What's next for the rules that govern insurers' investments:

Developments from the NAIC's 2024 Spring National Meeting

Spring 2024

Synopsis:

Regulators continued their efforts to refine the rules to align with insurers' shifting investment strategies more closely at the NAIC 2024 Spring National Meeting in Phoenix. At its core is an aspiration of achieving "equal capital for equal risk," which is no easy task considering the framework's interconnected components that govern insurers' investments. There were significant developments on multiple fronts, including:

- Changing the classification and valuation of investment across the categories of insurers' investments whose risk characteristics can vary significantly. This includes the debt and residual interests of asset-backed securities (ABS).
- Addressing concerns over 'blind reliance' on agency ratings in NAIC Designations, which help oversee hundreds of thousands of debt instruments worth $trillions of insurers' debt investments. Designations aspire to consistently rank order credit risk, which is argued to be challenged by agencies that use different methodologies and standards.
- Differentiating capital for structured assets and ABS's residual interests, including investment vehicles. While structured products are argued to provide attractive risk-adjusted returns, the products are complex, and establishing the appropriate capital requirements for such products requires a deep understanding of their nuanced risk-mitigating features and performance.
- Moving forward with the Financial Condition (E) Committee's long-term aspirations of modernizing the NAIC's investment oversight framework.

This report reviews these recent developments, their potential implications for investment strategy, and what might happen next.

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

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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 complex regulations across jurisdictions using disparate language and varied rulemaking processes. The platform is used by insurers' investment, risk, compliance, legal, government affairs, accounting, and reporting functions and their regulators.

- **ART Newsreels** weekly emails alert users of the changes to the investment landscape, including NAIC, state investment guidelines, and global activities packaging, and deliver 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, state investment guidelines, and global activities. It allows you to quickly log in and find out the latest updates, next steps, and any deadlines associated with respective investment activities. The Outlook plugin will keep your calendars updated.
- **ART System** provides users access to codified state investment guidelines in a searchable and understandable format.
- **ART Investment Classification (beta)** assists with the classification of assets, which includes requirements under the principles-based bond definition, including possibly heightened reporting requirements.

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1 Executive summary

Regulators continued their efforts to refine the rules to align with insurers' shifting investment strategies more closely at the NAIC 2024 Spring National Meeting in Phoenix. At its core is an aspiration of achieving "equal capital for equal risk," which is challenging considering the interconnected components of the NAIC investment oversight framework. This report summarizes the core aspects of the changing landscape governing insurers' investments, distilling the nuances and details, and presents what matters most.

Core aspects of the changing landscape governing insurers' investments:

- Changing the classification and valuation of investment across the categories of insurers' investments whose risk characteristics can vary significantly. This includes the debt and residual interests of asset-backed securities (ABS).
- Addressing concerns over 'blind reliance' on agency ratings in NAIC Designations, which help oversee hundreds of thousands of debt instruments worth $trillions of insurers' debt investments. Designations aspire to consistently rank order credit risk which is argued to be challenged by agencies using different methodologies and standards.
- Differentiating capital for structured assets and ABS's residual interests, including investment vehicles. While structured products are argued to provide attractive risk-adjusted returns, the products are complex, and establishing the appropriate capital requirements for such products requires a deep understanding of their nuanced risk-mitigating features and performance.
- Moving forward with the Financial Condition (E) Committee's long-term aspirations of modernizing the NAIC's investment oversight framework.

What's driving these changes? Discussed extensively in our previous reports,[1] noticeable shifts in insurers' investment strategies toward private and structured assets, often with more complex characteristics, had the NAIC embark on significant multi-year updates to the RBC and STAT frameworks with revisions to classification (i.e., bonds and residual interests), the Designation process, reserving (e.g., Actuarial Guideline (AG) 53) and capital assignment (e.g., CLOs and ABS).

This report begins by breaking down 'in play' efforts to revise guidelines and then reviews developments with the E-Committee's long-term efforts to revise the investment oversight framework. The report explores potential implications for investment strategy and what might happen next. We conclude by highlighting what we are optimistic about.

2 In-Play Efforts to Revise Investment Guidelines

We now dive into the three initiatives: (1) Classification of debt and investment vehicles and their valuation; (2) Assigning Designations; (3) Differentiated capital for structured assets and their residual interests.

2.1 Classification of Debt and Investment Vehicles and their Valuation

2.1.1 Context

The principles-based bond definition was adopted at the 2023 Summer Meeting and will go live on January 1, 2025. The extensive multi-year effort covers a broad spectrum of investments, including those under SSAP No. 26—Bonds, and SSAP No. 43—Asset-Backed Securities (with subsequent SAPWG revisions). A bond is characterized, in spirit, as any security representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation or an asset-backed security. A security that possesses equity-like characteristics or represents an ownership interest in the issuer in substance does not represent a creditor relationship

[1] See, for example, Developments from the NAIC's 2023 Summer Meeting, The changing rules governing US insurers' investments: Capital requirements and the role of agency ratings, or Trends in the Ownership Structure of US Insurers and the Evolving Regulatory Landscape.

and is inconsistent with what is expected of bonds reported on Schedule D-1. The approach distinguishes between two types of bonds:

- **Issuer Credit Obligation (ICO).** A bond for which the general creditworthiness of an operating entity or entities through direct or indirect recourse is the primary source of repayment.
- **Asset-backed securities (ABSs)**. A bond issued by an entity (an "ABS issuer") created for the primary purpose of raising debt capital backed by financial assets or cash-generating non-financial assets owned by the ABS Issuer, for which the primary source of repayment is derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity.

