, providing regulators *"a more in-depth analysis of the transaction, the methodology used to arrive at the private rating, and, as appropriate, discussion of the transaction's credit, legal and operational risks and mitigants"*. These private letter rating rationales should greatly assist the regulators in their analysis of the CRP ratings going forward.

However, we also agree with the need for a more robust **"holistic" due-diligence framework around CRP usage** and particularly **the utilization of an independent external consultant** to design and implement such a system. Ideally, in our view, any system would include an active and regular dialog between the CRPs and the SVO, which hopefully over time would increase mutual understanding and greatly reduce the need for SVO discretion over individual CRP ratings. (One idea would be to have the CRP and the SVO each make presentations to the Task Force or an independent third party, outlining their ratings process, methodologies, due-diligence procedures, analyst staffing and experience.)

- 3.) With such a due-diligence framework in place, the ability of the SVO to perform individualized credit assessments would only need to be used rarely as a *"backstop"* and *"under well-documented and governed parameters"* which would be widely and transparently shared with the market.
- 4.) With regard to the implementation of this regulatory discretion by the SVO, we believe those parameters should include the following requirements, many of which we previously listed in our comment letter to the VOS Task Force. **These recommendations are in line with the many comment letters submitted, all of which emphasized the need for maximum transparency in order to avoid unnecessary disruption in the capital markets:**

- Any review of an NAIC-approved CRP credit rating needs to be based on a thorough and detailed analysis by the SVO of the specific credit, presented to the investor in a ratings-report format comparable to the ratings rationales required by the SEC of all Nationally Recognized Statistical Ratings Organizations. The level of disclosure in the SVO report should be equivalent to the level of disclosure required by the SEC under CFR §240.17q-7: "Disclosure Requirements: Disclosures to be made when taking a ratings action".
- Just as with the NRSROs, that report needs to specify exactly what specific ratings methodology* was used in determining the SVO's assessment. (*This needs to be a full methodology appropriate to the given security, not just a sampling of bits and

pieces of several random methodologies. A ratings methodology is coherent set of steps and processes particular to the type of credit being analyzed (a “recipe”, if you will) to arrive at an objective credit assessment.) Without such a methodology, which was shared with the investor, an appeal would be meaningless.

- The SVO report should highlight the specific data and/or conclusions in the CRP report which the SVO disagrees with. (It should not be: “We looked at all the same data, but just came to a different conclusion.”)
- The appeal process needs to be shortened [one to two months at most] and would commence only once the SVO had submitted its full ratings rationale to the investor in order to reduce market uncertainty and possible disruption.
- There needs to be an independent third party, *not the SVO itself*, which adjudicates any disagreement about which credit opinion is more appropriate to be applied to a given credit. In our view, this should ideally be the state regulator.
- To preserve the assumption of convertibility in the current standard, the burden of proof should be on the SVO to refute the credit opinion of the CRP -- by citing specific omissions or conclusions of the CRP -- not on the investor to defend the CRP rating.
- Ideally, the CRP itself would be a participant in any appeals process and have a seat at the table along with the independent arbiter or state regulator.
- Any policy implemented should be monitored and then reviewed no later than six-months to a year after implementation -- and if necessary, periodically after that -- to assess its impact on the capital markets, its effectiveness and to perform a cost-benefit analysis.

These safeguards -- especially the requirement for an independent arbiter -- are important because, as we stated in our letter to the Task Force: in advance, there is no such thing as a “correct” credit rating: all opinions about credit are just that: opinions. They are predictions about the future, and as Yogi Berra once famously remarked: “Predictions are hard to make -- especially about the future”.

- 5.) We are also fully supportive of the establishment of **a broad investment working group** to act in an advisory capacity and facilitate coordination between the various groups (accounting, risk assessment and especially capital adequacy) as these workstreams progress.
- 6.) Finally, we also support the suggestions contained the Memo regarding the possible restructuring of both the SVO and VOSTF to give the Task Force a more active role in overseeing the activities of the SVO staff. Even the name “Securities Valuation Office” is an anachronism from many years ago and does not reflect the SVO’s current responsibilities or procedures, as laid out in the P&P Manual. (As an aside, we would note that the current SVO “Purposes & Procedures” Manual, as the result of numerous edits and interpolations over many years, is a dense, disorganized and occasionally self-contradictory document which makes for additional ambiguity and confusion in the market.)

I hope the members of the E-Committee and the VOS Task Force find these comments helpful, and would be happy to engage in further discussions of these ideas or any others going forward.

Sincerely,

JMGarrison

John Garrison

On behalf of The Lease-Backed Securities Working Group

*The various workstreams already underway include:

- The “Bond Redefinition” Project -- a massive effort underway for over three years and scheduled to take effect in 2025.
- Various revisions to the “Blanks” forms growing out of the Bond Definition Project.
- A proposal to re-write the definition of “NAIC Designations” in the Purposes and Procedures Manual.
- A due-diligence questionnaire for CRPs to provide information about their ratings process to the SVO.
- The submission for the first time of full “ratings rationale reports” to the SVO to assist in their review of CRP ratings -- only implemented last year.
- A proposal to allow the SVO to reject the CRP ratings of securities which would be otherwise eligible for “Filing Exemption” and to require that security instead to be filed with the SVO for a NAIC designation.
- A new framework for the analysis of CLOs.

cc: Dan Daveline



October 9, 2023

Via email

Dan Daveline
Director, Financial Regulatory Services
NAIC
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Framework for Regulation of Insurer Investments – A Holistic Review

Dear Mr. Daveline:

This letter is submitted on behalf of MetLife, Inc. (hereafter, “MetLife”). MetLife appreciates the opportunity to comment on the thoughtful Framework for Regulation of Insurer Investments – A Holistic Review (“the proposed Framework”) developed by the Financial Condition (E) Committee (“E Committee”) and exposed for comment after its August 15, 2023 meeting.

MetLife is an active member of the American Council of Life Insurers (“ACLI”) and fully supports the comment letter separately submitted by the ACLI. MetLife also seeks to share certain more detailed views that it holds regarding ways in which the proposed Framework may be applied in practice going forward.

In this letter, MetLife provides some contextual comments on the overarching themes covered by the proposed Framework as well as more detailed comments on the Framework’s Proposed Regulatory Enhancements concerning investment risk assessment and risk-based capital (“RBC”) for investments. Our hope is that these opinions will be helpful to Regulators and Staff as you thoughtfully move forward with the implementation of the proposed Framework.

Comments on Overarching Themes

MetLife agrees with the E Committee that the evident shift in insurers’ investment strategies over the last several years towards more private, structured, and complex assets requires a commensurate evolution of the current investment regulatory framework. We note that these new insurer investment practices present risk that the Financial Stability Oversight Council (“FSOC”) and other authorities have commented on repeatedly, and we firmly believe that the NAIC is best positioned to address such risk effectively and efficiently. Furthermore, we concur that this needed regulatory evolution will demand adequate resourcing to conduct the impartial analytical work required.

MetLife also agrees with the E Committee’s observation that capital parity should be a directional guidepost while recognizing practical limitations. At the same time, we believe that the capital approach should be regularly assessed to ensure that it properly and consistently captures risks incurred through investment activities.

Finally, MetLife applauds the E Committee’s decision to continue, uninterrupted, with the important ongoing initiatives to enhance supervision of investments in structured securities given the accelerated evolution of activities in this space it has witnessed in recent years. We welcome the proposed Framework’s focus on increased coordination across task forces and working groups as these and any future initiatives are brought into fruition in an open and deliberative fashion.

