Amnon Levy & Nathan Houdek

Episode 209: Modernizing the NAIC's investment risk oversight framework

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. I'm Stewart Foley. I'll be your host. Thanks for joining us. We're thrilled that you're here with us today. We're going to be talking about insurance regulation. I've got a couple of housekeeping items. First of all, I want to give a huge shout-out to the University of Denver Pioneers for their 10th national Championship in Men's D1 Hockey. Congratulations. Go Pios! 10X National Championship, quite an accomplishment. Also, my daughter, Maggie, whose ultimate Frisbee team, the Denver Hype, have made it through regionals and they'll be coming to none other than right here in Austin, Texas to compete in the national championship round. And I'm going to get a chance to see her in a couple of weeks. So we're thrilled about those two things. And we're also thrilled to have our guests today. We are joined by none other than the regulatory savant Mr. Amnon Levy, who is the founder and CEO of Bridgeway Analytics. Amnon, welcome. Thanks so much for being on.

Amnon: Thank you, Stew. It's always great to join you on these discussions.

Stewart: That's great. And we are joined today by Commissioner Nathan Houdek. Commissioner Houdek, thanks so much for being on. I don't want to mess up the intro, so I would love for you to tell us about your background and just a little bit about your role, and then we'll go into the icebreaker questions and then I've got more questions for you about the structure of the NAIC.

Nathan Houdek: Yeah, fantastic. Thanks, sir. Appreciate the opportunity to be here and have this discussion today and be joined by Amnon. So I've been the commissioner in Wisconsin since January of 2022, so I'm in my third year in this role. I was the deputy commissioner here in Wisconsin for three years prior to that. And before joining the office, I spent about 20 years working in and around Wisconsin government and politics. So a lot of experience here in Madison and Wisconsin. It's been a fun ride to now be in the insurance regulatory role for the last few years.

Stewart: I will tell you, as a new resident of Texas, I used to live outside of Chicago and love, love Wisconsin, a really good friend who lives just outside of Madison and Cross Plains. Shout out to Tom Jevon, I'm sure he is listening. And so I just want to make sure that our listening audience knows that just because you're part of their regulatory and NAIC community, you're not immune from our icebreaker questions, which include, where did you grow up? What was your first job, not the fancy one? And what makes insurance regulation so cool?

Nathan Houdek: Oh, great questions. So I grew up in a small town in Northern Wisconsin called Phillips, with about 1,600 population. Like a lot of people who grew up in Phillips, my first job was at the local IGA, both stocking shelves and working the cash register. Insurance regulation is cool because we get to touch everything. We're in the middle of all the big issues in a way that isn't always on the front pages, doesn't always get the headlines, but we touch everything and every issue is relevant for us. So it's a cool space to be in.

Stewart: And I will say this, I really appreciate you taking the time. I think that, and Amnon has pointed this out on a number of occasions, but the NAIC is somewhat unique in their approach to having such a collaborative discussion with the industry that you regulate. And so with that as a backdrop, could you please set the stage and provide some context for the significant long-term initiative to revamp investment risk oversight?

Nathan Houdek: Absolutely. So this really goes back to right after the great financial crisis where we saw the prolonged low interest rate environment. And obviously, that was a challenging environment for insurers and particularly life insurers to find yield. What we saw was really a shift in the investment strategy of a lot of insurers, and again, particularly life insurers into more private assets, more structured assets, many of which have more complex characteristics. And so as we've seen this investment shift occurring, we as insurance regulators have been looking at the regulatory framework for overseeing insurer investments and kind of looking at where there might be some gaps in that framework because of this shifting investment landscape as well as what additional resources and tools might we need to be able to adequately analyze the risk and just really make sure that we're comfortable from a capital requirement standpoint and an overall kind of insurer solvency oversight standpoint with the tools, resources that we have in place to manage the risks associated with that shifting investment landscape.

Stewart: And so can you talk a little bit about how agency ratings are used by the NAIC and why that's problematic?

Nathan Houdek: Problematic might be a strong word. I think securities that receive a rating from a credit rating provider are then assigned an NAIC designation. And the designations are really regulatory tools used by insurance regulators for a variety of reasons, one of the largest being capital requirements related to RBC. So it's really an issue of the current system is really a system where we're blindly reliant on the ratings from the CRPs for the designations that then are provided.