In addition to security investments that qualify under the principles-based definition as issuer credit obligations, certain securities are also captured in the scope of this statement, including SVO-Identified Bond ETFs and SVO-Identified Credit Tenant Loans.

The definition for residual interests was also recently adopted, which are those of ABSs, as well as 'in substance' residuals held through investment vehicles (with guidance and definition soon to be centralized under SSAP No. 21 – SAPWG Ref #2024-08).

Why does this matter? Debt classified as a bond generally receives preferential treatment, including lower capital charges. In addition, residuals of ABS held by life companies, and soon likely health and property and casualty, will receive the more punitive interim 45% capital treatment beginning this year unless the industry proposes an alternative that regulators view as more appropriate. Equity interests of operating companies will continue to receive the 30% C-1 charge.

2.1.2 What to watch out for, and what's next?

- **The principles-based approach is precedence-based by its nature.** With insurers' investments having a broad spectrum of characteristics, it will take time to converge on the classification of bonds and ABS, as well as the full scope of their treatment.

- **Non-SEC registered funds, including feeder funds.** The classification of debt and equity or residual interests issued by non-SEC registered funds faces several open questions. In their current form, the definition and bond issue paper suggest that debt issued by a non-SEC registered fund would be classified, de facto, as that issued by an ABS, meaning a direct investment in those funds would be classified as a residual. Specific references include:
    - Debt issued by CFOs is possibly classified as ABS when the pool of funds is highly diversified and overcollateralized. (19 and 32c)
    - Bonds issued by business development corporations, closed-end funds, or similar operating entities registered under the 1940 Act classified as ICOs. It proceeds to qualify that the intent of classifying them as ICOs is specific to bonds issued from SEC-registered entities. (32c)

  SAPWG proposed revisions to the bond definition and the draft issue paper, clarifying that debt issued by non-SEC registered funds would not de facto be treated as debt issued by ABS. Thus, investments in the fund would not de facto be treated as residual interests of an ABS. This is significant given the more punitive capital treatment of residual interests held by life companies and likely future treatment of residuals held by health and property and casualty insurers. The revised language removes SEC registration requirements for debt issued by a fund to be classified as issuer credit obligation of an operating entity. The revisions included guidance with determining whether a fund represents an operating entity, and the issue paper guidance continued to identify that collateralized fund obligations (CFOs) and other similar structures would be required to be assessed as ABS to determine if they qualify for bond reporting.

  Feedback and questions received by NAIC staff indicated the need for further refinements to the definition and issue paper. Staff noted that some interpreted the proposed guidance to permit debt issued from feeder funds to be

classified as issuer credit obligations (ICOs). In contrast, the guidance, in its current form, suggests that if the debt were to qualify as a bond, it would be that of an asset-backed securities (ABS). The delineation is significant, given the resulting classification of the funds' equity or residual interests.

- **What's next?** SAPWG requested comment on the bond definition under SSAP No. 26R (Ref #2024-01) through May 31, 2024, with a request for:
    - Language to better define the extent of debt that may be issued to fund operations.
    - Language on the scope of guidance and types of debt securities issued by funds that should be considered operating entities rather than ABS.

- **The treatment of debt that does not comply with the bond definition** (Ref #2019-21, SSAP 21R). SAPWG adopted revisions to the treatment of debt instruments that do not meet the bond definition. Those assets will be filed under Schedule BA, and only NAIC-based Designations will be acceptable, with agency rating-based Designations prohibited. An example is provided of a debt security that relies on the underlying collateral retaining its value to repay the debt (e.g., through the sale of collateral or refinancing), may not qualify to be reported as a bond such as non-cashflow-producing real estate at a 50% loan-to-value. While it would not qualify to be reported as a bond, its characteristics are consistent with that of a mortgage loan and may warrant a fixed income RBC charge.
    - **It is noteworthy that only life companies would receive RBC reductions** for reporting debt with SVO-assigned NAIC Designations on Schedule BA. The provision is intended to apply only to those entities until/unless the Capital Adequacy (E) Task Force (CATF) and related RBC Working Groups incorporate changes to provide those capabilities to non-life entities.
    - **What's next?** The adoption is effective in 2025, with the bond definition and early adoption allowable for residuals.

- **Revisions to the valuation of residual interests** (Ref #2019-21, SSAP 21R). SAPWG adopted revisions to the valuation of residuals that will now be reported at the lower of "adjusted cost" or fair value.[2] The proposal incorporates the "Effective Yield with a Cap" along with the "Cost Recovery Method," whereby cash flows shall be treated as a return of principal, reducing the adjusted cost. Under the "Cost Recovery Method," distributions are not recognized as interest or investment income until the residual tranche has a book adjusted carrying value (BACV) (adjusted cost basis) of zero, which is not standard and more conservative but is less onus than the "Effective Yield with a Cap," which is argued to require extensive non-automation work. Under the "Effective Yield with a Cap," BACV represents the acquisition cost, net of distributions in excess of the Allowable Earned Yield. Allowable Earned Yield, established at acquisition, is the discount rate that equates the initial best estimate of the residual's cash flows to its acquisition cost and other-then-temporary impairments (OTTI).
    - **What's next?** The adoption is effective in 2025, with the bond definition and early adoption allowable.

