Framework for Regulation of Insurer Investments – A Holistic Review

Executive Summary

- Recent initiatives to address gaps in the regulatory framework for insurer investments have received much attention by a variety of stakeholders.
- While the broader commentary has included many misconceptions around these initiatives, it has also included constructive feedback with themes and observations that many regulators have shared.
- At the most basic level, the question has arisen – **what is the most effective use of regulatory resources in the modern environment of insurance regulation for investments?**
- The historical focus of the SVO has been on risk assessment of individual securities, with filing exempt securities blindly reliant on credit rating providers (CRPs) for designations.
- The SVO currently lacks the tools to provide due diligence and assessment over the use and effectiveness of CRPs, or to conduct enterprise- or industry-wide risk analytics.
- Rather than a framework that utilizes valuable SVO resources to prioritize synthesizing CRP functions, a more effective use of those resources would be to prioritize the establishment of a robust and effective governance structure for the due diligence of CRPs.
- Further, with investment in modern risk analytics tools, the SVO could provide invaluable risk analysis capabilities to better support the risk-focused approach to supervision, at both a micro- and macro-prudential level.
- This memo provides concrete proposals envisioning a modernization of the role and capabilities of the SVO in a way that correlates with the observed shift towards more complex and asset-intensive insurer business strategies.
- It also provides high-level guidelines for considering consistency of capital across assets as the investment RBC initiatives move forward, recognizing the practical limitations of absolute capital parity.

Background

The NAIC is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators of the 50 states, the District of Columbia and the five U.S. territories. NAIC Designations are produced solely for the benefit of NAIC members in their capacity as state insurance regulators as a tool to help assess insurer's solvency.

There are several workstreams underway related to investments, which are meant to address a material, observable shift in insurer investment strategies – primarily but not limited to life insurance/reinsurance – toward more private assets, more structured assets and more complex assets. The workstreams are not meant to be punitive for the sake of being punitive, or to discourage innovation in insurers' investment strategies, but they recognize existing frameworks did not contemplate these investment strategies and will need to be enhanced to appropriately incorporate their characteristics into the regulatory framework.

While this goal is largely accepted by all interested parties as being necessary, the details of various proposals and the processes by which they have been undertaken have received an immense amount of attention from industry, other supervisory stakeholders and special interest groups, with stark divides in approval or disapproval of various initiatives. The collective commentary has included a significant amount of constructive feedback and valid critique, but has also been marked by misconceptions and competitive dynamics.

Recent comments have referred to these projects as "piecemeal" and "disjointed" and recommended a pause to all such workstreams. Others have suggested that these efforts are motivated by objectives other than enhancing regulators' ability to protect policyholders. In reality, what is being observed is the natural strain that results from solving complex problems through open and democratic processes.

Purpose

While much of the characterization of these ongoing projects in the broader commentary is misplaced, it is prudent to reflect periodically on a holistic basis over the course of a complex project to evaluate potential areas for process improvement to the overall regulatory framework. **The intent of this memo is to highlight areas that regulators have identified where the insurance regulatory framework for investments could be enhanced based on reflections on the past several years of work on these issues, as well as comments on individual current initiatives and how they could be improved upon by addressing certain of the challenges described above.** This memo is not directly responsive to any particular feedback from stakeholders, but draws upon the experience of regulators involved in these workstreams, as well as comment letters written on current proposals, stakeholder communications not directly related to working group exposures, and ongoing conversations among regulators and stakeholders.

Proposed Regulatory Enhancements

The goal of the Framework and its proposed enhancements is to set a long-term, strategic direction for investment regulation and ensure current and future initiatives are thoughtfully coordinated and supportive of this holistic direction. A workplan will be utilized to further consider such proposed enhancements in more detail and where appropriate, changes will be made to this to reflect the final enhancement. The Framework does not have an objective of reaching technical conclusions on ongoing initiatives. Ongoing work will continue without delay or pause. Current workstreams are directionally consistent with the Framework and are producing iterative feedback that will inform future progress towards their objectives. As is always the case, workstreams and the Framework itself are subject to future refinement based on this iterative process of incorporating new information.

This Framework will be updated and retained in the future, but the following principles are expected to remain in place after the implementation of the work.

Core Principles

(1) The goal of the Framework is to set a long-term, strategic direction for investment regulation and ensure current and future initiatives are thoughtfully coordinated and supportive of this holistic direction. It does not have an objective of reaching technical conclusions on ongoing initiatives.
(2) The primary objective of the Framework and all supporting initiatives is to ensure state insurance regulators have appropriate tools to ensure the solvency of insurers. While other impacts will be

assessed in the design and implementation of current and future initiatives, they will be secondary to ensuring insurer solvency.

