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ANALYTICS

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

Overseeing Designations and the Prudent Use of Agency Ratings

September 2023

Synopsis:

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

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

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

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

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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 the multitude of complex regulations across jurisdictions that use disparate language with varied rulemaking processes. The platform is used by insurers' investment, risk, compliance, legal, government affairs, accounting, and reporting functions, as well as their regulators.

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

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1 Executive Summary

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

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

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

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

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

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

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

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

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

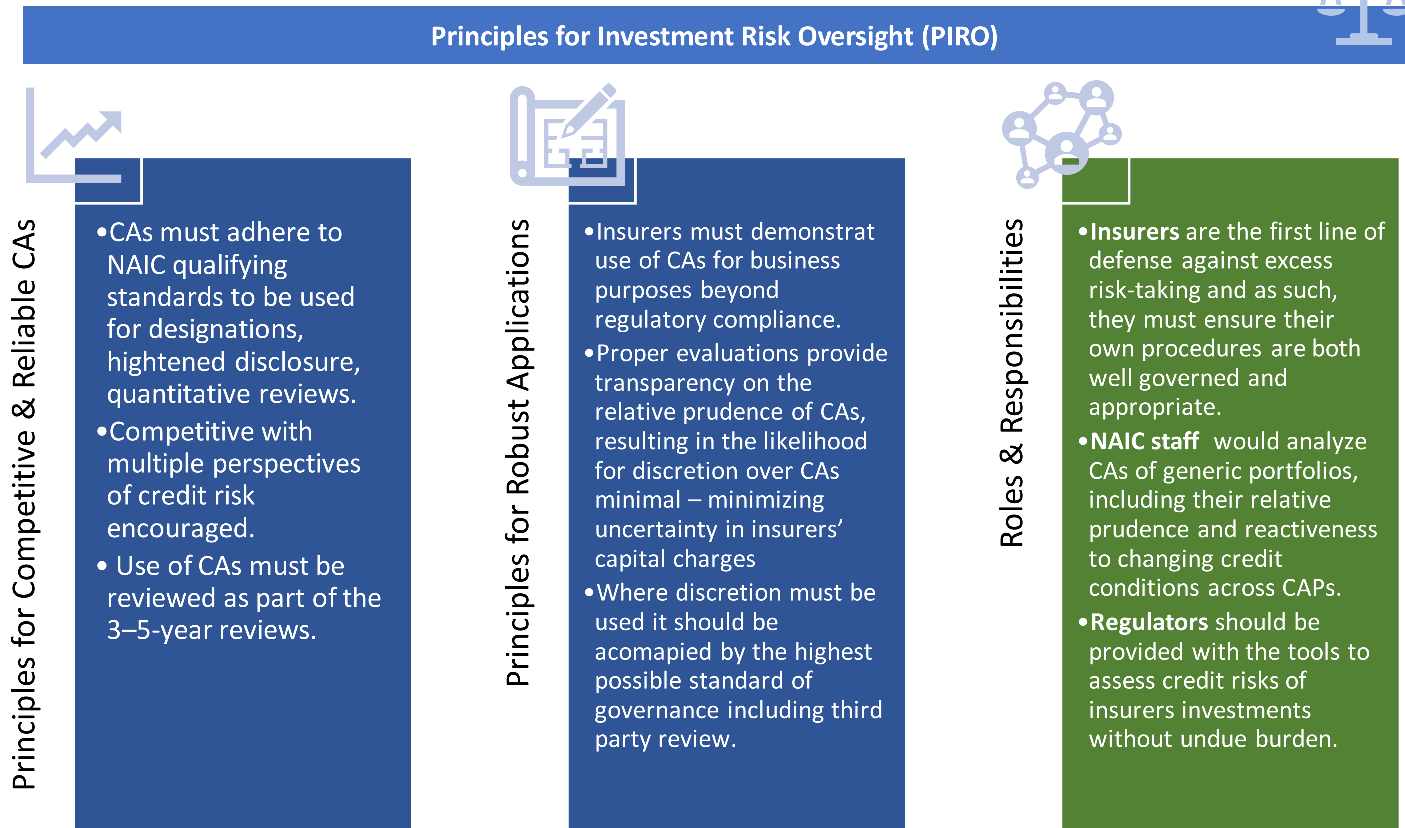
   b. **Multiple perspectives of credit risk are encouraged,** and mechanistic reliance on a single ubiquitous model in the designation process should be avoided when possible. Agency credit ratings and insurer internal ratings are the first choice for CAs with NAIC-assigned designation used in very limited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