2.2 Revisions to the Definition of Designations and the Use of Agency Ratings

A desire to move away from 'blind reliance' on agency ratings has regulators initiate several related and evolving initiates, including three that were deliberated over at the Valuation of Securities (E) Task Force (VOSTF) 2024, Spring National Meeting: **(1) Revisions to the definition of NAIC Designations, (2) Procedures for establishing criteria to permit staff's discretion over agency-ratings based Designations, and (3) NAIC model-based Designations for CLOs**. **In parallel, (4) the E-Committee is petitioning for the development of a request for proposal (RFP) to engage a consultant that would design and help implement a new process under which the NAIC develops a strong due diligence program over the ongoing use of agency ratings.** The effort is very much in line with recent postings from the E-Committee, which had formed a Drafting Group of regulators and Workplan for its proposed Framework for the Regulation of Insurer Investments.

The initiatives have significant potential implications, and there is a consensus among market participants and regulators for the improvement needed in using agency ratings for regulatory purposes. However, a spectrum of approaches has been

[2] Reductions in fair value below adjusted cost are reported as an other-than-temporary impairment (OTTI).

proposed, each of which can have a broad set of varied implications. The issues can be technical and nuanced, and we encourage interested readers to check out our report, Overseeing Designations and the Prudent Use of Agency Ratings. Let's dive in.[3]

2.2.1 A revised definition of NAIC Designations

2.2.1.1 Context

Defining NAIC Designations is critical in providing regulators and market participants clarity on the risks they measure and, thus, guidance on their use and limitations. If, for example, the definition deviates from that of an agency rating, there may be a resulting need to adjust a rating (e.g., notch) prior to its use in the Designation process.

Defining a Designation is no easy task, and several aspects of this effort remain contentious. 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. The definition is kept at a high level, with methodological details provided separately in technical documents. The current proposal (Attachments Two) reads as follows:

> *NAIC Designations... reflect the likelihood of timely and full payment of principal and scheduled periodic interest, in accordance with the regulatory objectives explained above, and the likelihood of principal and/or interest payment default. Where appropriate for a given investment, NAIC Designations shall reflect "tail risk" and/or loss given default. NAIC Designations and Designations Categories shall reflect the position of the specific liability in the issuer's capital structure and other non-payment risks or non-payment mitigants...*

2.2.1.2 What to watch out for, and what's next?

Commenters' oral statements and NAIC staff's response to key issues, including 'other non-payment risks' and 'tail risks' in the definition, lined up with written comments and responses (see meeting Material), with concerns raised over references to other non-payment risks and tail risks in the definition.

- **Other non-payment risks.** The proposed definition includes a need for Designations to reflect "non-payment risk," which has not been defined. However, references to Subscript S, which was part of the prior proposal and intended to delineate debt with 'non-payment risk,' have been removed. Commenters have raised concerns over the lack of clarity regarding the use, relevance, and understanding of 'non-payment risk,' with one letter noting that while Subscript S has been part of the process for decades, it has never been used as far as they are aware. One commenter provides a reminder of the completed SAPWG's "bond project," arguing that it identifies and deals with these risks, allowing for the definition of NAIC Designations to be simplified to reflect credit risk, thus aligning it with conventional risk measures such as reflected in agency ratings.
    - **NAIC staff response (paraphrased).**
        - NAIC should retain the ability to reflect that risk if it impacted insurers' likelihood of receiving cash payments, noting that two parties can agree with any manner of contractual terms, including receiving payment in different securities with different terms or receiving payment in other forms (e.g., Bitcoin, inventory, kilowatts, automobiles, or anything else agreed to in the contract). The existence of contractual terms inconsistent with the regulatory objectives (e.g., PIK or other deferrals of interest) could be reflected in an NAIC Designation if they are determined to impact the likelihood of principal and/or interest.

[3] For additional discussion, see Developments from the NAIC's 2023 Summer Meeting and Developments from the NAIC's Fall 2023 Meeting.

The SVO has the authority to assign NAIC Designations to all investments regardless of reporting Schedule, including debt that moves from Schedule D to BA that does not qualify as a bond but may receive favorable capital treatment if Designated by the SVO.

- **Our reaction**. For bonds reported under Schedule D, the examples noted by NAIC staff should be addressed in classifying debt as a bond under the new definition without needing to incorporate them into the definition of a Designation. Incorporating cumbersome and undefined language to cover debt failing bond classification and reported under Schedule BA seems unnecessary since the SVO will most likely oversee the methodology of assigning Designations for these assets.

- **Tail risks.** The proposed definition includes the need for Designations to reflect 'tail risk,' a concept not formally defined by the NAIC or in the definition of ratings under the SEC or rating agencies such as Moody's or S&P, which has commenters raise concerns. With the lion's share of Designations derived from agency ratings, deviating from definitions used by agencies can lead to confusion. Several commenters point to the potential for capturing duplicative risks (e.g., tail risk) if those risks are already captured and defined in, say, the risk-based capital factors.
  - **Our reaction**. We've previously explored different notions of tail risk, given the concept has been discussed increasingly, including Brett's unusually weedy [ART Newsreel | August 10, 2023](), In the Weeds. Regulators are rightly worried about the impact of extreme events on insurers, but several concepts often get conflated. In particular, the use of agency ratings, which in spirit rank order stand-alone expected credit risk, in the context of RBC, which is calculated based on the 96% loss (roughly 90% CTE). Agency ratings undoubtedly account for extreme events (e.g., AAA or AA defaults are extremely rare, with frequencies measured in single or fractional basis points). The rank order of stand-alone credit risk does not generally change if one focuses more on extreme tail events; AAA-rated corporate bonds will continue to be safer than those rated A. However, this is not to say that tail risk is the same across different asset classes with the same Designation, given differences in correlation, concentration, and recovery risks. Those differences are generally captured in the capital framework, as is the case with Solvency II and Basel, which permit the use of agency ratings. By incorporating capital-related metrics into Designations, the lines between the NAIC's three-legged investment oversight stool are blurred, complicating efforts to properly account for critical features such as correction and concentration risks within the RBC framework."

