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ANALYTICS

Supporting the investment and regulatory community to navigate increasingly complex capital markets

Modernizing the NAIC’s investment risk oversight framework

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Synopsis:

Efforts to revise the NAIC investment risk oversight framework are moving forward on several fronts. The Financial Condition (E) Committee formed a Drafting Group of regulators, which has mapped out a Workplan. The Workplan includes an assessment of a significant expansion of the NAIC’s analytical capabilities through centralized investment expertise (CIE). The effort acknowledges that the SVO currently limits its focus on credit risk, highlights regulators’ needed understanding of macroprudential and emerging risks, as well as needed guidance on policy design. In addition, the E-Committee is 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.

This report reviews these developments and relates them to workstreams at the NAIC, which continue in parallel.

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

The NAIC is looking to modernize its investment risk oversight framework. The Financial Condition (E) Committee (E-Committee) formed a Drafting Group of regulators and posted a memorandum summarizing views on the next steps to implement the Framework, proposed changes to the Framework, and a Workplan. The Workplan includes an assessment of a significant expansion to the NAIC's analytical capabilities through centralized investment expertise (CIE). The effort acknowledges that the SVO currently limits its focus on credit risk, highlights regulators' needed understanding of macroprudential and emerging risks, as well as needed guidance on policy design. In addition, the Spring National Meeting materials (Attachment Eleven) include a petition 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.

The goal of the Framework is to set a long-term, strategic direction and ensure initiatives are thoughtfully coordinated. Coordination across the E-Committee's workstreams is key given the continuation of ongoing workstreams and their overlapping goals (e.g., extending NAIC staff discretion over agency ratings-based Designations) and positioned to be directionally consistent with the Framework, producing iterative feedback that will inform future progress.

At their core, efforts aspire to achieve "equal capital for equal risk," considering the noticeable shifts in insurers' investment strategies toward private and structured assets, often with more complex characteristics.[1] While a revamp is critical, the undertaking is no easy task, considering insurers' broad spectrum of holdings with varying risk characteristics and the compounding complexities of the interconnected components of the NAIC investment oversight framework.

The Workplan laid out by the Drafting Group includes action items actively being worked on. Insights include how the assessment of a conceptual CIE might be approached, which is acknowledged as a longer-term initiative and should have a phased implementation.

This report reviews these developments and relates them to workstreams at the NAIC, which continue in parallel. We begin by breaking down the recommendations from the Framework. We then outline the Action items from the Workplan and our views on what's next. We conclude by highlighting what we are optimistic about.

2 Proposed Framework to modernize the SVO

This Section reviews the seven recommendations from the Framework, and we primarily focus on two themes:

- Addressing regulators' concerns over the "blind" reliance on agency ratings, with no mechanism for overall due diligence around their usage. This is significant in the context of agency ratings helping oversee $trillions of insurers' investments.
- The buildout of a CIE function, appropriately staffed and resourced, intended to provide regulators with the needed transparency to ensure insurer solvency.

2.1 Reduce "Blind" Reliance on Agency Ratings

The Framework recommends reducing/eliminating the "blind" reliance on agency ratings but retaining their utilization. To achieve that goal, the E-Committee is 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 from the Spring National Meeting materials). In parallel, the Valuation of Securities (E) Task Force (VOSTF) is

[1] As discussed extensively in our prior reports, the NAIC embarked 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). Want to learn more? Take a look at:

- Developments from the NAIC's 2024 Spring National Meeting.
- Developments from the NAIC's 2023 Summer National Meeting.
- The changing rules governing U.S. insurers' investments: Capital requirements and the role of agency ratings.
- Trends in the Ownership Structure of U.S. Insurers and the Evolving Regulatory Landscape.

mapping out a process extending NAIC staff discretion over rating agency-based Designations, making clear the NAIC's determination to designing a long-term, thoughtful approach for the prudent use of agency ratings, along with immediate measures.

With agency ratings supporting the oversight of $trillions of insurers' debt holdings, the community has broadly supported the efforts, although significant details need to be worked through. Toward those goals, our reports, Overseeing Designations and the Prudent Use of Agency Ratings and Investment Risk Oversight, explore mechanisms for the prudent use of agency ratings, avoiding their mechanistic use, and with considerations for the efficient use of resources. The mechanisms are designed with considerations for the conflicts of interest driven by rating agencies' commercial incentives and insurers' desire to, all else equal, minimize regulatory capital. They align with the E-Committee's petition for an RFP that existing resources should be used to the extent possible (e.g., disclosures to the U.S. SEC) but that the governance needs of the NAIC transcend those of SEC oversight.

The mechanisms include novel disclosure requirements that help overcome universal challenges of assessing credit risk measures in the context of agency ratings, with considerations for their varying methods and standards challenging their comparability. The E-Committee's petition acknowledges challenges with comparability, noting that agency ratings are opinions and inherently subjective.