Comments on Proposed Enhancements to Investment Risk Assessment

Credit Rating Provider (“CRP”) ratings identify gradations of risk to guide investment decisions and were not designed with the purpose of determining the capital adequacy levels for insurer investment activities. Furthermore, as many CRPs publicly document, ratings may not necessarily be comparable across all asset classes¹.

In this context, we wholeheartedly agree with the E Committee’s view that a review of how the Securities Valuation Office (“SVO”) utilizes CRP ratings for NAIC Designation purposes is warranted – particularly for more complex securities such as structured products. To truly have consistent levels of capital for similar risks it is critical to identify instances where CRP ratings are not the best indicator of those risks that are relevant to RBC.

We include below our comments on each of the proposed components in the Framework to modernize the SVO:

1. A strong due diligence process to help the SVO determine instances where CRP ratings may not capture the nature or level of risk that C1 RBC is meant to address will be a critical element in a renewed investment regulatory framework.
2. It is important for the SVO to retain its current ability to perform individualized credit assessments, particularly for the evaluation of private unrated securities. We believe that once due diligence parameters for CRPs are instituted, any SVO discretion around established NAIC Designation mechanisms should be extremely limited. Any such discretion should only be applied in narrowly prescribed instances under a strong governance process to avoid introducing undue uncertainty that could disrupt insurers’ investment activities and even the capital markets more broadly.
3. Adequately resourcing the SVO will be key to the effectiveness of the renewed framework.
4. While asset modeling capabilities will be very important for SVO CRP due diligence – particularly related to structured securities, we believe that the American Academy of Actuaries (“the Academy”) brought up a pivotal issue in its presentation to the Risk Based Capital Investment Risk Evaluation Working Group (“RBC IRE WG”) during the 2023 NAIC Summer Meeting: tail loss risks for subordinated structured securities are not comparable to those of similarly rated corporate bonds. For this reason, we believe it is essential for the Structured Securities Group (“SSG”,) when practical, to retain the ability to model structured securities for NAIC Designation determination purposes and reduce reliance on CRP ratings. As the Academy noted in its presentation, some of the major structured asset sectors have sufficient historical performance data on their underlying

¹ See Annex A for an example of CRPs highlighting this possible discrepancy.

asset types to make security-level modeling practical, which would be conducive to the SSG managing an efficient process that properly designates structured securities to ensure they receive a prudent RBC treatment. We believe that today RMBS, CMBS, and CLOs are security types that will fall into the category where cash flow modeling by the SSG for NAIC Designation determination purposes will produce a much more appropriate result than deriving Designations from CRP ratings. For the remaining sectors of structured securities where a modeling solution is not the most practical approach, we believe that a streamlined CRP rating derived process that captures the credit quality gradation implied by the CRP rating but that also addresses the binary loss risk of subordinated tranches is the most effective path forward. For example, for non-modeled structured securities, the NAIC could apply the current RBC factors to senior tranches and apply a multiplier² on current factors for subordinate tranches.

5. For the SVO to have a policy advisory function that can bring in key external consultants, as needed, is consistent with the theme of properly resourcing the SVO to effectively operate under the renewed supervisory framework. We would simply recommend that the hiring of external consultants be handled through a transparent and well-governed process that minimizes any potential commercial conflicts for these consultants.
6. While we understand the intent behind establishing an advisory body under the E Committee to assist in situations requiring more intense or confidential regulatory engagement, we would only caution that clear parameters will be required to avoid introducing new, cumbersome bureaucratic processes.
7. Given the SVO's remit and its expected enhanced capabilities, we believe that leveraging its resources to support the work of other working groups is not only efficient, but it will also help enhance consistency and coordination across these groups.

Comments on Proposed Enhancements to RBC for Investments

The creation of the RBC IRE WG was a critical step in the development of a robust and consistent RBC approach. The working group's ongoing partnership with the Academy further enhances the prospects that this approach will continue to be thoughtful and technically sound. Under the renewed framework proposed by the E Committee, we also believe there is an opportunity for further collaboration among NAIC working groups and task forces to identify parallel initiatives that could benefit from a single joint approach.

One topical example of the above is the current RBC IRE WG initiative to develop new RBC factors for CLOs and the Valuation of Securities Task Force ("VOSTF") initiative to model CLOs for proper NAIC Designation mapping. Both initiatives pursue the same objective: ensuring that holdings of CLOs receive a prudent capital treatment. These parallel initiatives offer a great opportunity for consolidation in a way that could leverage the resources and expertise that each group brings to the table. Doing so would obtain a more effective result that can be promptly implemented in a more agile fashion. In this example the NAIC could leverage:

- the Academy's technical actuarial capabilities,

² See Annex B for an example of credit risk charge multiplier utilized by a CRP to address the diverging loss profile of subordinated structured securities in their proposed capital adequacy methodology to rate insurance companies.

- the RBC IRE WG’s strategic view on RBC,
- the SSG’s technical securitization expertise and modeling capabilities, and
- the VOSTF’s strategic view on security risk classification and reporting.

Consolidating these initiatives would develop a single solution to model CLO holdings and properly map them to NAIC Designations so they receive an RBC treatment that is consistent with the NAIC’s broader RBC philosophy.

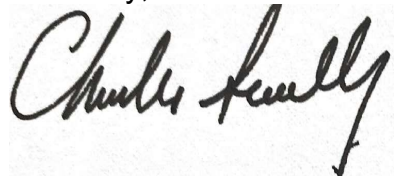
We offer the below additional comments on the individual items under the proposed enhancements to RBC for investments:

1. We agree that the NAIC should strive to maintain consistency in the RBC treatment of securities in a way that properly captures their level of risk, and that thought should be given to the potential consequences of treating asset sectors inconsistently. We would note, as suggested earlier, that this goal can be achieved either through the refinement of RBC factors, or, when practical, through modeling approaches that map individual securities to the appropriate existing factor that best captures the security’s RBC-relevant risks.
2. We also agree that the RBC approach should be developed in a way that minimizes the incentives and opportunities for market participants to engage in capital arbitrage. We would argue that for larger sectors of structured securities such as RMBS, CMBS, and CLOs, for which collateral has a reasonable level of homogeneity this goal can more effectively and efficiently be achieved through a security modeling and mapping approach than through a wholesale revision of RBC factors – in fact, such a process has been successfully in place for RMBS and CMBS for over a decade. For less homogenous sectors such as ABS, a simplified approach like the factor multiplier discussed in the prior section could be applied rather than developing new factors from scratch, which will likely be a highly impractical endeavor.

Closing

We reiterate MetLife’s sincere appreciation for the opportunity to comment on this thoughtful Framework. We look forward to continuing this constructive discussion. If, in the interim you have any question 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

Annex A

Excerpt from “Rating Symbols and Definitions” by Moody’s Investor Services, May 3, 2023, p.5.

Credit Rating Services

Moody's Global Rating Scales

Ratings assigned on Moody's global long-term and short-term rating scales are forward-looking opinions of the relative credit risks of financial obligations issued by non-financial corporates, financial institutions, structured finance vehicles, project finance vehicles, and public sector entities. Moody's defines credit risk as the risk that an entity may not meet its contractual financial obligations as they come due and any estimated financial loss in the event of default or impairment. The contractual financial obligations¹ addressed by Moody's ratings are those that call for, without regard to enforceability, the payment of an ascertainable amount, which may vary based upon standard sources of variation (e.g., floating interest rates), by an ascertainable date. Moody's rating addresses the issuer's ability to obtain cash sufficient to service the obligation, and its willingness to pay.² Moody's ratings do not address non-standard sources of variation in the amount of the principal obligation (e.g., equity indexed), absent an express statement to the contrary in a press release accompanying an initial rating.³ Long-term ratings are assigned to issuers or obligations with an original maturity of eleven months or more and reflect both on the likelihood of a default or impairment on contractual financial obligations and the expected financial loss suffered in the event of default or impairment. Short-term ratings are assigned to obligations with an original maturity of thirteen months or less and reflect both on the likelihood of a default or impairment on contractual financial obligations and the expected financial loss suffered in the event of default or impairment.^{4,5} Moody's issues ratings at the issuer level and instrument level on both the long-term scale and the short-term scale. Typically, ratings are made publicly available although private and unpublished ratings may also be assigned.⁶

Moody's differentiates structured finance ratings from fundamental ratings (i.e., ratings on nonfinancial corporate, financial institution, and public sector entities) on the global long-term scale by adding (sf) to all structured finance ratings.⁷ The addition of (sf) to structured finance ratings should eliminate any presumption that such ratings and fundamental ratings at the same letter grade level will behave the same. The (sf) indicator for structured finance security ratings indicates that otherwise similarly rated structured finance and fundamental securities may have different risk characteristics. Through its current methodologies, however, Moody's aspires to achieve broad expected equivalence in structured finance and fundamental rating performance when measured over a long period of time.