What's next? The Chair explained that the proposal is 'near final' and requested that the SVO continue working with interested parties to incorporate suggestions in a revised draft, which will then be posted for a 30-day public comment period and in time for deliberations at the 2024 Summer National Meeting.

2.2.2 Procedures for the SVO's discretion over agency-ratings-based Designations

2.2.2.1 Context

The proposal to extend staff discretion over agency ratings-based Designations is unchanged from the one deliberated at the 2023 Fall National Meeting (Attachment Three). Still, it is acknowledged to have evolved substantially since its inception. In line with postings from the E-Committee and related deliberations, regulators seem determined to incorporate a stop-gap oversight process as soon as practical, as a longer-term due diligence framework is structured. In its current form, the proposal would have an effective date of January 1, 2025, and would involve:

- **SVO discretion**
  - The formation of an SVO Senior Credit Committee (SCC) that determines whether a rating appears unreasonable and placed "Under Review," along with an information request informing insurers holding the security.

- If the SCC views the rating-based Designation as three or more notches different from its own opinion (i.e., Materiality Threshold), the rating will not be eligible for use in Designations.
- If an alternative agency rating is available or subsequently received, it will be incorporated into the Designation process. Otherwise, the SCC's assessment will be used.

- **Reporting**
  - An anonymized summary of each unique issue or situation will be published.
  - SVO Administrative Symbols will identify ratings that have been removed for security.
  - An annual summary of actions will be provided at the Spring National Meeting.
- **Oversight by VOSTF**
  - The SCC will discuss the basis for removing an agency rating from the Designation process as long as the VOSTF chair deems it necessary.
- **The right to appeal**
  - An insurer may appeal if they believe the SVO did not follow the procedures
  - An insurer may request the NAIC's IAO to contract, at the insurer(s) expense, with an independent third party acceptable to the NAIC IAO.

2.2.2.2 What's new, and what's next?

What's new? Before opening the floor to discussions at the Spring National Meeting, the VOSTF Chair provided perspectives on the intent of the proposal, acknowledging procedural issues will need to be worked through:

- Discretion is intended for a single asset and not an asset class, which speaks to concerns raised by commenters (see below) over possible market disruption. It reinforces that challenges are intended to be the exception rather than the rule. It also speaks to the data and systems accessible to the SVO, and thus its ability to conduct reviews in mass, which commentators have pointed out.
- Transparency for affected insurers is intended to be complete and key to the process.

There is much to learn from the eleven posted comment letters (see meeting Materials) and NAIC staff reactions, which aligned with oral statements from commenters and NAIC staff. We've summarized a few themes:

- **Overwhelming support for needed oversight**. There is a general consensus for the need to avoid blind reliance on agency ratings and for the NAIC to establish a process for agency rating oversight.
- **Proceed with caution**. With reference to the E-Committee initiative, several commentators note the need for a thoughtful and cautious approach to challenging ratings to minimize market disruption and for challenges to be the exception rather than the rule if it takes effect. Opacity has been argued to result in confusion among insurers and could disrupt capital markets more than necessary.
- **Transparency over methodology and concerns.** Commenters pointed to the lack of articulated concerns over specific gaps or flaws in methodologies used by rating agencies and the lack of clarity on criteria and analytical tools the SVO staff will use to identify ratings they believe may be unreasonable. Some suggested a need to identify in writing whether and why the rating methodology is not fit for purpose and the reason the SVO's methodology is more appropriate.
  - **NAIC staff response (paraphrased)**: The insurer(s) impacted will have full transparency into the SVO analysis and rationale confidentially.
  - **Our reaction**: The SVO might consider a tangible example of what insurers and regulators should expect, which should provide context for the level of transparency the SVO has in mind.
- **The need for better data.** At least two commenters, including a rating agency, noted that actual performance data provides a much more reliable and justifiable method for identifying potential problems than conducting challenges and debates over how opinions are determined.

- **Oversight.** Several commenters pointed to the lack of SVO oversight, with suggested processes ranging from having subcommittees that included affected insurers' domiciled state regulators to VOSTF or the E-Committee's involvement.
- **Appeals and third-party review.** Several concerns were raised, including the efficacy and viability of the proposed blind appeals process and third-party review, with necessary considerations for the confidential nature of many investments. The proposal does not require the SVO to produce a report explaining their analytical process to the investor, similar to what is done by rating agencies, making it difficult for an appeal to be effective if the insurer was not informed of what went into the analysis. A meaningful review was argued to require access to the original documentation, rationale, and other information that can often only be fully understood through dialogue with the relevant investment parties.
    - **NAIC staff response (paraphrased)**: The SVO agrees that engaging an independent third party to adjudicate these decisions would be very challenging. The SVO would welcome more agency ratings in the process and believes there should probably be a minimum number of ratings required to ensure a broad assessment of risk.
    - **Our reaction**: NAIC staff response is notable and might suggest consideration for a process whereby more than one agency rating is required in the Designation process. We advocate for multiple opinions of credit risk in our report, Overseeing Designations and the Prudent Use of Agency Ratings, but argue that there should be a materiality threshold to limit an overly costly process.

What's next?