As discussed in our reports, the challenges are not unique to agency ratings and apply to NAIC model-based Designations. The challenges are tied to the nature of credit risk, which is generally remote, with an associated dearth of default events and, thus, a dearth of data. The structure by which rating agencies are governed encourages agencies to have differing opinions.[2] The E-Committee petition reinforces this view, highlighting the need for ratings to be innovative. The United States SEC, which oversees rating agencies by law, is not permitted to regulate the substance of credit ratings or the procedures and methodologies that determine credit ratings. Methodologies include, among other things, the quantitative and qualitative models used to determine credit ratings. Per the SEC, there are no standard or agreed-upon methods to measure the accuracy of credit ratings, in part because of the necessarily subjective nature of credit ratings and the lack of performance comparability across different industry sectors.[3]

The mechanisms we propose require varying costs and possibly new systems to support heightened disclosure; some are expected to be attainable relatively easily. For example, placing the onus on insurers to defend their use of agency ratings in business applications beyond regulatory compliance, demonstrating their genuine belief that the risk assessment is prudent and accurate, and avoiding flagrant misuse of ratings. This mechanism very much aligns with Principle (6) of the Investment Framework Workplan:

> *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.*

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

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

By requiring insurers to disclose differences between credit risk measures used in their internal processes and Designations used for regulatory purposes, regulators will be provided transparency on the degree to which Designations are credible.[4] Confidentiality considerations might require the data to be reported publicly on an aggregated basis but available to regulators individually. The approach can be deployed relatively quickly since it does not rely on the NAIC to develop new methodologies or onboard new tools or personnel.

2.2 Retain the Ability to Perform Individualized Credit Assessment and Utilize Regulatory Discretion

This recommendation would have the SVO perform individualized credit assessments and utilize regulatory discretion as a "backstop" that would, ideally, be rarely used. Forming an opinion on credit risk and their assessments is core to the micro and macro-prudential goals of the Framework, which members of the Drafting Group make clear. While we agree with the need for the NAIC to form opinions of credit risk, it is important to consider how those opinions can be formed cost-effectively and the possibility of disentangling forming and reporting those opinions from extending the SVO discretion over agency rating-based Designations.

The Valuation of Securities (E) Task Force 2024 Spring National Meeting Materials includes a proposal to extend NAIC staff with discretion over agency rating-based Designations. Public comments highlight the complexities of designing a robust process with appropriate governance. Comments also highlight the limitations of the data and systems to which the SVO currently has access, which limits the degree to which the SVO can directly model credit risk across the broad sets of insurers' credit holdings. Precision and independence must be balanced with cost as regulators work through this recommendation and its goals. On one end of the spectrum, systems and models can be developed at the standards set by rating agencies, which is not in the spirit of the Framework's intent, given the costs. On the other end, regulators can follow the suggestion above and require insurers to disclose differences between credit risk measures used in their internal processes and Designations used for regulatory purposes, providing transparency on the degree to which Designations are credible, which does not rely on the NAIC developing new methodologies or onboarding new tools or personnel.

2.3 Enhance SVO's Portfolio Risk Analysis Capabilities with Risk Analytics Tools

Investing in risk analytics tools and corresponding personnel, which could perform company-specific, industry-wide, and macroprudential analysis, is critical. The recommendation includes the need for 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.

This is tied to Recommendation #5, which would establish a policy advisory function at the SVO. It is also tied to Action Item #4, under the Investment Framework Workplan, which we are encouraged by and will begin an assessment of conceptual 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. In the context of both Recommendations #3 and #5, a worthwhile exercise would review how other rulemaking bodies have organized resources that support the supervisory and policy/regulatory process, with considerations for efficient use of resources that include the American Academy of Actuaries. An additional consideration is the need to form independent opinions on contentious policy matters with technical underpinnings, where the public comment process, which generally works well in forming a consensus, can provide less value.

2.4 Enhance Structured Asset Modeling Capabilities in Line with #3

With insurers' holdings having significant and ongoing growth in investment vehicles and structured assets, this recommendation is a natural extension of #2 and #3. The recommendation proposes less focus on individual Designation

[4] In some cases, as with CMBS and RMBS, insurers do not have a choice over the source of Designations and are required to use an NAIC model-based Designation, which they may not view as prudent. In such cases, disclosing differences between their internal risk measure and Designations may be more appropriate than requiring the use of the Designations in their internal processes.

production but instead on rating agency due diligence function, company and industry stress testing, and emerging risk identification. Provide additional resources to SSG to continue building this capability, including model governance and validation of key parameters.

2.5 Establish a Policy Advisory Function at the SVO to Provide Guidance Under a Holistic Lens

The recommendation to build a broader advisory function would permit staff to consider and recommend future policy changes, including retaining external consultants to provide guidance. This would be akin to using the Academy of Actuaries or similar for risk-based capital and reserving initiatives. We view the capabilities of forming independent opinions on policy as critical to the holistic goals of the Framework. The function should consider resources that have a deep understanding of the interconnected elements of statutory accounting and RBC that are often challenged by the nature of needed subject expertise, which is often siloed.