Annex B

Table based on “Request for Comment: Insurer Risk-Based Capital Adequacy—Methodology And Assumptions” by S&P Global Ratings, May 9, 2023.

Rating	Structured Products Charge % ("SP")	Senior Secured Bonds Charge % ("SSB")	Senior Unsecured Bonds Charge % ("SUB")	SP to SSB Ratio	SP to SUB Ratio
AAA	0.21	0.19	0.36	1.1x	0.6x
AA	0.66	0.51	0.94	1.3x	0.7x
A	1.88	0.7	1.29	2.7x	1.5x
BBB	3.53	1.42	2.64	2.5x	1.3x
BB	11.73	3.39	6.29	3.5x	1.9x
B	19.27	5.24	9.73	3.7x	2.0x
CCC to C	73.88	24.63	45.74	3.0x	1.6x
D/SD	100.00	35.00	65.00	2.9x	1.5x

* 99.5% Confidence Interval, more than 5 and 10 or less years

Comment on Draft “Framework for Regulation of Insurer Investments – A Holistic Review”

Fred Andersen – Minnesota Department of Commerce

As complex asset activity in life insurers continues to increase at a rapid rate, I believe that the adoption of standards appropriately addressing the risk of complex assets should not pause as a holistic approach to regulation of insurer investments is being contemplated.

In recent months, some firms who potentially benefit from currently understated financial requirements have been arguing to delay various workstreams (usually through saying more "testing" or "evaluation" or level playing field is needed). Without clarification, the draft Framework could be seen as a means to delay the adoption of workstream-developed financial standards that help ensure the solvency of insurers.

There's a concern that if certain financial standards, such as risk-based capital (RBC) factors, continue to not appropriately reflect additional risk for emerging complex assets, that an increasing portion of assets will have understated RBC charges. This will render the RBC ratio as a less effective metric for identifying weakly capitalized companies, as well as being less effective for serving ancillary purposes, such as being a factor for reviewing the appropriateness of shareholder dividends.

October 9, 2023

Via Email

Ms. Elizabeth Kelleher Dwyer
Chair, Financial Condition (E) Committee
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Proposed Framework for Regulation of Insurer Investments

Dear Ms. Dwyer,

Moody's Investors Service, Inc. ("Moody's") appreciates the opportunity to provide comments on the National Association of Insurance Commissioners' ("NAIC") exposure draft, *Framework for Regulation of Insurer Investments – A Holistic Review* ("Framework"), which was released for comment by the Financial Condition (E) Committee ("E-Committee") on August 15, 2023. Moody's supports the E-Committee's proposal to undertake this holistic review in response to an observable shift in insurer investment strategies away from holdings consisting of mainly publicly rated corporate debt and toward increased holdings of private assets, structured assets, and complex assets.

Many of these assets are subject to the "filing exempt" ("FE") process, by which ratings from credit rating providers ("CRPs") are automatically mapped to NAIC designations, and are therefore not required to be filed with the NAIC's Securities Valuation Office ("SVO") for review. A growing share of insurers' assets, however, are rated by only one CRP and, in many cases, the ratings are private (i.e., not shared with the market at large). Moreover, the SVO has previously highlighted that differences in opinions across CRPs may be more common and more material across these assets than across insurers' more traditional investments, raising questions about the consistency of the capital charges assigned through the FE process.¹ The perceived opacity of these assets and the often single and/or private nature of their CRP-provided ratings increase the risk of capital arbitrage, rating shopping, and rating inflation. To address these concerns, the SVO has contemplated applying its discretion more frequently, and in at least one asset class, dispensing with the FE process altogether.

In response to these developments, the holistic review proposed by the E-Committee seeks to

¹ See NAIC Special Report "[Growth in Private Ratings Among U.S. Insurer Bond Investments and Credit Rating Differences](#)," dated January 21, 2022.

establish, among other things, an objective framework through which the SVO can efficiently and predictably exercise discretion over the use of CRP ratings in the FE process. As discussed further below, the NAIC should consider incorporating the following three recommendations into its holistic review:

1. Develop a review process in support of the SVO's exercise of discretion in the use of CRP ratings that is narrowly focused on potential differences in the meaning of ratings across CRPs in particular sectors, asset classes, or between public and private ratings. Beyond this process, we believe that any additional due diligence of CRPs' rating processes, internal controls and resources would be redundant to existing regulation and oversight of current CRPs by the U.S. Securities and Exchange Commission ("SEC");
2. Rely to a greater extent on market discipline to drive greater consistency and transparency in the use of ratings from different CRPs to assign NAIC designations in different asset classes; and
3. Reduce the risk of rating shopping by expanding the scope, depth and frequency of the NAIC's oversight of insurers' investment risk management controls.

Our comments in this letter are narrowly focused on opportunities to improve the use of CRP ratings in the FE process, to increase transparency around insurer investments and their uses of ratings, and to enhance regulatory oversight of the uses of ratings by insurers. However, we also support a broader scope of review under the proposed Framework that would consider, for example, revising risk-based capital factors for certain investments, expanding data acquisition by the NAIC to enhance its monitoring of industry investment trends, and reviewing the implications of the industry's evolving ownership models and its increased use of offshore reinsurance.²

I. Recent Trends in Insurers' Investment Strategies Require New Oversight Tools

In recent years, insurers have increased their allocations to higher-yielding alternative investments, private debt, funds and asset-backed securities, such as collateralized loan obligations, expanding beyond investment-grade, publicly issued and publicly rated corporate bonds.

In addition, in the past few years, new and existing strategic partnerships between alternative asset managers and insurers (mainly annuity providers) have grown substantially. Both sides reap benefits, although not without risk. Alternative asset managers gain access to perpetual assets under management, which bring stable, recurring fees. Insurers gain higher incremental returns, mainly through expansion into private investments, largely investment grade, but also including some lower-rated private credit.³ While these investments potentially offer higher returns relative to corporate bonds, in part due to a liquidity premium, they may also lead to decreased transparency of insurers' holdings and less reliable sizing of capital against risk.⁴ The risk-based capital allocated to

² See Moody's Sector Report "[Private credit drives alternative manager, insurance partnerships](#)," dated October 3, 2023.

³ See *Id.*

⁴ In August 2023, the NAIC published a Special Report highlighting that "higher proportion of ABS and other structured securities, private label RMBS, and CMBS among PE-owned insurers' total bonds—coinciding with a smaller proportion of municipal bond investments— demonstrates a higher concentration of nontraditional, higher-yielding

support these alternative investments is often determined by a process that is less transparent due to the lack of public disclosure regarding the composition of the investment portfolio and the underlying risk analysis. Such investments often bear a private letter rating assigned on a confidential basis by a single CRP selected by the insurer. Due to the private nature of the transaction and the assigned rating, insurers do not generally disclose detailed information for market participants to assess the sufficiency of capital set aside in support of these investments.