- Per the Chair, a regulator-only meeting is scheduled in May, and an updated draft will subsequently be posted for a 30-day comment period and ready for deliberations at the Summer National Meeting.
- The SVO expects that the implementation of the process will require enhancements to NAIC's VISION and AVS+ applications. Funding for the application enhancements in the amendment, if adopted, will be needed, and it could take 1-2 years before this proposal can be fully implemented with a targeted effective date of January 1, 2025.
- The process will take time to work itself through, and we encourage the community to continue sharing suggestions, helping regulators keep an eye out for unintended consequences and the need for possible refinements.

2.2.3 NAIC model-based Designations for CLOs

2.2.3.1 Context

VOSTF adopted the intrinsic-price modeled-based Designations with a year-end 2024 timeframe. The approach is outlined in Instructions for the Financial Modeling of CLOs and will follow that of CMBS and RMBS. It has authorized the CLO Modelling Ad hoc group, which includes NAIC staff, interested regulators, and key stakeholders, to work through the various issues to achieve consensus over technical modeling details. At the end of 2023, and in a move to place closure on the modeling framework, the CLO Modeling Ad-Hoc Working Group posted preliminary results from CLO Default & Recovery Scenarios that would feed into the modeling framework. The scenarios are similar in spirit to those used in the NAIC CLO Stress Test Methodology. CLO tranche losses are measured across ten scenarios, with a baseline default rate and recovery scenario estimated from historical data and stressed scenarios (e.g., historical + 2 standard deviations). Several deals were analyzed and posted under CLO Preliminary Results. The probabilities/weights of each scenario will ultimately determine the total lifetime loss, which will be used in mapping to a Designation and capital.

2.2.3.2 What to watch out for, and what's next?

Model performance and impact will ultimately determine the degree to which the approach will be accepted. There have been notable flags raised by commenters in this and other workstreams, questioning the benefits of CLO model-based Designations and the degree to which they are comparable or improve upon agency ratings. In Benchmarking the Treatment of CLOs, we've pointed to features of the intrinsic price approach that result in capital ultimately having characteristics that depart from those of corporate bonds, including longer-dated tranches receiving more punitive treatment; RBC is agnostic to maturity for corporate bonds.

What's next? Efforts to complete the model for assigning CLO Designations are taking longer than desired, and NAIC staff requested that the rollout be pushed out to 2025 rather than 2024, as initially planned. Once effective, agency rating-based Designations will no longer be allowable.

2.2.4 A due diligence program from the E-Committee

2.2.4.1 Context

The E-Committee met to move forward efforts to develop its Framework for Regulation of Insurer Investments (the Framework). The E-Committee is modernizing the NAIC's oversight of insurers' investments, and formed a Drafting Group and posted a memorandum summarizing the views of the Committee on the next steps to implement the Framework and proposed changes to the Framework, along with a Workplan that includes core principles and action items which we discuss in detail in Section 3. As part of the Workplan, the posted Agenda & Materials include a proposal petitioning for the development of a request for proposal (RFP) to engage a consultant who would help the NAIC develop a due diligence program over the ongoing use of agency ratings (Attachment Eleven). Between the E-Committee and the Valuation of Securities (E) Task Force (VOSTF)'s efforts to map out a process extending NAIC staff discretion over rating agency-based Designations (see below), the NAIC is making clear its determination to design a long-term, thoughtful approach for the prudent use of agency ratings, along with stopgap measures.

2.2.4.2 What's new, and what's next?

Regulators addressed the need to maintain the ongoing workstream to extend NAIC staff discretion over rating agency-based Designations by VOSTF. It was argued that a stopgap is needed to the E-Committee's development of a due diligence program over the ongoing use of agency ratings, which will take much longer to implement; the VOSTF process itself will possibly take a couple of years to develop and implement.

2.3 Differentiating Capital for CLOs and Structured Assets and Their Residual Interests

We now explore recent developments with efforts to differentiate capital for structured assets, which we break down into two initiatives: (1) a broad effort to design an RBC C-1 framework for structured assets and (2) interim capital charges for of residual interests.

2.3.1 Designing a capital framework for structured assets

2.3.1.1 Context

The Risk Based Capital Investment Risk & Evaluation (E) Working Group (RBC-IRE-WG) has requested the American Academy of Actuaries explore possible differentiated capital charges for structured assets and initially focus on CLOs. Recognizing the inherent inconsistencies with the C-1 framework (e.g., C-1 bond factors are measured over a 10-year horizon while C-1 equity is measured over a 2-year horizon), the Academy put forth and agreed on with regulators a set of Principles for the modeling of C-1 for Structured Securities**.** It includes a flowchart for determining whether an asset class needs to be modeled separately and the level of modeling granularity. The principles highlight the nuanced capital framework with inconsistent components that inherently violate aspects of almost every principle that would otherwise seem reasonable. For example, Candidate Principle 3 highlights that RBC is measured net of reserves and thus should be

measured consistently with an asset's accounting treatment. It observed that bond factors are calculated assuming that bonds are measured under amortized cost, which is inaccurate for impaired bonds (i.e., OTTI) that can be carried at fair value. Meanwhile, Candidate Principle 4 highlights the inherent 'arbitrage' where typical collateral of an ABS is often in the form of unrated debt (e.g., student loans), which would result in punitive RBC treatment if held directly and should not be used as a point of reference when assigning capital to the tranches that might have favorable risk characteristics.