(3) Ongoing work will continue without delay or pause. Current workstreams are directionally consistent with the Framework and produce iterative feedback to inform future progress toward its objectives. As is always the case, workstreams and the Framework are subject to future refinement based on this iterative process of incorporating new information.

(4) Initiatives are, and will continue to be, regulator-driven. Any enhancements to centralized resources are for the benefit of regulators, and regulators will retain the authority over how to use such resources.

(5) This work plan commits to being fully transparent, with multiple checkpoints for deliberation with interested parties.

(6) The ultimate responsibility for prudent investment oversight is with the insurers themselves, notwithstanding any of the work done to bolster regulatory resources and oversight over-reliance on credit rating providers (CRPs). This responsibility should not be "outsourced" to CRPs or the regulators.

A. Investment risk assessment / role of a centralized investment expertise function (e.g. SVO: IAO/SSG)

Currently, risk-based capital charges rely upon NAIC Designations for assets reported as bonds, with limited risk assessment for non-bond holdings. NAIC Designations are either provided directly by the SVO for filed securities or by a direct translation of a credit rating from a Credit Rating Provider ("CRP") for those securities that are exempt from filing ("FE"). There is currently a "blind" reliance on the CRP rating, with no mechanism for overall due diligence around CRP usage, nor an ability to challenge an individual rating for not conforming to regulator expectations of how it was determined. Both of these issues are potentially addressed through current initiatives of the Valuation of Securities Task Force ("VOSTF"), with multiple challenges and concerns (both warranted and unwarranted) of how they may be implemented.

Proposed Framework to modernize the SVO:

(1) Reduce/eliminate "blind" reliance on CRPs but retain overall utilization of CRPs ***with the implementation of a strong due diligence framework***. This framework should be extremely robust with focused resources within the NAIC in its implementation and maintenance. This initiative should be a ***primary*** focus of the NAIC and ***utilize an external consultant/resource to design & implement***. It is both inefficient and impractical for the SVO to effectively replicate the capabilities of CRPs on a large scale, and would not provide incremental benefit if the output is substantially similar. Rather, the SVO should focus primarily on holistic due diligence around CRP usage. That process must be vigorous and consequential (e.g. clear quantitative and qualitative parameters for CRPs utilized to provide ratings for use as NAIC designations).

(2) ***Retain ability*** within the SVO to perform individualized credit assessment 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.

(3) ***Enhance SVO's portfolio risk analysis capabilities*** with investment in a risk analytics tool and corresponding personnel, which could perform both company-specific risk analytics at the request of regulators, and industry-wide risk analytics for use in macroprudential efforts. ***Review/***

increase staffing to include analysts with investment actuarial and risk management backgrounds that can provide dedicated investment-related support to risk-based capital and reserving teams, understanding the key functions of asset-liability management and resulting portfolio impacts. Changes to this centralized investment expertise at the NAIC will be determined based upon the needs of regulators.

(4) ***Enhance structured asset modeling capabilities*** in line with #3 with less focus on individual designation production, but in support of the CRP due diligence function (can provide tools for validation of CRP designations), company and industry stress testing, and emerging risk identification. Provide additional resources to SSG to continue to build this capability, inclusive of ***model governance*** and validation of key parameters.

(5) ***Build out a broad policy advisory function*** at the SVO that can consider and recommend future policy changes to regulators under a holistic lens, considering input from all impacted processes. If needed, ***hire key external consultants*** to be on retainer to provide key guidance on policy related issues, assess market impact and provide recommendations. This would be akin to the use of the Academy of Actuaries or similar for risk-based capital and reserving initiatives.

(6) Consider establishing a ***broad investment working group*** under E committee that acts in an advisory capacity to various investment processes that would ultimately need more intensive regulator engagement and analysis on confidential basis (similar to FAWG/VAWG), including (1) review of bond reporting analysis under the principles-based bond definition, (2) challenges to individual designations provided by CRPs, (3) review of work provided by external consultants for investment-related projects for broad impacts to the framework (beyond the group that would have commissioned the review)

(7) If the multitude of the above recommendations are implemented, rename the SVO and VOSTF to better reflect the responsibilities of the groups beyond securities valuation. ***Empower SVO*** to utilize the tools and analysis available to raise key issues to other applicable working groups, such as SAPWG or LATF (or RBC-IRE, but also noting key support for that group via an investment-focused actuarial team). ***Reduce the size*** of VOSTF membership or its successor to encourage active regulator engagement on core issues.

Impacts of Proposed Framework on Current Initiatives:

VOSTF:

(1) CRP Due Diligence: Re-prioritize this initiative (currently in place with limited resources) and retain an external consultant to build out the framework. Allow for engagement with CRPs in its creation.