The NAIC is appropriately concerned that these conditions – more opaque and potentially riskier investments in insurers’ portfolios and increased regulatory reliance on private ratings from a single CRP – may give rise to regulatory capital arbitrage and rating shopping.⁵

II. Due Diligence of CRPs Should Be Narrowly Focused

Moody’s supports the NAIC’s proposal to have the SVO undertake a “due diligence” process in support of the SVO’s exercise of discretion in the use of CRP ratings; however, we recommend that this process be narrowly focused on potential differences in the meaning of ratings across CRPs in particular sectors, asset classes, or between public and private ratings.

All credit rating agencies currently included on the NAIC’s list of CRPs are registered with the SEC as Nationally Recognized Statistical Rating Organizations (“NRSROs”) and are subject to the SEC’s oversight and comprehensive disclosure requirements. SEC staff conducts examinations of NRSROs at least annually⁶ to assess and promote compliance with applicable federal securities laws and rules, and also monitors the NRSROs’ activities. In addition, other regulators perform oversight of these NRSROs’ operations in their jurisdictions. For example, the European Securities and Markets Authority (“ESMA”) oversees these firms’ activities in the European Union (“EU”).

In light of the extensive regulation and oversight of CRPs by multiple regulators, we believe that repeating the work of these regulators by establishing a framework for conducting parallel comprehensive reviews of the CRPs’ business processes, internal controls and resources is redundant and would divert the NAIC’s resources from other, more important priorities.

Rather, the NAIC should consider an approach that is focused on reviewing discrete areas of concern previously identified by the NAIC. The NAIC should also consider developing objective, data-driven tools, standards and procedures to identify significant outliers among CRPs’ methodological approaches in different sectors.

bonds and, perhaps, the potential for increased volatility and risk.” See NAIC Special Report “[Increase in Number and Total Investments of Private Equity \(PE\)-Owned U.S. Insurers in 2022](#),” dated August 15, 2023.

⁵ See Letter, dated July 25, 2023, from the NAIC to Rep. Warren Davidson and certain other members of the U.S. House of Representatives, available at <https://content.naic.org/sites/default/files/government-affairs-letter-chairman-davidson-svo.pdf>.

⁶ Section 15E(p)(3)(B) of the Securities Exchange Act of 1934 provides that each NRSRO examination shall include a review of the following eight topic areas: (i) whether the NRSRO conducts business in accordance with its policies, procedures, and rating methodologies; (ii) management of conflicts of interest by the NRSRO; (iii) implementation of ethics policies by the NRSRO; (iv) internal supervisory controls of the NRSRO; (v) governance of the NRSRO; (vi) activities of the Designated Compliance Officer of the NRSRO; (vii) processing of complaints by the NRSRO; and (viii) policies of the NRSRO governing the post-employment activities of its former staff.

III. The NAIC Should Consider Alternative Approaches to Drive Consistency in the Use of Ratings to Derive NAIC Designations

In its review of the proposed Framework and assessment of effective ways of using regulatory resources, the NAIC should also consider: (i) gaining insights from the use of credit ratings by regulators of US financial intermediaries and by regulators of European financial institutions; (ii) enlisting market discipline to discourage capital arbitrage and rating shopping by reducing reliance on private letter ratings and, where possible, by bolstering insurer disclosure requirements; and (iii) expanding the NAIC's oversight of insurers' investment risk management controls to include, among other review areas, insurers' use of CRP ratings to reduce the risk of rating shopping.

1. Gaining insights from the role of credit ratings in other regulatory frameworks

Analyzing the use of credit ratings among US financial intermediaries, including banks and mutual funds, alongside European financial institutions, could yield valuable insights.

As a consequence of the Dodd-Frank Act⁷, US bank and mutual fund regulations no longer rely on externally provided credit ratings. The supervision of credit risk in these sectors can be studied to see if there are ways in which the NAIC might want to reduce its reliance on CRP ratings, at least in some sectors or asset classes.

In contrast, regulated European banks and insurers can reference external credit ratings in determining their capital requirements. Under the EU's transposition of the Basel framework⁸ and the EU's Solvency II regime, respectively, EU banks and insurance companies have the option to use external credit ratings to determine their regulatory capital adequacy or solvency capital requirements. If financial institutions choose this approach, they can reference credit ratings issued by an eligible external credit assessment institution (ECAI), which is a credit rating agency ("CRA") registered or certified with ESMA pursuant to the EU Credit Rating Agencies Regulation (CRAR)⁹. For this purpose, the European Supervisory Authorities "map" CRAs' credit ratings to Credit Quality Steps¹⁰, which in turn determine the risk weights applicable by exposure.

EU regulations mandate that only publicly assigned credit ratings are eligible for regulatory purposes.¹¹ EU banking regulations also provide that such credit ratings must be used in a systematic fashion.¹² To avoid excessive reliance on ECAIs, EU regulations further require that

⁷ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, H.R. 4173 (July 21, 2010).

⁸ See Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms ("Capital Requirements Regulation"), and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms ("Capital Requirements Directive").

⁹ See Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, as amended.

¹⁰ See <https://www.eba.europa.eu/regulation-and-policy/external-credit-assessment-institutions-ecai>.

¹¹ See Article 2(a) of the CRAR.

¹² See Article 138 of the Capital Requirements Regulation.

firms undertake their own credit risk assessments and do not rely solely or mechanically on credit ratings.¹³

2. Enlisting market discipline to discourage regulatory capital arbitrage and rating shopping

We also see opportunities for the NAIC to enlist market discipline in order to discourage potential regulatory capital arbitrage and rating shopping associated with the use of CRP ratings for insurance regulatory purposes.

Use of public credit ratings enhances ratings comparability and promotes market discipline. Ratings assigned by different CRPs are most likely to be comparable when they are publicly assigned to many of the same credits within large market segments. These conditions allow market participants to directly observe differences in average rating levels and in the rank ordering of individual credits. The same conditions also support a mechanism that helps drive ratings comparability, since investors and issuers can – and regularly do – challenge a CRP’s absolute and relative rankings, resulting in healthy market discipline. This “market oversight” mechanism does not operate in market segments where ratings are private or when there is little overlap in ratings assigned by CRPs.

Additional accountability could be achieved by allowing only public ratings to be submitted through the FE process in certain sectors and asset classes. As discussed above, private letter ratings lack transparency and comparability in contrast to public ratings. This is due to the confidential nature of private ratings and the practice of some issuers to seek a private letter rating from only one CRP for certain types of securities held by insurers. Better market discipline around the use of credit ratings by insurers could potentially be achieved by limiting the FE process to public ratings in certain sectors and asset classes where the NAIC identifies increased risks of regulatory capital arbitrage and rating shopping.

Each insurer could also be required to report in connection with their Schedule D filing with the NAIC, for each privately rated asset in certain sectors and asset classes: (i) the security’s structure and assets and (ii) the NAIC designation assigned to each such asset. This could assist market participants with forming their own opinions about the risks associated with the insurers’ investments and corresponding capital adequacy. These additional disclosures could be made while ensuring that there is no disclosure of proprietary business information or private rating information.

3. Shifting the focus from CRPs to reviews of insurer risk management and asset underwriting

The Framework’s recommendations, as they are currently proposed, are primarily focused on the mechanisms that are under the direct control of the NAIC, such as regulatory capital requirements, the use of CRP ratings by the NAIC and the SVO’s analysis and discretion authority. However, we believe that the NAIC’s efforts could be effectively supplemented by enhancing the oversight of insurers’ risk management processes and asset underwriting standards, including their use of CRP ratings. Under such an approach, insurers would retain clear ownership of their risk exposures and

¹³ See Article 5a of the CRA Regulation.

would be required to demonstrate to their supervisors how they manage such risks.