2.3.1.2 What to watch out for, and what's next?

The American Academy of Actuaries provided an update at the 2024 Spring National Meeting (RBC-IRE-WG Agenda & Materials), mapping out its next steps:

- **A review of the Oliver Wyman residual tranche study by April (see below).** The Academy plans to review the study and opine on the degree to which it provides appropriate guidance for interim C-1 residual tranches, focusing on consistency with the Academy's Principles for RBC of ABS endorsed by RBC-IRE-WG in December. While regulators expressed a desire to receive the review as soon as possible, the Academy explained their review goes through their internal governance, limiting their turnaround time.
- **A review of CRP rating methodologies by the Summer National Meeting.** The Academy will review the methodology of the five agencies that rate structured products, with an initial focus on CLOs.
- **A review of comparable attributes for CLO tail risk, with a target interim update at the Summer National Meeting and completion by the Fall National Meeting.** The Academy plans to map out and assess a comprehensive set of attributes that can differentiate the risks of ABS, which it references as comparable attributes, as part of its process for assessing an appropriate C-1 charge for ABS. A comparable attribute might be an agency rating, NAIC Designation, or tranche subordination. They then plan to determine the set of easily identifiable attributes that explain most of the tail risk. If the set is small, they become candidate comparable attributes for determining C-1. They explained that if that set is large and complex, modeling individual CLOs may be necessary.

2.3.2 Interim capital of 45% for residual interests of ABS

2.3.2.1 Context

C-1 charges for ABS residuals held by life companies will be 45% effective this year. The adoption was contentious, with strong and differing views expressed by a bifurcated industry and with some regulators questioning the urgency and need for an interim change, considering the longer-term and broader initiative of updating the treatment of structured assets and the need for more analysis. Others question whether life insurers should hold residual interests. The capital charges are interim in that they are expected to be overridden as the Academy progresses with a long-term solution for the treatment of structured assets. A 45% RBC charge for residual interests held by property and casualty, as well as health, is also being proposed, with an exposure period running through April 18, 2024. In part, the challenge with differentiating the capital treatment of residual interests is the lack of clarity over what constitutes an ABS and, thus, what gets classified as a residual interest rather than common stock, which we discussed above in the context of potential revisions to the bond definition.

2.3.2.2 What's new?

An empirical assessment of the 45% interim ABS residual tranche C-1 capital charge was conducted by Oliver Wyman on behalf of the Alternative Credit Council ("ACC"), the private credit affiliate of the Alternative Investment Management Association Ltd ("AIMA"), and included in the RBC-IRE-WG Materials for its March 17, 2024 meeting. The study analyzes a random sample of ~30 residuals for each class of ABS analyzed, including CLOs, auto loans, and student loans. Losses were estimated along tail scenarios designed for each class of ABS (e.g., loan default rates for CLO). The study concludes that, on a portfolio basis, ABS residuals perform better than common equity under all modeled stress scenarios. The study finds that common stock losses are 30 percent higher than ABS residuals in the Deep-Tail stress scenario and 35-50 percent higher than ABS residuals in the Mid-Tail stress scenario.

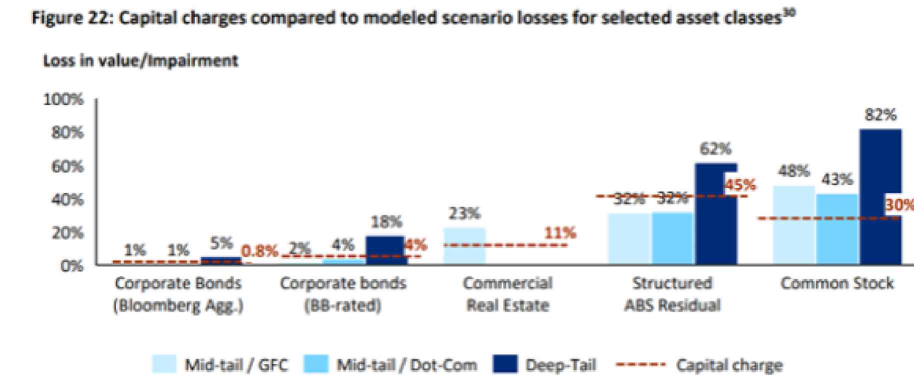


Figure 22: Capital charges compared to modeled scenario losses for selected asset classes[30]

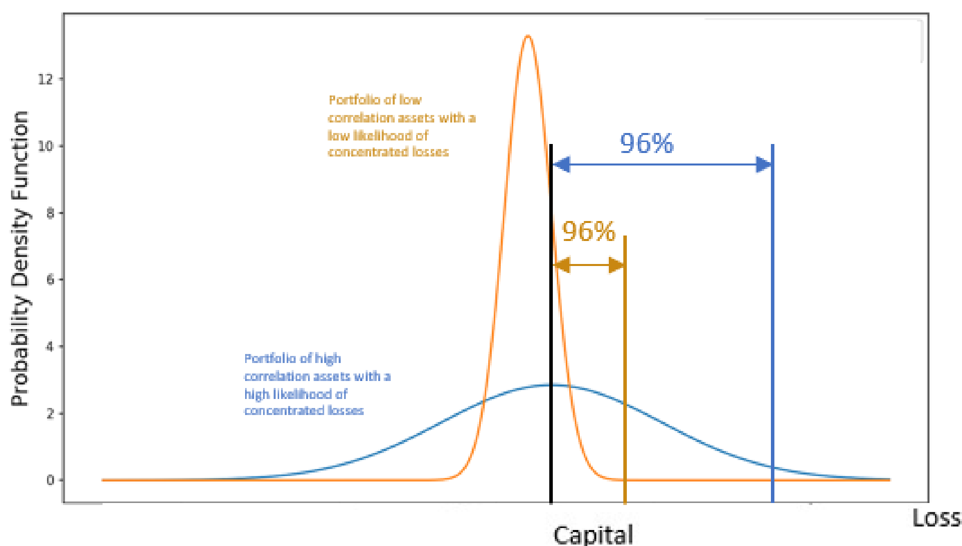
The accompanying letter argues that the study provides ample evidence that more diligence should be done before imposing any interim capital charge and delay in implementation, allowing further consideration of any data put forth by interested parties.