Stewart: At the risk of disrupting here, tell me what... Can you need to unpack CRP, just in case somebody doesn't know what that means?

Nathan Houdek: Sure. CRP is a credit rating provider, so it's really what we commonly think of as rating agencies.

Stewart: Thank you.

Nathan Houdek: And Amnon could probably go into a deeper dive on CRPs in a little bit, but I'll explain at a high level from a regulatory standpoint. It's really making sure that we have a level of comfort with how these CRP ratings are tracking to the NAIC designations and creating a system where we have more informed reliance on those ratings rather than being blindly reliant. I know we'll discuss this in more detail here in a little bit, but we're kind of pursuing this informed reliance through a couple different avenues, one of which creating a process by which the securities valuation office would have some discretion over the ratings and creating a system where we could potentially take a closer look and analyze some of those ratings if we have concerns with them. And then also longer term, creating a due diligence and governance oversight for how those CRP ratings are utilized.

Stewart: That's great. Amnon, what do you want to add?

Amnon: I really liked how Commissioner Houdek positioned the reliance and the question of the blind reliance. So currently, the NAIC has what would be referred to as a mechanistic approach to using a rating agency, or an agency rating I should say. So most debt instruments are going to get a capital assignment based off of a designation that is based off of an agency rating, and that process is mechanistic. And whenever you have a mechanistic process, all sorts of conflicts of interests generally wind up having agents direct towards measures that make them look more attractive.

There's the old Goodhart's law, for example. Once you have a statistic out there that you have some control over, you're naturally going to want to start looking prettier, right? And that's kind of the inherent nature of the problem. The problem is significant in two dimensions. First of all, since most debt is assigned capital based off of agency based designations and since the vast set investments of life companies and PNC for that matter is debt, we're talking about a multi-trillion dollar question that is being posed to an external body to assess the quality of. And so, that's just with the inherent nature or the inherent conflicts of interest that we're going to get into associated with say, ratings shopping, challenges with even estimating a credit measure given the nature of these remote events across vastly different asset classes, there's a significant challenge here, and it's not specific. The challenge isn't specific or unique to the NAIC. The challenge transcends and it's a challenge paged by all participants in debt capital markets.

Nathan Houdek: And just to kind add on to what Amnon said, it really relates to this shift that we were talking about a little earlier where we're seeing investments in more private assets. And the kind of lack of transparency related to those types of investments is a large part of why we are taking a closer look at having more oversight of the CRP ratings. When you move those assets and the investments from the public market to private, you lose some transparency. And so it's part of that process that's driving some of this work. Well, largely driving the work that we're doing related to the investment framework broadly, but the CRP oversight more specifically.

Stewart: And it really gets into being able to accurately assess the financial strength of a particular insurance company. As I used to tell my students, the regulator's job is that you wreck your car and the check comes to you to fix it and you go fix it and it clears and you get your car fixed. It's really that simple just to make sure that insurance companies are making good on their promises that they're making to their policyholders. At the end of the day, this is where it all comes back to centrally, is understanding the true risk that an insurance company is bearing. Is that a fair assessment?

Nathan Houdek: That is 100% true. I mean, at the end of the day, everything that we're doing related to what we're talking about today, related to changes to our investment oversight framework is about ensuring that insurers are solvent and consumers are protected. And just to continue the conversation on the ratings piece, we plan to still rely on credit rating providers very important in the process. In no way are we trying to not include or have the CRPs excluded from any of the work that they're doing. It's just changing our oversight structure and making sure that we have a level of comfort as regulators with the ratings, and again, how those ratings track to the NAIC designations.

Stewart: That's terrific. Thank you.

Amnon: And maybe if it's okay, could I dig into this notion of private rating a little bit and some of the challenges there and try to demystify?

Stewart: Oh yeah, for sure. Your demystification is the favorite part of the show, so let's do it.

Amnon: Okay. Yeah. So if you look at, say, a rating of a corporate, if a rating agency assigns, let's say, an overly favorable or overly punitive rating to a public corporate, other companies in the ecosystem will raise concerns that they're getting rated. If the rating is overly favorable relative to what a competitor, say, views themselves as lining up with, they're going to call up the rating agency and request an explanation for why they're receiving a lower rating. And so there's a market mechanism to level set the rank ordering of risk when things are really out of line when it comes to public ratings.