Specifically, the NAIC should consider: (i) enhancing the requirements for insurer asset and NAIC designation disclosures, as described in more detail above, and (ii) enhancing the scope, depth and frequency of its oversight of insurers' asset underwriting and internal risk management practices to reduce incentives for regulatory capital arbitrage and rating shopping. This oversight could include ensuring that these firms have effective controls around individual insurers' selection and use of CRPs and private letter ratings in managing credit risk in their portfolios. Assessment of the effectiveness of such controls could be built into the scope of regulatory exams and other risk management reviews of insurers, and in the insurers' Own Risk and Solvency Assessment ("ORSA") processes and reports.

The NAIC could also consider establishing a two-tier system for insurers' use of CRP ratings – one that would permit both public and private ratings, as long as such use is supported by robust internal processes and analysis. Firms that lack the resources to support such processes would default to the use of public ratings for regulatory capital requirements (or SVO-provided designations) for certain sectors and asset classes identified by the NAIC.

* * *

We look forward to continued engagement with the NAIC on these and other important topics and would be pleased to discuss these issues with you in more detail.

Sincerely,

/S/ Nick Miller

Nick Miller
Managing Director – Global Regulatory Affairs

Commissioner Beth Dwyer
Financial Condition (E) Committee
National Association of Insurance Commissioners
Via Email: Dan Daveline, dddaveline@naic.org

RE: Framework for Regulation of Insurer Investments - A Holistic Review

Dear Commissioner Dwyer,

Thank you for the opportunity to comment on the Framework for Regulation of Insurer Investments (“the Proposed Framework”).

NAMIC understands the goal of the National Association of Insurance Commissioners (“NAIC”) with the Proposed Framework and is appreciative of the noted legitimate and significant challenges that lay ahead with modernizing the role of the Securities Valuation Office (“SVO”). NAMIC offers the following comments for consideration.

Comments on Proposed Regulatory Enhancements

The Proposed Framework states that the NAIC would like to reduce or eliminate “blind” reliance on the credit rating providers (“CRP”) for securities that are filing exempt. To meet that goal, the NAIC proposes building out its own due diligence framework with the help of external consultants. There are a few questions regarding the NAIC’s own due diligence framework. How much more differentiation is the NAIC expecting in its ratings compared to the CRPs? Additionally, will SVO equivalency ratings be impacted by this process as well? Will the NAIC continue to use external consultants on an ongoing basis to evaluate the ratings or does the NAIC plan to take all the work in-house once the framework is built? If the latter, what education will the NAIC provide to staff and industry on the new process of equivalency ratings?

The Proposed Framework discusses different type of assets and the capabilities that the SVO plans to build out in the future. Have there been discussions around private debt investments and if so, does the NAIC believe that the SVO will take a closer look at those assets? Finally, how is the NAIC going to fund the proposed SVO changes such as paying for external consultants, review and increase staffing, and building a strong due diligence framework?



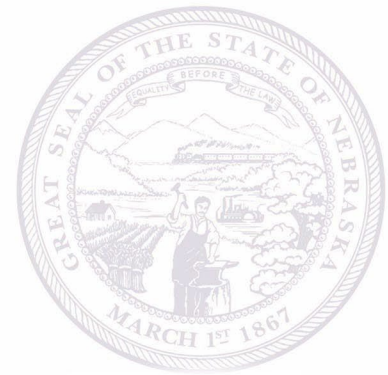
Comments on Risk-Based Capital for Investments

- Section B(1)
 - NAMIC recommends a consistent definition of “capital arbitrage” as well as “review framework.”
- Section B(2)
 - NAMIC represents a variety of mutual insurers, ranging from small to large. The risk-based capital (“RBC”) formula may have inconsistencies in treatment across asset classes that incentivize particular legal forms of investments. These inconsistencies can exist across category of insurance as well. For example, life companies may get credit for rated funds, by rating the entire fund, whereas P&C companies may not get that credit. The RBC capital project has potential for scope creep and could become very cumbersome, very quickly. NAMIC suggests that the RBC Working Group work toward the best achievable results, be measured in their work and efforts, and heavily consider industry input throughout whatever projects arise out of this framework.

Thank you for your consideration of these comments on this matter of importance to insurers and policyholders. NAMIC looks forward to continuing the dialogue on these issues and being helpful to moving these discussions forward.

Best,

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



Governor Jim Pillen

October 9, 2023

Financial Condition (E) Committee
National Association of Insurance Commissioners
1100 Walnut St, Suite 1500
Kansas City, MO 64106-2197

RE: Framework for Regulation of Insurers Investments –A Holistic Review

Dear Superintendent Dwyer and Committee Members,

The Nebraska Department of Insurance (“Nebraska”) appreciates the opportunity to provide feedback on the “Framework for Regulation of Insurer Investments-A Holistic Review” (“Framework”). The investment strategies of insurers have significantly changed over the past two decades as companies rebalanced their portfolios to support product liabilities in a fluid interest rate environment. This shift resulted in more complex and opaque investment portfolios and created a need to modernize our regulatory framework. Recent initiatives led by the NAIC to modernize investment accounting practices, financial statement reporting and disclosures, and related risk-based capital charges have garnered significant public attention. Nebraska emphasizes its strong support for the continuation of NAIC workstreams which aim to enhance areas within the insurance regulatory framework and the need for a holistic approach. This must also be accomplished without pause given the material risk invited by the lack of appropriate regulatory guardrails; further, the sooner we provide the market regulatory certainty, the sooner we can prevent additional regulatory risk and minimize market disruption.

We strongly believe conducting a comprehensive evaluation of insurer investment regulations will complement existing efforts to promote secure, financially sound, and resilient insurance markets. Nebraska supports the Framework and endorses the policy objectives it represents.

In support of this holistic review and as vice-chair of the Valuation of Securities Task Force, Nebraska encourages the NAIC to consider a set of guiding principles for their efforts. We emphasize the importance of the following characteristics in any framework designed to regulate insurer investments:

- Practicality and Reasonableness: It is vital the framework's implementation **does not create excessive burdens for industry or regulators**. It should be practical, reasonable, and easy to understand.
- Transparency: The framework should promote transparency when assessing asset risks and effectively measuring these risks. **Equal capital for equal economic risk**.
- State Regulator Authority: **Decision-making authority should remain exclusively with state regulators** and there should be appropriate oversight of the Securities Valuation Office (“SVO”).

- Consistency and Comparability: The framework should ensure capital requirements are consistent, comparable, and appropriately calibrated across different asset classes, thereby **minimizing opportunities for undue capital arbitrage**.
- Proactive Risk Identification: The framework should empower regulators to proactively **identify and respond to emerging risks as investments evolve**, both at the company and industry levels.

