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

Developments from the NAIC's 2023 Summer Meeting

August 2023

Synopsis:

The rate of change to the regulatory landscape governing US insurance investments is only accelerating, with broad implications for investment strategy. This report explores developments from the National Association of Insurance Commissioners (NAIC) 2023 Summer National Meeting with possible changes to the treatment of investments. Several initiatives have the potential to result in far-reaching implications for insurers' investment strategies and capital markets:

- Classification of investment vehicles, including bonds and residual interest of structured products.
- Revisions to the definition and oversight of ratings-based designations.
- Revisions to the capital framework to potentially differentiate Collateral Loan Obligations (CLOs) and structured assets more broadly.

In addition, the investment community closely watched the Financial (E) Committee (E-Committee) meeting to deliberate on its memo that proposes a holistic framework for investment guidelines. The memo could lead to significant implications for the path and outcome of how investment guidelines will be revised. While potential long-term implications are noteworthy, the E-Committee Chair clarified that they "do plan to hear from all interested parties as we finalize this document, but we do not plan to stop any of the work that is currently ongoing," citing three current initiatives (i.e., those related to CLO model-based designations, differentiation of C-1 capital for structured assets, and SVO discretion over designations). However, it was noted that these are deliberative processes that will continue with no commitment to adoption in their current form.

This report reviews recent developments with efforts to revise NAIC investment guidelines, including the E-Committee memo, their potential implications for investment strategy, and what might happen next.

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

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Bridgeway Analytics supports the investment and regulatory community work to optimize the design, organization, and utility of regulations surrounding the management of insurance company portfolios. While the content in this document is informed by extensive discussions with our client base, the broader industry, NAIC staff, and state regulators and may contain analysis that Bridgeway Analytics had conducted as part of a commercial engagement and retains the right to reuse, the views in this document are solely those of Bridgeway Analytics and are based on an objective assessment of data, modeling approaches, and referenced documentation, that in our judgment and experience, are viewed as appropriate in articulating the landscape. Methodologies are available to the public through an email request at: support@bridgewayanalytics.com.

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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 (beta)** 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

Discussed extensively in our previous reports,[1] noticeable shifts in insurers' investment strategies toward private assets, along with structured and complex assets, had the NAIC embark on significant multi-year updates to the RBC and STAT frameworks ranging from asset classification (i.e., bonds and residual interests), designations, reserving (e.g., Actuarial Guideline (AG) 53) to capital assignment (e.g., CLOs and ABS). Progress was made on several fronts at the 2023 NAIC Summer Meeting, including that on three ongoing initiatives with potentially far-reaching implications for insurers' investment strategy and capital markets:

- Classification of investment vehicles, including bonds and residual interest of structured products.
- Revisions to the definition and oversight of ratings-based designations.
- Revisions to the capital framework to potentially differentiate Collateral Loan Obligations (CLOs) and structured assets more broadly.

In addition, the Financial (E) Committee (E-Committee), whose working group's mandate includes overseeing these initiatives, met to deliberate on its memo that proposes a holistic framework for how insurers' investments are governed (Attachment 16). It aspires to address the piecemeal nature of updates that tactically respond to changing market conditions but have left essential framework elements disjointed. The memo can lead to significant implications for the path and outcome of how investment guidelines will be revised. While potential long-term implications are noteworthy, the E-Committee Chair clarified that they "do plan to hear from all interested parties as we finalize this document, but we do not plan to stop any of the work that is currently ongoing." Specifically citing three current initiatives (i.e., those related to CLO model-based designations, differentiation of C-1 capital for structured assets, and the NAIC's Securities Valuation Office (SVO) discretion over designations. However, it was noted that these are deliberative processes, so while the processes will continue, this is not a commitment to adoption in their current form.

This report reviews recent developments with efforts to revise NAIC investment guidelines, their potential implications for investment strategy, and what might happen next. We begin by breaking down 'in play' efforts to revise guidelines; we then provide a review of the aspirational vision of the E-Committee memo and conclude by highlighting what we are optimistic about.