When it comes to private ratings, the rating agency may be using the same methodologies, but there's no market mechanism to oversee that process. Also, you often have certain rating agencies specialize or focus on certain market segments. Some agencies focus more on the private segment and others really don't participate in that market nearly as much. And so you have this other challenge where ratings across agencies may not be completely comparable, and that's okay because ratings are intended to be opinions of risk. It's okay to have different opinions of risk, but you want to have governance around that. If anything, we've advocated for having multiple opinions of risk because we're talking about often very complicated nuanced issues. And you want innovators, you want disruptors to point out new issues and think about the problem in different ways, and the only way that's going to happen is if you encourage different opinions.

Stewart: Yeah. Just so that our audience is clear, when you say 'we', you're referring to Bridgeway Analytics and not Commissioner Houdek.

Amnon: Yeah.

Stewart: I just want to make sure that we're keeping our opinions straight and who say what.

Amnon: That's right, yeah.

Stewart: Yeah. So just to you, Amnon, what mechanisms can allow for the prudent use of agency ratings? And then we'll go to Commissioner Houdek after you lead it.

Amnon: Yeah, that's an excellent question. I think it's worth recognizing how rating agencies are currently regulated in the US. So in the US, the SEC, the US Treasury, Securities and Exchange Commission oversees what's called nationally recognized NRSROs. NRSROs are required to disclose information regarding their methodologies. They're required to disclose information regarding their ratings. You're only allowed to rate segments for which you're authorized to rate. For example, some agencies aren't allowed to rate structured assets, as an example.

Stewart: Just let me just hop in there real quick. So when you talk about that, that need to disclose, just so people kind of get the sense of this, that's because the general public is relying on those ratings, right? And investors are relying on those ratings so that in effect, your aunt or your grandmother looks at a municipal bond that's rated AA and they don't have to go dig out the financials themselves. They go, "This NRSRO says this is AA, and I feel good about that." So as a result of the public relying on those ratings, that is where you get this public disclosure of process and so forth. Have I got that about right?

Amnon: Yeah, that's correct. What makes ratings unique is that agencies are privy to non-public information, which is really an important point here. So they get to see often details that are critical in the ratings process and they distill information that provides insights for the public.

Now, what's interesting here, and I point this out earlier, when you're talking about high credit quality credit, which is really what insurers generally invest in, default events are incredibly remote. We've had, in the last 50 years, what was it, globally, 6 corporates defaulting within 10 years of being rated AA. That's just incredible, right? And somehow Moody's is able to rank order between a AAA, a AA+, a AA. And if you look over long periods of time, the default rates across these cohorts are pretty stable. Moody's and S&P and others, they've come up with mechanisms of rank ordering these cohorts in ways that is quite surprising given how infrequent some of these events are.

Now, what's interesting in terms of the SEC's oversight of ratings, by law, the SEC is not permitted to regulate the substance of a credit rating. And that in effect creates differences of opinion. They're very clear. A rating is an opinion, and you don't want to necessarily define it in any more constraining way in order to generate different market views.

Now, we know from the financial crisis that there are all sorts of problematic conflicts of interest when relying on rating agencies. The fact that they have different opinions, even if rating agencies are doing their best to assess credit from their perspective, ensures if they're relying on those rating agencies for capital, they're going to be incented to get the most favorable possible capital, all else equal. That's just a very natural incentive that's created through the system. And so by the very nature of having different opinions, they're necessarily going to be incented to choose the one that's most favorable or have the asset manager who's getting the rating choose the one that's most favorable.

So that conflict of interest, for example, that needs to be deliberately considered in every mechanism that's used to govern. Or, any mechanism that's ultimately used to govern, that needs to be acknowledged. And so when you look at different mechanisms, in governance, often it really starts with disclosure. One mechanism that we've advocated for is really requiring insurers to disclose what internal risk measure they're using and assess whether that corresponds with the designation that's actually used for regulatory purposes.