We also wish to provide specific comments on each of the seven elements outlined in the proposed framework for the modernization of the SVO:

1. *Due Diligence Framework*: We concur with the notion that CRP ratings may not consistently capture relevant risks across different investment types for C1 RBC. Therefore, we endorse the implementation of a robust CRP due diligence process by the SVO as an initial step in reducing regulatory reliance on CRP ratings.
2. *Individualized Credit Assessments Backstop*: The SVO should retain the ability to conduct individualized credit assessments, especially for private securities. Given the historical significance of CRPs' industry knowledge, any discretion over NAIC Designations derived from CRP ratings should be used sparingly and be accompanied by strong governance and state regulator-governed appeals processes. More specifically,
 - a. The SVO should, independently and at the direction of state regulators, identify investments for which market data or asset characteristics indicate a rating anomaly.
 - b. Appeals should be made to a smaller working group of the Task Force composed of select state regulators with expertise in investments and related accounting principles.
 - c. All ratings reviews should remain confidential until after the appeals process.
 - d. Domiciliary regulators should be notified at the onset of the review and retain final authority to implement a notched rating independent of the working group's recommendation.
3. *Portfolio Risk Capabilities*: Adequate resources should be allocated to the SVO to support regulators and reduce their overt reliance on CRP ratings, both for modeling capabilities and determining appropriate risk charges.
4. *Structured Asset Modeling Capabilities*: Strengthening this capacity is essential for CRP due diligence and effective activities-based prudential oversight. Data from American Academy of Actuaries makes clear tail risks associated with structured securities are not directly comparable to those of similarly rated corporate bonds. Given the availability of adequate data in sectors such as RMBS, CMBS, and CLOs, adopting a security-level modeling approach to estimate appropriate RBC is feasible with the right resources. Instead of developing single ratings-based factors for various structured securities, it may be more practical for the SSG to map these securities to the appropriate existing RBC factor using a modeling approach, especially for more homogeneous sectors like RMBS, CMBS, and CLOs. In this context, we support the initiative to enhance the SSG's modeling capabilities, as we consider these capabilities central to the proposed principle of enabling regulators to proactively identify and respond to emerging risks that could be material during periods of stress.
5. *Policy Advisory Function/External Consultants*: Nebraska strongly advocates for the continuation of state-led insurance regulation and policy formulation. We also believe the ability to engage external consultants, when necessary, aligns with the goal of adequately resourcing the SVO for its expanded responsibilities. We recommend the retention of any external consultant be conducted under a transparent and robust governance framework to effectively manage potential conflicts of interest.
6. *Broad Investment Working Group*: We look forward to the formation of a comprehensive advisory body under the E Committee to coordinate efforts across multiple NAIC groups and promote the most cohesive process possible.

7. *SVO Oversight*: Given the potential expansion of resources available to the SVO and the IAO more broadly, we agree it is sensible to explore reasonable means by which these capabilities can be leveraged with other parts of the NAIC beyond the VOSTF.

Lastly, regarding the ongoing project to review RBC factors for investments, Nebraska actively participates in the RBC-IRE Working Group. The RBC-IRE Working Group's collaboration with the Academy of Actuaries has been invaluable, particularly in developing RBC factors for collateralized loan obligations (CLOs). We fully agree with the observations noted in the Framework and submit the following additional comments:

- *Capital Consistency and Stress Testing*: We agree that perfect consistency in capital treatment across asset classes is ideal, but the NAIC should strive to apply comparable levels of stress and consider tail risk when determining solvency requirements. Such an approach will ensure that similar economic risks receive similar capital treatment regardless of which asset form is employed and will minimize the uneven capital treatment (capital arbitrage) seen periodically with certain structured securities. We hope to see an eventual specific quantification of the magnitude of this capital arbitrage beyond hypothetical comparisons between C1 treatment, if it exists.
- *Data Availability and Modeling*: We concur with the Academy of Actuaries regarding the abundance of data accessible for the underlying collateral of specific structured products, such as CLOs (including RMBS and CMBS). Coupled with the widespread availability of commercial analytical tools, modeling individual securities for capital determination becomes a practical and prudent approach.
- *Diversity of Structured Products*: Recognizing the diversity within structured products, we find it impractical to establish a single set of factors for all structured securities. Even within a single sector, such as CLOs, adopting a static set of factors may not be the most suitable approach due to the evolving nature of structuring practices. Therefore, we advocate for a principles-based approach.
- *Security-Level Modeling*: We believe that a security-level modeling approach is the most logical one, where practical (for CLOs, RMBS, and CMBS), that maps individual holdings to existing factors in a dynamic manner.
- *Mapping Approach*: We would like to underscore the successful application of the mapping approach in determining NAIC designations for RMBS and CMBS over the course of more than a decade. We are fully supportive of the SSG's extension of this to CLOs and look forward to application to other structured securities.
- *Recommendation for Coordination*: Given the above, we recommend the effort to determine factors for CLOs currently pursued by the RBC-IRE Working Group with the support of the Academy of Actuaries, and the effort to develop a modeling approach to determine the credit designations of CLOs currently pursued by the SSG under VOSTF supervision be combined under the auspices of a broad investment working group.

Nebraska appreciates the open dialogue amongst industry participants, state regulators, and interested parties. We are eager to continue this discussion and are happy to answer any questions regarding this letter.

Sincerely,



Lindsay Crawford
Chief Financial Regulator



October 9, 2023

Dan Daveline
Director-Financial Regulatory Analysis
National Association of Insurance Commissioners ("NAIC")
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Via email: ddaveline@naic.org

Dear Mr. Daveline,

Pacific Life Insurance Company ("Pacific Life") appreciates the opportunity to respond to the "Framework for Regulation of Insurer Investments-A Holistic Review," recently exposed by the Financial Condition (E) Committee. We support the above referenced NAIC effort to respond to a material shift in life insurer investment strategies in recent years. The NAIC's work to modernize the investment regulatory framework is an important step to make sure the industry is adequately capitalized against investment tail risk scenarios and to minimize opportunities for capital arbitrage.

Pacific Life also strongly supports the E Committee's decision to move forward without pausing ongoing investment related workstreams under its ultimate purview, particularly given the complex, time-sensitive, and technical nature of the issues under discussion. We further agree with the points addressed by the American Council of Life Insurers' ("ACLI") letter and will continue to actively collaborate with the ACLI. The industry and regulators working together toward our common goals will help lead to the desired result of protecting the long-term interests of policyholders and in doing so, the reputation of the industry as a whole.

The NAIC is right to consider additional process, governance, and Commissioner level engagement on the oversight of insurer investments. While Pacific Life believes that the NAIC process has been transparent and consultative from the outset, with ample opportunity for public comment at the working group and task force level, we support and appreciate the additional focus on transparent dialogue and stakeholder engagement.

Pacific Life further concurs with regulators that in the past several years there has been a "material, observable shift in insurer investment strategies" toward "more complex" investments and the "existing framework did not contemplate these investment strategies" and therefore needs to be enhanced. This shift into more complex structured securities, which play an important role in insurer portfolios, has occurred among all life insurance companies, albeit to differing degrees. ***Of particular concern to Pacific Life is the rapid expansion of investment strategies that exploit opportunities for capital arbitrage for structured securities.***

The U.S. regulatory capital framework is unique in being both heavily reliant on rating agency ratings to set capital requirements for structured securities¹ and not differentiating, for a given rating, between the capital required for corporate bonds and the capital required for structured securities. Regulators have appropriately identified that this is fundamentally flawed. Rating agency ratings, based on expectations of default or expected loss, are not comparable between corporate bonds and structured securities for the purposes of establishing capital requirements given the “fatter” tail risk profiles of structured securities in general, and of subordinated structures more specifically. To underscore this fact, rating agencies generally acknowledge that structured securities and corporate bonds with the same rating do not behave the same.² Further, in some cases rating agencies assume investment grade structures require 1.5-2x – or more – the capital of investment grade corporate bonds in their internal capital models.³

As the NAIC reviews adjustments and modernizations to the insurer investment regulatory framework, we agree with the ACLI that a principles-based approach is appropriate. A principles-based approach would allow for the most effective use of regulatory and insurer resources, and make sure regulations are dynamic to the greatest extent possible in anticipation of future innovation in financial markets. In addition, we would like to point out a few thematic areas where we believe it is critical that regulators focus their efforts.