(2) Regulatory Discretion over CRP designations: Continue deliberative process on this existing proposal to incorporate interested parties' constructive feedback on framework.

(3) CLO/RMBS/CMBS Modeling: Review output in conjunction with the Academy of Actuaries and RBC-IRE to determine if (1) NAIC designations, (2) dynamic ad hoc modeling/stress capabilities or (3) a combination of both, are the most valuable use of SSG resources, noting the request above to provide additional resources to this group.

LATF:

(1) SVO Staff enhanced as suggested above could be an additional resource in AG 53 type reviews, and may be able to provide validating analysis via its analytical tools.

(2) Investment actuarial staff can provide key recommendations to enhancements to asset adequacy testing based on investment characteristics identified.

SAPWG:

(1) No direct impact to implementation of the bond project outside of establishment of a working group that can assess specific assets for reporting purposes.

RBC-IRE:

(1) Increased investment actuarial and risk management could provide key support to establishment of structured asset RBC factors given the cross-functional understanding of investments and RBC parameters.

B. Risk-Based Capital for Investments

The project to review RBC factors for investments remains ongoing but has made considerable strides with the formation for the RBC-IRE Working Group in 2022 and the engagement of the American Academy of Actuaries to begin developing factors for CLOs. As this project moves forward, the following guidelines should be considered:

(1) **Secondarily to the emphasis on ensuring insurer solvency, changes in RBC factors should consider market impacts and consistency across asset classes in** in determining when and how to implement such changes. While perfection under a principle of "Equal Capital for Equal Risk which includes consideration of tail risk" is likely unachievable, it should nevertheless be a goal to create consistent standards to the highest degree practicable. For example, the current work at RBC-IRE is appropriately beginning with studying CLOs for developing RBC factors for structured securities. It is possible that new factors for CLOs would be available before a determination has been made for how to extrapolate a framework to other types of structured securities. As the phases of this project progress, care should be taken to consider the impacts of changing factors for an asset class while similar asset classes may remain unchanged. Factors to consider may include impacts to asset allocation and financial markets, in balance with the level of urgency of regulatory action.

(2) The RBC-IRE Working Group should consider and address areas where inconsistencies in treatment across asset classes ***incentivize a particular legal form***. The RBC-IRE Working Group should coordinate with the SAPWG where needed on this item. A key example of this is private credit funds, where the underlying assets are fixed income, but regulatory barriers frequently prevent them from receiving a fixed income capital charge, instead assigning an equity factor. This requires insurers to structure such investments into bond-form through securitization in order to receive a fixed income charge, which may ***"overcorrect"*** and lead to ***capital arbitrage***. Developing an avenue for such assets to receive a capital charge commensurate with the underlying asset risk would significantly reduce the need to form structured securities out of many types of private fixed income assets.

NAIC WG/TF	NAIC Identifier	Topic	Subtopic	Purpose of Purposed Work	Committee Consideration	Exposure Date	Targeted Effective Date	Most Recent Update
RBC Investment Risk and Evaluation (E) Working Group	IR4	Comprehensive Fund Review for investments reported on Schedule D Pt 2 Sn2		Review inconsistencies across asset classes based on legal form	Added to working agenda on 11/16/18 call			Pending completion of other work
RBC Investment Risk and Evaluation (E) Working Group	IR5	RBC for ABS including CLOs, CFOs or other similar		Long-Term Different RBC Requirement	Committee made request 1/12/22			American Academy Update Expected Quarterly
RBC Investment Risk and Evaluation (E) Working Group	IR7	Evaluate and develop an approach to map other ABS to current bond factors. Project will likely require outside consultant.		Long-Term Different RBC Requirement	Committee made request 1/12/22			Pending completion of other work
RBC Investment Risk and Evaluation (E) Working Group	IR8	Address the tail risk concerns not captured by reserves for privately structured securities		Long-Term Different RBC Requirement	Added to working agenda on 8/11/22 call (Referral from Macroprudential)			Pending completion of other work
Valuation of Securities (E) Task Force	VOSTF 2023-005	Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process		Reduce Reliance on Rating Agencies	Proposal addresses charge from the Committee from 2021	07/26/24		06/18/24
Valuation of Securities (E) Task Force	VOSTF 2024-007	Implement financial modeling of CLOs for purposes of designations		Reduce Reliance on Rating Agencies / Enhance Structured Asset Modeling Capabilities	Coordination with related workstream IR5 at RBC-IRE		1/1/2025 (but subject to finalization of methodlogy and coordination with RBC-IRE)	6/18/24 - Effective date change adopted
Financial Condition (E) Committee		Draft Request for Proposal to develop a dilligence process related to use of rating agency ratings		Address proposal from Investment Framework	Drafted by Valuation of Securities Task Force and Committee regulators			

INVESTMENT FRAMEWORK
RECOMMENDED WORK PLAN FOR THE FINANCIAL CONDITION (E) COMMITTEE

In early 2024, the Committee formed a drafting group, which, among other things, developed this work plan to guide the implementation of the Investment Framework.