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

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

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

Figure 1: Core Elements of the Bridgeway Analytics Proposal



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

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

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

2 The Role of Designations

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

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

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

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

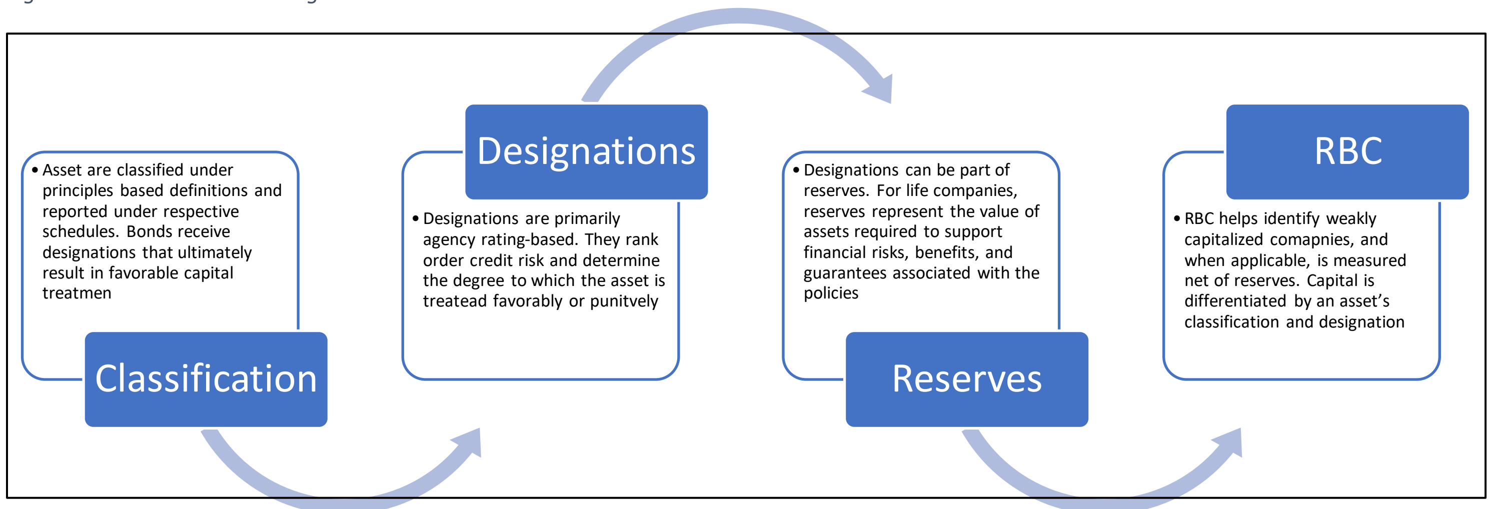
Designations can impact **reserves**. For life companies, reserves represent the value of assets required to support financial risks, benefits, and guarantees associated with the policies. They are being updated to consider the nature of complex assets more explicitly for life companies, as an example,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

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

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

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

Figure 2: Investment risk oversight



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

3 Fundamental Challenges with Overseeing Credit Assessments

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

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

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

3.1 Measuring Default Risk, which is a Remote Event

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

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

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

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

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

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

3.2 Level-Setting Risk Across Asset Classes

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

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

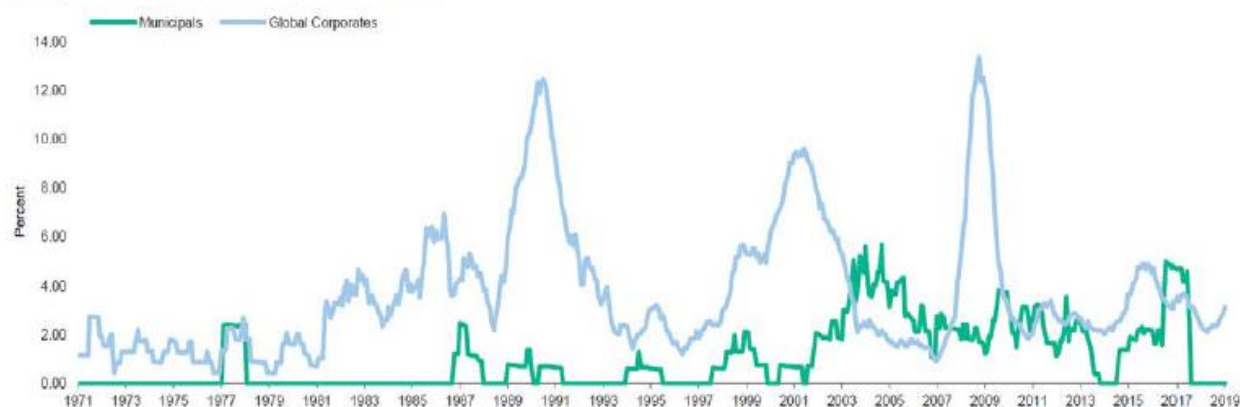
The report provides context, highlighting how municipal bonds, as an example, have experienced substantially lower default rates than global corporates. Between 1970 and 2019, the ten-year cumulative default rate for A-rated global corporates was 2.11%, significantly higher than the 0.1% experienced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

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

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

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

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



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

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

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

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

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

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

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

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

4 Principles for Designation Oversight

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

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

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

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

5 Governing Designations and Roles & Responsibilities

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

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

5.1 Qualifying Standards, Credit Assessment Performance, and Designation Assignments

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

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

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

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

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

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

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

***Additional standards qualifying CAs to be used in designations**:*

1 For each asset class (e.g., corporate credit), the provider (i.e., rating agency, SVO, or the insurer) must submit an assessment of a generic set of assets (e.g., varying industries and financial ratios). CAPs would maintain a right to appeal the design of generic assets to ensure a fair comparison.

2 Disclose details related to their discretionary overlay practices, e.g., notching a rating to account for subordination resulting in a lower expected recovery in the event of bankruptcy.

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

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

Qualified CA would be used in setting designations as follows:

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

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

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

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

Private Letter Ratings

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

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

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

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

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

5.2 Insurers: Governance and Audit

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

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

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

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

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

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

5.3 Regulators and the NAIC: Oversight and Toolset

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

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

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

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

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

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

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

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

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

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

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

6 What Immediate Next Steps Should the NAIC Consider Taking?

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

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

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

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

7 What Are We Optimistic About?

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

8 Appendix- SEC Oversight of Rating Agencies

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

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

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

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

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

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

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

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

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