- **The NAIC should take a broad approach when considering emerging risks and where there may need to be enhanced oversight of insurer investments.** Even if only a small number of insurers are investing in a particular asset, or investments are limited to a sub-sector of a certain investment class (e.g., Mezzanine Collateralized Loan Obligations) in times of stress there can still be a material impact on insurer solvency, the industry’s reputation as a financial safety net, and the reputation of the state insurance regulatory system at large. Furthermore, many investment risks are correlated—as we learned from the 2008 Great Financial Crisis—and credit crises by their nature are hard to predict, making it even more important to take a broad approach to spotting and appropriately addressing potential risks.
- **There should be consistent treatment across asset classes to encourage economic decision making and limit the potential for capital arbitrage.** We agree that capital must be consistent across asset classes to limit opportunities for capital arbitrage (e.g., inadvertently incentivizing companies to hold investments in different legal structures, etc., primarily for the purpose of lowering capital charges). The regulatory framework should encourage economic decision making to the greatest extent practicable. Notably, when supporting “consistent capital treatment” we mean ensuring consistent **outcomes** not consistent methods for determining

¹ With the notable exception of Residential and Commercial Mortgage-Backed Securities modeling which was instituted by the NAIC Structured Securities Project in 2009-2010.

² See, Moody’s Investor Service: Ratings Symbols and Definitions (May 3, 2023) page 5: “The (sf) indicator for structured finance security ratings indicates that otherwise similarly rated structured finance and fundamental securities may have different risk characteristics.”

³ See for example, S&P’s proposed changes to their Insurer Risk-Based Capital Adequacy Criteria, expected to become effective year end 2023, which includes a relative capital upcharge in the range of 1.7-1.8x for A/BBB rated structured securities over senior unsecured debt; and Fitch’s Prism Factor-Based Capital Model which includes more conservative charges than S&P (approximately 3x).

capital charges. The methods for determining capital charges may be different based on the nature of the investment as long as the outcomes are appropriately calibrated to the risk of the investment class, and stress scenarios are consistent in severity across investment classes.

- **The NAIC should embrace the use of modeling to supplement the limits of historical data for structured securities.** This will help to ensure that capital levels are reasonably risk-calibrated for newer asset classes. Using modeling and data analytics will also help to reduce potential moral hazard. For example, modeling can allow recalibration around historical asset and market performance regarding recent government intervention to prop up credit markets as such intervention is not a given in the future. The same principle that applies to underwriting also applies here, which is that historical performance is a proxy for but not a guarantee of future performance and should be refined with other risk measures when practical.
- **The analytical capabilities of the SVO should be proportional to the complexity of the investment strategies of U.S. insurers, particularly for the purpose of “industry-wide risk analytics for use in macroprudential efforts.”** Pacific Life strongly supports enhanced structured securities modeling capabilities particularly for “industry stress testing, and emerging risk identification.” We also support the policy goal of reducing “Blind Reliance” on ratings where appropriate.
- **The NAIC should continue to modernize regulatory tools to address potential liquidity risks.** One item not mentioned in the NAIC framework is how regulators might consider liquidity risk in the context of any insurer investment framework, and in the context of structured investments specifically. Growing concentrations of insurer investments in more illiquid asset classes should be carefully analyzed against insurer liabilities. Regulatory focus on managing, understanding, and mitigating liquidity risk requires constant diligence to ensure that consumers are not adversely impacted if max lapsation occurs on products and an insurer’s assets are not sufficiently available to fund such scenarios.

While the focus of this letter is primarily on the regulatory framework for capital charges, we also support the NAIC continuing other ongoing initiatives that look at asset management and other fees, and asset transfer mechanisms beyond structuring.

Life Insurers play an integral role in the U.S. economy, and we can all agree that being able to confidently keep the long-term promises made by the industry requires continued strong capitalization and robust tail risk capital management. The U.S. life industry today is healthy and vibrant, having raised through retained earnings and other sources over \$100B of capital over the past 10 years to secure and support the insurance needs of the customers and communities we serve.⁴ It is necessary for regulators to consider how the insurer investment regulatory framework should evolve to make sure solvency regulations are appropriate—we understand that doing so was always contemplated by regulators as a second phase to the recent C-1 Bond factor work.

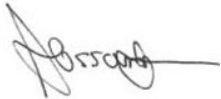
⁴ Statistic derived from S&P Global Market Intelligence and SNL Financial Data based on historical Statutory Capital & Surplus.

In conclusion, we applaud regulators for taking proactive steps to respond to the shifts in insurer investment strategies and we strongly support the NAIC efforts to undertake a holistic review. Targeted updates of the insurance investment framework will ensure that the industry can continue to serve consumer financial needs in any economic environment. Thank you for your consideration of our viewpoints.

Sincerely,

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Vibhu Sharma
Executive Vice President and Chief Financial Officer
Pacific Life Insurance Company

A handwritten signature in black ink, appearing to read "Alessandro Papa", with a horizontal line extending to the right.

Alessandro Papa
Executive Vice President and Chief Risk Officer
Pacific Life Insurance Company

Memo

To: Elizabeth Kelleher Dwyer, Chair, Financial Condition (E) Committee

Cc: Dan Daveline

From: Tricia Matson, Partner and Edward Toy, Director

Date: September 15, 2023

Subject: RRC comments regarding the Framework for Regulation of Insurer Investments

Background

The Financial Condition (E) Committee exposed a document on August 15 for comment entitled “Framework for Regulation of Insurer Investments – A Holistic Review”. RRC appreciates the opportunity to offer our comments. Should you have any questions, we would be glad to discuss our comments with you and the committee members.

RRC Comments

We begin by acknowledging several key elements.

- The investments and investment practices of U.S. insurance companies have evolved significantly over time. While bonds continue to be the predominant asset type, structures are more complicated. Other asset types have increased in importance, including different subcategories.
- The markets in which U.S. insurance companies must operate have grown increasingly complex and volatile.
- These two factors in combination, along with changes in the liability structure of insurance companies, mean significantly different risk profiles than insurance regulators needed to deal with in the past.
- It is important that the regulatory approach for oversight evolve to meet these challenges.
 - This new approach must be holistic, considering the entire portfolio of the insurance company and reflect appropriate attention to what should be the primary focus of insurance regulators, the liabilities of the insurance company and its ability to meet policyholder claims.
 - This new approach should take advantage of efficiencies that are available, including making the best use of existing resources.
 - This evolution will require new tools and new resources that may not currently be available within the NAIC or state insurance departments.

Our remaining comments are general thoughts on considerations for future enhancement, rather than specific, prescriptive suggestions on the appropriate next steps since this work is still in an early stage of development.

Reliance on Rating Agencies and the Role of the NAIC’s Investment Analysis Office

The Effectiveness and Efficiency Project, resulting in Filing Exempt (FE) status for most of the industry’s bond holdings, was adopted many years ago to improve on the process. The goal was to eliminate the administrative burden of translating nationally recognized statistical rating organization (NRSRO) ratings and reallocate those resources to more critical and valuable analysis.

There is a degree of judgement involved in rating investments and rating agencies can have different approaches to assessing the risk of default of a bond. Trying to make a direct interpretation across rating agencies is difficult. Because of this, we believe that it is not the best use of the NAIC's resources to focus on a relatively small number of differences in ratings for a given asset class or asset type. We encourage the NAIC instead to engage in a robust dialogue with each of the rating agencies about the process and approach that they have for each asset class. Are the procedures robust and well documented? Is there good tracking of ratings changes over time, sometimes referred to as transitions matrices, to ensure reliability? If the regulators are convinced that the process being followed is not robust or otherwise does not meet their needs, they can consider making an appropriate adjustment to the translation formula for those asset types, asset classes or for the individual rating agency. When material concerns are surfaced, regulators have tools at their disposal while a more thorough review of the rating agency's process is undertaken. The NAIC's Valuation of Securities Task Force can expose the concerns at one of its meetings and has the ability to implement an interim change in guidance until a more thoroughly vetted approach can be agreed upon.