Useful insights.

- **Characteristics that affect the potential losses on residual tranches**. The study observes that residual tranche thickness and the rating of the next-most junior (i.e., the junior-most rated tranche) tranche can help differentiate losses on residuals, where thicker tranches and better ratings are often associated with lower expected losses in the residual tranches. Of course, a thick residual tranche will typically both improve the rating of the junior-most rated tranche and lower the expected loss of the residual tranche. These findings are supportive of the Academy's approach to differentiating RBC C-1 using comparable attributes that could potentially be applied to ABS residuals.
- **Analyzing risks across classes of ABS**. The study takes on the significant effort of picking past experience and estimating baseline and stress loss scenarios across different markets, which is no easy task. Assessing a baseline default rate for corporates alone, for example, can lead one to significantly different conclusions depending on the market segment (e.g., broadly syndicated loans versus corporate bonds) and sample period; S&P provides useful context in A Tale of Two Markets: Credit Dispersion Characterizes U.S. Leveraged Finance in 2024. Choosing comparable baseline and tail scenarios across, say, corporate credit, auto loans, and student loans requires a heavy dose of professional judgment. Notice, for example, that the loss on common stock under the chosen scenarios is well over 40%, rather than the 30% that represents the 94% 2-year loss on the S&P 500 between 1960 and 1991.

Additional needed analysis

- **Considerations for concentration and diversification when assessing portfolio tail risk**.
    - The study applies the same scenario to all residuals of the class of ABS, thus having the risk factors be perfectly correlated - in the case of CLOs, for example, it assumes all CLOs hold the same collateral loans - they don't.
    - C-1 bond factors measure the expected tail loss on a large portfolio of bonds and attribute that loss to a bond with a particular rating (e.g., A-rating), with considerations for their correlation and diversification, providing an assessment of the likelihood of concentrated loss. Similarly, the C-1 equity factor is estimated using the S&P 500, which by its nature incorporates the correlation and diversification associated with its constituents, providing an assessment of the likelihood of concentrated loss.
    - A portfolio of highly (low) correlated assets can lead to a higher (lower) likelihood of concentrated losses, as depicted in blue (orange), and should be assigned a higher (lower) capital.



- **The framework should aspire to back-test and represent observed dynamics experienced historically**.
    - For bank syndicated loan (BSL) CLO residuals, for example, the study estimates losses in the order of 45% through their Dot-Com and Great Financial Crisis (GFC) scenarios. In contrast, CLO residuals performed reasonably well over that period (CLO Performance). While the study acknowledges the modeled losses differ from the observed performance of CLO residual tranches during the GFC, pointing to several factors, including the several modeled assumptions, the difference leaves one questioning the degree to which quantitative inference can be extracted from the analysis in its current form.

Table 8: CLO summary statistics

Scenario Severity	Scenario	CLO type	Simple average losses	Portfolio average losses
95th percentile	Dot-Com	BSL	-48%	-45%
		MM	-34%	-27%
	GFC[25]	BSL	-46%	-42%
		MM	-32%	-25%
99th percentile	Deep-tail	BSL	-74%	-72%
		MM	-64%	-55%

    - For common stock, regulators pointed out (see below) a lack of comparability of scenario severity across asset classes, pointing to the study measuring losses for common stock using the largest 2-year decline in market value for the S&P 500 during the 'Dot-Com bubble' (2000- 2002) and GFC (2007-2009) (see reference to the study's Figure 22 above). The choice was seemingly overly punitive and not aligned with the spirit of a 95% scenario, and questioned the choice as an appropriate benchmark to compare against the performance of ABS.

Deliberations at the Spring National Meeting proved contentious, with several notable comments from regulators:

- Prior to the sponsors of the study's presentation, the Chair opened, noting that they "...believe[s] the report, as it is now,... justifies the 45% interim factor... that it's a tough hill to climb, to get to a point to support something... less than the 45% charge." But left the door open, noting that if "...there's an interest in pursuing it... we will make every effort... to get us to a point where we could potentially adopt something for this year's end. That would require exposing a proposal for public comment by the end of April.

- The Chair also pointed out that the methodologies that would underpin an alternative to the 45% interim residual charge are expected to face a lower bar as far as sophistication compared to the Academy's long-term effort.
    - Several regulators commented on the estimated loss under the ~95% scenarios for the broadly syndicated loan (BSL) CLO residuals of ~45%, roughly aligning with the interim charge. The sponsors highlighted that significantly lower loss rates were observed on other ABS residuals, including student loans and autos, in the range of 10%-20%, and the average loss across all ABS classes was significantly more benign than that of corporate equity under similar scenarios.
- Discussions turned surprisingly technical, with regulators pointing to:
    - The need for using a conditional tail expectation (CTE) measure rather than a single percentage (i.e., value at risk) that is used in the study.
    - Lack of comparability of scenario severity across asset classes, pointing to the study measuring losses for common stock using the largest 2-year decline in market value for the S&P 500 during the 'Dot-Com bubble' (2000- 2002) and GFC (2007-2009). The choice was pointed to be seemingly overly punitive and not aligned with the spirit of a 95% scenario, having it be questioned as an appropriate benchmark to compare against the performance of ABS.
- While supportive of the initiative and the broader need to evolve regulations, the ACLI requested to delay the implementation of the 45% interim charge by a year. While the ACLI did not fund the study, it did point to the high degree of variation in risk profiles across classes of ABS residuals, which they argued the study demonstrates, and that the charge has long-lasting elements, given the nature of the Academy's long-term efforts, initially focusing on CLOs.
    - The Chair reacted, pointing out that the original proposal had the interim charge go into effect in 2023, with the 2024 effective date already representing a deferral of one year.