Discussed above under Recommendation #3, this is closely tied to Action Item #4, under the Investment Framework Workplan, which we are encouraged by and begins an assessment of conceptual CIE. The Action Item lists examples of initial related discussion points. We are encouraged by the initiative and suggest the Action Item also consider lessons learned from how other rulemaking bodies structured their supervisory and policy/regulatory processes, including expensive regulatory initiatives, such as CCAR and Solvency II, that can provide important guidance on governance and the effectiveness of various mechanisms.

2.6 Establish an Advisory Investment Working Group of Regulators Under the E-Committee

Under this recommendation, an investment working group of regulators would be formed under the E-committee. It would act in an advisory capacity on investment matters that require intensive engagement and analysis on a confidential basis, including (1) review reporting under the principles-based bond definition, (2) challenges to individual Designations provided by CRPs, and (3) review of work provided by external consultants for investment-related projects. We encourage forming such a group to include regulators with expertise beyond capital markets and to include statutory accounting and reserving.

2.7 Empower SVO to support other applicable working groups, such as SAPWG or LATF

Under this recommendation, the SVO and VOSTF would be renamed to reflect better the groups' responsibilities beyond securities valuation, which would be natural if the other recommendations were followed. The recommendation also includes empowering the SVO to conduct analysis applicable to other applicable working groups, which would also be natural and allow for effective use of resources.

3 The Workplan and Action Items

The Drafting Group developed a Workplan, intended to be a working document with core principles intended to guide the implementation of the Framework, with seven Action Items:

- Action Item #1 had the Drafting Group propose updates to the Framework, which are largely editorial, emphasizing key points, and was re-exposed through April 8, 2024.
- Action Item #2 had the E-Committee request approval from the NAIC Executive (EX) Committee to develop the RFP to hire an independent consultant to provide recommendations for a due diligence framework, which we discussed above.
- Action Item #3 has the Framework implemented in parallel with VOSTF's efforts, including extending NAIC staff discretion over agency-ratings-based Designations and the Risk-Based Capital Investment Risk and Evaluation (E) Working Group (RBC-IRE-WG) efforts, including collaborating with the Academy to differentiate capital for ABS.
- Action Item #4 will initiate an assessment of a conceptual CIE, discussed in Sections 2.3, 2.4, and 2.5, and would be a significant step forward with modernizing investment risk oversight. The Workplan outlines several areas that can be considered when conducting the assessment of this new function, with reinforcing references to holistic

capabilities beyond assessing credit risk, covering macroprudential and prospective risks, with enhancement of structured asset modeling capabilities to support due diligence, validation, and stress testing, as well as a policy advisory function. This Action Item is acknowledged to be a longer-term initiative and should have a phased implementation.

- Action Item #5 would follow Recommendation #6 above (discussed in Section 2.6) and have the Drafting Group appoint an investment-focused working group. The process would first define charges (i.e., a mandate) for this working group, which will help identify the appropriate time for formation.
- Action Item #6 has the Drafting Group develop coordination mechanisms between the Committee's workstreams, referencing dependencies such as the CLO model-based Designations effort within VOSTF and efforts to differentiate CLO capital by the RBC-IRE-WG.
- Action Item #7 excludes any action items related to RBC at this time.

3.1 What's next?

With ongoing workstreams moving forward and being used to produce iterative feedback for future progress with the Framework, we expect significant progress with its implementation in 2024 and 2025:

- Progress with ongoing workstreams:
  - A process that extends NAIC staff discretion over agency rating-based Designations, with a rollout in 1-2 years.
  - The NAIC's CLO model-based Designation rollout in 2025, originally 2024. In addition, exploratory use of the model for macroprudential oversight and stress testing is expected.
  - Progress with the American Academy of Actuaries efforts to differentiate capital for CLOs and other structured assets flowing into 2025.
- Progress with the Workplan to implement the Framework on several fronts:
  - Approval to hire a consultant to help with the agency rating due diligence framework to move forward.
  - Efforts to design a CIE function with holistic capabilities to move forward.
  - Charges to be drafted for the investment-focused working group under the E-Committee.
  - Development of coordination mechanisms between the Committee's workstreams.

4 What are we optimistic about?

Discussed extensively in our reports, [Overseeing Designations and the Prudent Use of Agency Ratings] and [Investment Risk Oversight], the seemingly overwhelming task of overseeing investment risk can be managed cost-effectively by deliberately leveraging resources efficiently (e.g., rating agencies with prudent oversight). Lessons learned from expensive regulatory initiatives, including CCAR and Solvency II, can provide important guidance on governance and the effectiveness of various mechanisms, and we are confident that the U.S. insurance regulatory framework can be adapted in a way that benefits both policyholders and insurers. We are optimistic that by focusing on providing transparency, consistency, and appropriate governance in investment oversight, the system will be less costly to implement and supervise and be more robust. We are optimistic that NAIC's communal approach to policy design will have regulators and industry come together to solve the most critical issues.

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