NOTE: This work plan is intended to be a working document. Additional action plans may be added, and current action plans may evolve as more information becomes available. The drafting group will provide updates to the Committee, including the work plan, on a regular basis.

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Action Item #1

The drafting group will propose updates to the exposed Framework to the Committee as deemed appropriate. The Committee will re-expose the Framework for comment and further discussion at the next NAIC national meeting or an interim or virtual meeting as deemed appropriate. The Committee will engage in public discussion. Avoiding any perception of the drafting group not being all-inclusive is emphasized.

The updates to the Framework may be somewhat minimal at the beginning of the process. The drafting group anticipates the ultimate Framework will be the ongoing foundation of principles for investment oversight and less of an "action plan" as it exists today.

Action Item #2

The Committee received approval from the NAIC Executive (EX) Committee at the 2024 Spring National Meeting to develop a request for proposal (RFP) to hire an independent consultant to provide recommendations for a due diligence framework for CRPs.

- The NAIC is currently working to consider such a framework by hiring a consultant. We note that the selection of a consultant needs to consider potential conflicts with CRPs or industry.
- The consultant would deliver a comprehensive recommendation/request for the Committee to consider.

Action Item #3
Consistent with the commitment not to pause or delay any of the current workstreams, the Committee will ensure implementation of the Framework in parallel and without interference with the work that the Valuation of Securities (E) Task Force and the Risk-Based Capital Investment Risk and Evaluation (E) Working Group are developing related to the Framework. This work being completed by these groups (workstreams) is directionally consistent with the Framework. Therefore, the Committee will continue to defer to the workstreams as they progress toward and reach outcomes. Further, the workstreams must not slow their progress in waiting for the Framework's finalization. For example, the Valuation of Securities (E) Task Force is deliberating potential changes to regulator discretion over CRP ratings. The Framework's consideration of a due diligence framework over CRPs must not alter or impede any changes being considered or adopted by the Valuation of Securities (E) Task Force to CRP ratings.

Action Item #4
The Committee or the drafting group will begin an assessment of a conceptual centralized investment expertise (CIE). This term purposely differs from references to NAIC investment staff currently used, such as the Investment Analysis Office (IAO), Structured Securities Group (SSG), and SVO. While we expect much overlap between those existing organizations and this conceptual organization, we want to be deliberate when referring to a conceptual outcome.

Following are examples of initial discussion points (regulator- and comment letter-driven, but not exhaustive):

- Conducting a survey of all states, asking what output they would like from a CIE to assist in individual insurer examination/assessment. For instance, how could current portfolio reviews be improved?
- Investment risks that should be incorporated into a CIE. The current SVO is predominantly focused on credit risk in terms of a designation assessment for Schedule D investments.
- The enhancement of macroprudential and prospective risk capabilities.
- The ideal structure of a CIE, focusing on overarching holistic regulatory policy advisory staffing supported by strong capabilities in credit assessment, portfolio/market risk, asset adequacy, and macroprudential risk assessment.
- The enhancement of structured asset modeling capabilities to support due diligence, validation, and stress testing.
- Tools and resources (beyond personnel) that should be considered.
- The establishment of standards for validating tools and processes, including periodic assessments, model governance, etc.

Discussions should include open dialogue with interested parties.

An external consultant resource can be considered to add additional independent expertise.

This will and should be a longer-term initiative to ensure robust dialogue and value-added changes. However, regulators should consider phased implementation to have more timely results and manage costs.

Action Item #5
The drafting group will recommend appointing an investment-focused working group to support the Committee, the Financial Analysis (E) Working Group, the Valuation Analysis (E) Working Group, and other working groups.

- Define potential charges for this working group, which will help identify the appropriate time for formation. For example, charges may include support for initiatives not slated until 2025 or later.

Action Item #6

The drafting group will develop and implement best practices for enhanced coordination between the Committee's workstreams. Such efforts to harmonize efforts may involve regular reporting to the Committee and/or this new investment-focused working group, identification of dependencies and impacts between projects, and fostering improved communication between workstreams. These types of best practices can be informed by the work on the collateralized loan obligation (CLO)-related projects in process within the Valuation of Securities (E) Task Force and Risk-Based Capital Investment Risk and Evaluation (E) Working Group, including current efforts to highlight the coordination between the two during progress updates.

Action Item #7

The work plan will continue to review appropriate incorporation of risk-based capital (RBC) recommendations into the final Framework. However, at this time the work plan does not include related action items and will continue to review inclusion in a future iteration.