I mean, just to give you an example, in banking, under Basel for example, banks have to use the same internal rating for their pricing as they do for regulatory purposes. If they're running around trying to obtain overly favorable ratings to make their regulatory capital look overly favorable, they're just going to shoot themselves in the foot because they're going to extend credit to really poor-quality borrowers. That's not going to work. So, mechanisms like that, really as a first step, are relatively inexpensive ways of assessing the credibility of the credit measure that's being used for regulatory purposes.

Now, I don't want to dismiss the benefits of other mechanisms that the NAIC is exploring in terms of oversight and possibly extending the SVO with an authority to question the rating or what have you. In our view, really the first step is in disclosure, being able to really assess how these measures are being used and make sure that its incentives are aligned.

Stewart: Commissioner Houdek, is there anything you want to add to Amnon's comments or just kind of give me a sense there?

Nathan Houdek: No, I appreciate Amnon's comments on this point, and they really reinforce what I had mentioned already and related to the work that we as insurance regulators are doing to create more oversight of the CRP ratings, both from a shorter term, immediate term discretionary oversight and ability of the SVO to challenge ratings when appropriate and within the defined process that is being developed, as well as the longer term kind of due diligence oversight that's being developed as part of the framework. So that just, Amnon's comments really reinforce why we as regulators feel that these measures and these efforts are necessary to give us comfort with, again, how the ratings are being used for NAIC designation purposes.

Stewart: That's super helpful. So my next question reads, how does the (E) Committee... And so I want to ask a precursor. What is the (E) Committee, Commissioner Houdek? Just so that I know Amnon has used this term, and I have parroted this term, but I just am not... If you said, "Define the (E) Committee," I would give you a very blank stare. So could you help us with just first, what is the (E) Committee?

Nathan Houdek: I'm in year three as commissioner and year six as insurance regulator, and I'm still learning the whole NAIC committee process myself. But I'll say as the chair of the (E) Committee this year, the (E) Committee, so it's the Financial Condition Committee, it's one of, I believe, eight co-standing what we were referred to as letter committees within the NAIC. And the (E) Committee is really the main committee that oversees insurer solvency issues, so accounting, securities valuation, financial examinations, really everything related to the work that we do around solvency.

Stewart: And that's why this audience is particularly keen to pay attention to the (E) Committee. So with that, I'll go to this. How does the (E) Committee think about modernizing the SVO and desire to have it perform individualized credit assessment and utilize regulatory discretion? Now, that's a question that only Amnon could write, so can you... Do your best.

Nathan Houdek: That's a great question, Stewart/Amnon. I appreciate it. And really it's an extension of everything we've been talking about for the last few minutes. And we can get into, I think in the next couple questions, more broadly what we're looking at around SVO modernization. But really the SVO is focused on analyzing credit risk of individual securities. That's kind of been the main focus in the past. And that focus will continue, or those capabilities I should say, will continue as well as we've mentioned, developing a process by which the SVO will have discretion over ratings, kind of an ability to "challenge" a rating within that defined process, which is still being developed currently.

So those capabilities, that new process will still be in the purview of the SVO. What we're looking at, I'd say more broadly, as it relates to the investment framework is how do we expand the capabilities of the SVO as the entity that we as individual insurance regulators in the 50 states plus DC in the five territories to rely on from an investment analysis and oversight standpoint to really help us understand beyond just the individual security assessment, looking at company-portfolio-specific analysis, looking at industry-wide analysis, looking at macroprudential and perspective risk analysis, thinking about again the changes that we're seeing in the broader investment landscape as well as the changes that are occurring overall in different areas of insurance regulation, thinking about more principles-based regulation, thinking about more surveillance-focused, and trying to look at where we see potential risks emerging in different areas across the capital markets, across just really the macroprudential landscape overall. And so as we talk about modernizing the SVO, it's really how do we help provide the resources and the tools that can help achieve all of those things that I just talked about for the benefit of insurance regulators in the states across the country.

Stewart: That's really helpful. Amnon, anything to add there?

Amnon: Yeah, I certainly do. And I think the commissioner did an incredible job answering that really complicated question. When you read it out loud, I was really taken aback.

Stewart: Now you know how we feel.

Nathan Houdek: Yeah. You're here to provide the color commentary, Amnon, right?

Amnon: Yeah.

Stewart: That's right. Yeah, exactly.