2.3.2.3 What's next?

- The Oliver Wyman Residual Tranche Report was exposed for public comment through April 8, 2024.
- The RBC-IRE-WG will meet on April 12, 2024, at noon ET to discuss the empirical assessment of the ABS residual tranche C-1 capital charge conducted by Oliver Wyman.
- CATF exposed for comment a proposed 45% RBC charge for residual interests held by property and casualty, as well as health, through April 18, 2024.

3 More on the E-Committee's Aspirational Framework

3.1 Context

The E-Committee took significant steps forward with its proposed Framework for Regulation of Insurer Investments – A Holistic Review (the Framework) by forming a Drafting Group and a posted Workplan with action items.[4]

[4] In addition to the Workplan, a memorandum was posted and provides a detailed summary of comments from the Drafting Group and interested parties and reactions from the Committee, highlighting three notable points:

- The primary objective of the Framework is ensuring insurer solvency.
- A core component of the Framework must be enhancing the centralized investment expertise available to regulators.
- Coordination among the Committee's various workstreams is vitally important.

The memorandum includes a summary of the Drafting Group's views on each of the 9 recommendations from the Framework. Those recommendations include avoiding blind reliance on agency ratings, and having the NAIC build a broad policy advisory function and a need to seek a goal of "Equal Capital for Equal Risk."

3.2 What to watch out for, and what's next?

The Workplan includes seven action items (paraphrased):[5]

1. The Drafting Group will propose updates to the Framework, which it did, with proposed changes to the Framework predominantly editorial.
2. The E-Committee will request approval to hire a consultant to provide recommendations for a CRP due diligence framework for CRPs, which we discussed in Section 2.2.4.
3. Implementation of the Framework will be done in parallel with ongoing workstreams.
4. An assessment of conceptual centralized investment expertise (CIE), which would provide broader regulatory advisory support to regulators, including due diligence and not limited to credit as is the case with the Investment Analysis Office (IAO), Structured Securities Group (SSG), and SVO.
5. The Drafting Group will recommend candidates for a new investment-focused working group.
6. The Drafting Group will develop and implement enhanced coordination between the Committee's workstreams.
7. The Workplan does not include action items related to risk-based capital (RBC) recommendations at this time.

What's new?

- The 2024 Summer National Meeting Agenda & Materials includes a proposal petitioning for the development of a request for proposal (RFP) to engage a consultant who would help the NAIC develop a due diligence program over the ongoing use of agency ratings (Attachment Eleven).
- Deliberations at the meeting included oral comments on the Framework from commentators. While the comment period for the Framework remains open, the E-Committee invited initial observations that had common themes:
  - **Overall support** for the E-committee's goal of developing a holistic and consistent approach to regulating insurance investments.
  - **Effective use of resources, including agency ratings and needed cost-benefit analysis**. One commenter linked the importance of effectively using agency ratings as a resource to develop a consistent risk oversight framework across investments and the SVO's role in agency rating oversight rather than Designation assignment, with specific reference to the best use of the SVO CLO modeling efforts.
  - **Need to coordinate and communicate** across workstreams in light of not pausing existing efforts that overlap (e.g., changes to both the classification and capital treatment of residual interests) and articulating the tools that will be used to achieve those goals.
  - **Needed tools and data to assess the performance of agency ratings and the SVO modeled Designations.** With insurers holding 100s of thousands of debt instruments of varying characteristics, acknowledging the significant challenge is needed. Tools and data available through standard channels (e.g., through the SEC or disclosed by the agencies) may be insufficient, and additional disclosure may be required.

What's next?

- **Request for public comment.** The E-Committee has requested public comment on the Workplan, which is intended to be a working document, as well as related documents through April 8, 2024:
  - Memo from E Committee to Interested Parties
  - Investment Framework as Revised E Committee
  - Investment Framework Workplan
- **The Committee expects continued work on the Framework to occur over the rest of 2024 and into 2025**, with more details developed as work progresses on different aspects of the Workplan

[5] The Workplan also includes six core principles. We find principle six to be particularly compelling: *The ultimate responsibility for prudent investment oversight is with the insurers themselves… This responsibility should not be "outsourced" to CRPs or the regulators.* We feel this principle should be the core of any investment risk oversight framework that is ultimately adopted. We have advocated for this principle in our own comment letter and reports Overseeing Designations and the Prudent Use of Agency Ratings and Investment Risk Oversight.

4 What are we optimistic about?

The community remains determined to achieve an aspirational goal of equal capital for equal risk, with a spectrum of proposed paths, each with varying implications that can be significant. NAIC leadership remains committed to broad and thoughtful discourse around the challenges of regulating the evolving investment landscape. While many industry participants are concerned about some aspects of the chosen path, regulators have demonstrated an open ear and flexibility in addressing concerns. However, there are red lines regulators are unwilling to cross. With many perspectives on the table, there is much to learn, and we expect refined thinking on what makes the most sense for the industry. We have certainly updated our views as informed parties have brought new insights, which we encourage.

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