Regulators have always retained the right to determine that a rating agency's process is not reliable. This regulatory authority must continue to be taken seriously. It should be based on robust reasoning that is well documented. We believe decisions to not follow the current formula should not be based on differences in individual ratings but on an assessment of the process. Any decision should be based on a thorough analysis of the process being employed, why it is not appropriate, and be well documented. Transparency to all insurance companies (so that problems and issues can be properly monitored and managed) and to the market is paramount to avoid confusion and disruption.

Broadening the NAIC's Analysis of Investments and Portfolios

U.S. insurance company portfolios are very different today than they were 20 or 30 years ago. For example, RRC has noted overall growth in Mortgage Loan exposures, not just among Life insurance companies, but also in the portfolios of Property & Casualty insurers. More significantly, some of that growth has not been in the more traditional lending to stabilized commercial properties but has been on residential properties and for construction loans. There has also been growth in Investments Reported on Schedule BA including, especially, Collateral Loans.

In addition, the market environments have changed. After a prolonged period of low interest rates, interest rates are much higher and may continue to be. This very likely has impacted investment strategies in ways that may not have been anticipated. There are increasing regulatory concerns about liquidity in the markets and liquidity policies and strategies of insurance companies.

We encourage the NAIC to expand guidance beyond bonds. However, we also encourage the NAIC to look beyond credit risk. Credit risk has been a historic focus. While this should always be a concern, market risk and liquidity risk have increased dramatically due to substantial changes in investment practices. Actuarial Guideline LIII is an example of steps already being taken. We also acknowledge the work of the NAIC's Statutory Accounting Principles Working Group with its Bond Definition Project and the Capital Adequacy Task Force and its creation of the RBC Risk Evaluation Ad Hoc Group. We believe further regulatory enhancements would be beneficial.

Market risk and liquidity risk are very different from credit risk. Portfolio analysis, which may be considered a combination of all three risk assessments, is entirely a different skill. We advise caution and careful consideration be given to how to deal with these tasks from a regulatory perspective. It is quite likely that these will require different people, different tools and a different approach. We strongly encourage the NAIC to engage with the appropriate experts in how this should be taken on, including potentially bringing in outside advisors to complete a top to bottom assessment of what is needed.

We commend the regulators for what has been a robust and effective process to date, resulting in minimal problems from investments within the insurance industry. However, we believe that the more recent increase in risk in insurers' investment portfolios indicates a need for improved regulatory processes and tools.

Thank you for the opportunity to provide comments on this important initiative. We can be reached at tricia.matson@riskreg.com (860) 305-0701 and edward.toy@riskreg.com (917) 561-5605 if you or other committee members have any questions.



October 6, 2023

NAIC Financial Condition (E) Committee
Dan Daveline, Director, Financial Regulatory Services
RE: Framework for Investments Exposure Draft

Dear Mr. Daveline:

The Structured Finance Association (SFA) appreciates the work of the Financial (E) Committee of the National Association of Insurance Commissioners (NAIC) to conduct a holistic review of its regulatory approach to insurer investments.

The SFA has been actively reviewing and commenting on recent proposals from various NAIC task forces and working groups, including:

- A [response](#) to the Proposed Methodology for Valuing Collateralized Loan Obligations (CLOs) from the NAIC's Valuation of Securities Task Force.
- A [response](#) to the Proposed Interim subcategories within NAIC Category 6 from the Risk-Based Capital Investment Risk and Evaluation Working Group.
- A joint trade [response](#) on Proposed Amendments to P&P Manual for Discretion over NAIC Designations.

In these responses, the SFA has noted instances where there have been differing views among its members on the intent and substance of the proposals and the anticipated business impact. Notwithstanding these differences, our members have consistently agreed that improved transparency regarding process, access to more data, and a better understanding of the expected aggregate impact of these regulatory proposals will lead to better outcomes.

The holistic framework articulates a principles-based approach to organizing the Financial (E) Committee's regulation of insurer investments. The review offers a more risk-focused framework that balances the need for effective regulation against a recognition that resources are limited.

Provided that the NAIC leverages the holistic framework to improve its regulatory engagement process, we believe it will help ensure that insurance companies can continue to rely on asset-backed securities as a vital source of investment opportunities.

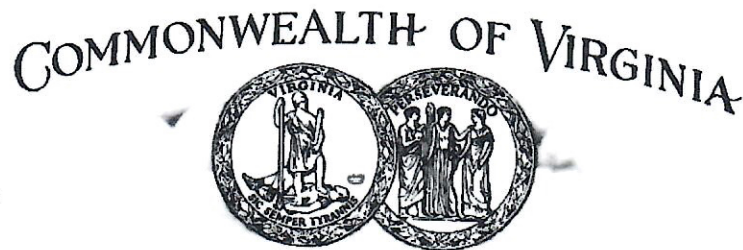
The SFA appreciates this opportunity to comment on the holistic review and looks forward to providing feedback on future regulatory proposals issued under this new approach.

Sincerely,

A handwritten signature in black ink, appearing to read "Dallin Merrill", positioned above a horizontal line.

Dallin Merrill

Senior Direct, Policy



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COMMISSIONER OF INSURANCE
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October 6, 2023

The Honorable Elizabeth Kelleher Dwyer, Chair
The Honorable Nathan Houdek, Vice Chair
Financial Condition (E) Committee
c/o Dan Daveline
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106

Re: Comments on the Framework for Regulation of Insurer Investments

Dear Superintendent Dwyer and Commissioner Houdek,

The Virginia Bureau of Insurance ("Bureau") appreciates the ability to offer its comments on the Framework for Regulation of Insurer Investments (the "Framework") released by the Financial Condition (E) Committee after the Framework's exposure at the NAIC Summer National Meeting in Seattle. The Bureau recognizes the importance of the issues that the Framework seeks to address.

The Bureau generally supports the concepts presented in the Framework. The Bureau does not question the need to review the operations of the NAIC's Securities Valuation Office ("SVO") in light of the drastic changes in insurers' investments over the past few decades; however, the Bureau encourages the Committee to keep financial solvency as the primary focus of the Framework as it moves toward potential adoption and implementation. The Framework's stated "guidelines" focusing on the consideration of market disruptions or other direct or implied market impacts are important regulatory concerns but must remain secondary to sound solvency regulation.

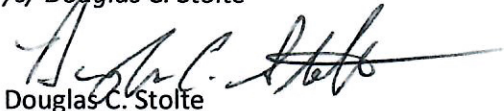
With solvency as the primary focus, the Bureau supports the Framework's commitment to not pause the current NAIC workstreams related to insurer investments. Pausing the current workstreams or work that evolves from them raises concerns in particular that RBC factors will not appropriately reflect the risk of recently-emerging complex assets, weakening the RBC framework as a useful tool in solvency regulation.

The Bureau finds that implementing many of the concepts of the Framework will provide benefit to regulators. For example, enhancing the SVO's capabilities to better understand credit rating provider ("CRP") ratings, those ratings' impact on financial solvency, and engaging in ongoing due diligence of the CRPs has the potential to improve solvency regulation. The SVO's many enhancements, as outlined in the Framework, should allow the NAIC and its member states to make smart decisions in responding to current and future changes to the macroeconomic and insurer investment landscapes.

Please do not hesitate to reach out with any questions.

Sincerely,

/s/ Douglas C. Stolte

A handwritten signature in black ink, appearing to read "Douglas C. Stolte", with a long horizontal flourish extending to the right.

Douglas C. Stolte
Deputy Commissioner