Amnon: So I want to maybe build off of something that the commissioner mentioned regarding kind of a macroprudential, and company-wide assessments of risk. And part of the problem with building out those capabilities are the complexities with aggregating risks across so many different asset classes, given that each asset class is so difficult to assess from a risk perspective and whether or not in the end of the day you actually believe that aggregated number is providing you with something informative.

And I'll just point out, I brought this up on your show before, Stewart, but take two of the oldest asset classes out there, municipal credit and corporate credit, you look at equally rated default rates across equally rated cohorts of corporates and municipalities. Default rates for corporates are like 10 or 20 times higher over the last 50 years for the same rating. In other words, if you're like single A+ or whatever, the default rate's like 10, 20 times higher for corporates. These asset classes have been around forever. And so what's the problem? Well, it's really hard. It's a really hard... We, meaning capital markets are relatively good at rank ordering segments that are relatively uniform.

In other words, if you look at airlines as a segment, we're relatively good at rank ordering which airline is riskier than the next. Once we start moving across industries, you're starting to compare airlines with, I don't know, tech or bio, it starts becoming much more complicated to have than apples to apples. And then once you move away, what we talked about this too, the risks that a municipality faces are very different from a corporate.

Stewart: Yeah, I always used to tell my students, I go, "The city of Fort Worth is not going to lever up and try and take over Dallas." It just doesn't happen, right?

Amnon: Yeah, that's not going to happen. Right.

Stewart: When I was the treasurer of the City of Columbia Missouri, we issued... I mean, just to get municipal debt issued is a major undertaking. It's not like somebody just walks in and goes, "Hey, we should issue bonds right now and we should build a parking garage." Hits. Hits. Believe me. I mean, that is a big process. So even to get one to market is a big deal. And then the performance of the credits has been stellar, for sure.

Amnon: Yeah, it makes it very difficult. And so now that we're going into more complicated asset classes, structured assets and the like, that comparability becomes increasingly more challenging. And you're trying to get a macro assessment of what's going on with a company or the industry. It's difficult to assess whether there's concentration risks building up and being able to articulate that in an effective way.

Now, what's critical here, and something that the commissioner touched on, is that resources are used cost effectively. In other words, that what makes this initiative really unique, I think, is that the NAIC decided not to acknowledge these challenges and see if they could work within the existing set of resources and use those resources effectively, acknowledging the inherent conflicts of interest and the challenges. That's very different from how, say, you saw the approach that was taken for CCAR and Solvency II, which were incredibly, incredibly expensive.

In our view, meaning Bridgeway's view, those initiatives, while incredibly valuable and helpful in providing transparency to the risk associated with banks and with European insurers and the like, certain parts of that process were approached in a way that was incredibly expensive. CCAR, the bill on that was hundreds of billions, if not billions or tens of billions of dollars. It was really, really expensive. It continues to be really expensive. And the question is, could you leverage those resources in a cost-effective way that could provide a level of transparency, possibly even better than some of the more expensive approaches because you are being very thoughtful about the use of those resources?

Stewart: And just to go a little further with Commissioner Houdek, how does the (E) Committee think about enhancements to the SVO's portfolio risk analysis capabilities and the risk analytic tools? Speaking of things that are expensive.

Nathan Houdek: I think we've kind of touched on that from what we were just saying. I think it might be worth taking a step further and talking about beyond the SVO one of the things that we as insurance regulators are looking at and is included in the investment framework is the development of a centralized investment expertise. So it would be, and this is all, it's very conceptual at this point, a lot of work still needs to occur as we build out this functionality, but really it would be some type of entity that would be separate from the SVO and the Structured Securities Group, but there would be some overlap with the work that's done. But it would really be about developing, again, the tools needed to do the type of risk analysis and the type of investment oversight in a more detailed way that Amnon was just talking about and that I had mentioned regarding more enhancement of macroprudential and prospective risk capabilities, looking at modeling capabilities for Structured Securities, really building out all those functions that would be, again, beneficial for individual state insurance departments.

And so, I think we'll probably get to this in one of the upcoming questions, but this idea of developing this centralized investment expertise is one of the items included in our investment framework work plan that we as the (E) Committee and a drafting group that we've developed will be looking at in the coming months and initially talking with states to understand what capabilities do state regulators feel they don't have, currently, and assessing where the gaps exist and where investments should be made, capabilities should be developed, and really, again, to Amnon's point of doing it in a cost-effective way. I mean, there will be some cost associated with this work. Obviously, anytime you're talking about developing new tools, adding resources, adding personnel, there's cost to that. But we're very conscious of those costs. And all of this work, we're really committed to doing it in the most cost-effective and transparent way as possible.

Stewart: So Commissioner Houdek, I understand that there is a work plan with specific action items on it. Would you please comment on that or discuss it with us?

Nathan Houdek: Certainly. So just to provide a little more context. So last summer at the Summer National Meeting of the NAIC, we unveiled the investment framework document, received comment letters subsequent to that exposure. And then earlier this year we released an updated framework document, released a memo commenting on the responses that we had received initially, as well as the work plan document that you touched on, Stewart.

And really included in that is two key components, the first being six core principles that we've laid out. And I won't go through all of those in the interest of time today. That document is publicly available on the NAIC website, but really laying out what are the core principles of this work as we go forward. And then seven action items, kind of talking about things as basic as making sure the investment framework document is updated and there are regular reports provided to the (E) Committee to more complex work plan items such as developing this centralized investment expertise. We intend for this work plan to continue to evolve over time, but we think it's very important to be transparent and open in how we're doing the work currently and where we intend for this work to go in the coming months and years, frankly, as we work through each of the steps in this process.

Stewart: That's really helpful. And just on the way out the door, the question is, what's next or what are you optimistic about? I mean, you've been traveling like crazy you had mentioned right before we came on. I know you're busy as you can be. I just want to say from speaking on behalf of our audience, we really appreciate you coming on and being willing to be so open and using our platform to speak with us. I want to say thank you so much. And also what's next or what are you looking forward to? What are you optimistic about?

Nathan Houdek: That's a great question. I mean, I think what's next is a continuation of what you've seen from the (E) Committee over the last couple of years, and especially in the last few months as it relates to the framework and the action items included in the work plan. I'd say the two main subcommittees to focus on are the valuation of securities task force. There's a couple key items that are advancing under that task force currently, as well as the risk-based capital, investment risk and evaluation working group. That's really where the main action related to these issues is occurring currently. We're excited about that work moving forward. And overall, we're optimistic because the feedback that we've received and that we continue to receive has been positive. I think that conceptually the industry and most stakeholders who are following this process understand why this work needs to occur and they directionally are supportive with the work that is occurring. Obviously, the devil's going to be in the details and we'll run into some rough patches as we work through it, but overall, we're encouraged by the general support and positive feedback that we've received so far.

Stewart: That's fantastic. And Amnon, we'll give you the last word. What are you optimistic about as we go forward here?

Amnon: I'm incredibly appreciative of how much effort is going into constructive dialogue. The NAIC is incredibly unique in how it goes about refining policy. The regulators involved are volunteer, they're volunteering their time. They're not getting paid for the added work of overseeing these efforts. They're being paid by their respective departments to oversee insurers in their state. And the effort is significant, as we all know. But in the long run, I think we're going to see that it's going to really help the insurance industry in the US and ultimately policyholders.

Stewart: That's fantastic. I want to thank you both for being on. I've had a great time. And I want you to know that I honestly believe that you two have made an insurance regulation fun today, so congratulations on that. We've been joined today by Commissioner Nathan Houdek, who is the commissioner of insurance for the state of Wisconsin, and the chair of the (E) Committee of the NAIC. Commissioner Houdek, thanks for taking the time.

Nathan Houdek: Thanks for having me, Stewart. Great conversation, Amnon. Really appreciate it. And appreciate all your listeners for being engaged and interested in this fascinating topic.

Stewart: Good stuff. I really appreciate that too. And we've also been joined by Amnon Levy. I've nicknamed him the Regulatory Savant. You're the founder and CEO of Bridgeway Analytics, a RegTech firm in the insurance industry. So Amnon, thanks as always for taking the time.

Amnon: Oh, Stewart, thank you for opening up your platform to go through this incredibly important issue.

Stewart: Thank you. And thanks for listening. If you have ideas for podcasts, please shoot me a note at stewart@insuranceaum.com. My name is Stewart Foley and this is the InsuranceAUM.com podcast.