2 In-play efforts to revise investment guidelines

We now dive into three initiatives, (1) Classification of investment vehicles, including bonds and residual interest of structured products, (2) Revisions to the definition and oversight of ratings-based designations; and (3) Revisions to the capital framework to potentially differentiate Collateral Loan Obligations (CLOs) and structured assets more broadly.

2.1 Classification of investment vehicles, including bonds and residual interest of structured products

Shifting investment strategies had insurance regulators and the NAIC revise guidelines to better align with the new landscape, including the classification of assets. The increased prevalence of investment strategies in complex assets, including debt and residual interests of structured assets and vehicles with nontraditional characteristics, motivated a reassessment of how the NAIC classifies 'bonds' that receive more favorable capital treatment.

2.1.1 Residual interests in structured products

Insurers began separately reporting residual interests on Schedule BA in 2022, previously reported alongside equity interests. A lower level of reporting was observed than expected, and it was noted that the concept of a 'residual interest' was not well defined under SAP and was often difficult to distinguish from equity interests. Covered in ART

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

Newsreel | August 3, 2023, the proposal provides guidance on reporting of 'in substance residuals,' with comments due September 12, 2023 (exposed draft).

A core challenge remains that all equity is, to some extent, always a residual claim, so differentiating between structured residual and other capital structures is tricky. In part, to address this issue, the Statutory Accounting Principles € Working Group (SAPWG) exposed a proposal to define further and provide examples of the investments reported under Schedule BA and captured as non-registered private funds, joint ventures, partnerships, or limited liability companies under *SAP No. 48*, or as residual interests, based on the underlying characteristics of those assets. Comments are requested on: Fixed-Income Instruments, Common Stocks, Real Estate, Mortgage Loans, and Other by September 29, 2023. SAPWG and NAIC staff plan to continue refining proposed changes to Schedule BA, as broadly covered in ART Newsreel | August 3, 2023.

2.1.2 The principles-based bond definition and the treatment of debt

The Summer Meeting brought closure to SAPWG's multi-year effort to adopt the remaining refinements related to the proposed principles-based bond definition that will go live on January 1, 2025. SSAP No. 26R characterizes the proposed bond definition, in spirit, as any security representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation or an asset-backed security. Equity-like characteristics or ownership interests in the issuer do not represent a creditor relationship and are inconsistent with what is expected of bonds reported on Schedule D-1. In addition to SSAP No. 26R changes, there are related updates to SSAP No. 43R, SSAP No. 21R, Other SSAPs, and Schedule BA.

The NAIC definition of a bond is generally broader than that used by the U.S. Securities and Exchange Commission (SEC). The principles-based approach avoids references to legal structure in the classification process and distinguishes between two types of bonds:

- **Issuer Credit Obligations** – represent credit obligations to the likes of a corporate entity or municipality. More formally, a bond for which the general creditworthiness of an operating entity or entities through direct or indirect recourse is the primary source of repayment.
- **Asset-backed securities (ABSs)** - represent credit obligations to the broad set of investment vehicles; the NAIC definition of an ABS is generally broader than that used by the SEC. A bond issued by an ABS issuer created for the primary purpose of raising debt capital backed by financial assets or cash-generating non-financial assets, for which the primary source of repayment is cash flows associated with the underlying collateral rather than the cash flows of an operating entity.

Principles provide guidance on the classification of debt instruments, including instruments with interest and principal payments that vary with the performance of an underlying value or variable, in general, will not qualify for bond treatment with exceptions for variables that are commonly linked to debt instruments, such as inflation, credit-quality interest rate adjustments, and nominal interest rate adjustments, as long as adjustments to total return are less than 10%.

What to watch out for?

- Guidance regarding the transition period (see Attachment 15 clauses 43-47), beginning with the first year of adoption (Jan. 1, 2025), reporting entities must make their best efforts to determine qualification. Investment assessments are required as of origination and permit current or acquisition information in determining whether investments qualify at the time of transition. Transition guidance shall be applied prospectively beginning with the first year of adoption (Jan. 1, 2025). For disclosures that provide comparative information, reporting entities shall not restate the prior year's information in the 2025 disclosure.
- Efforts to split Schedule D, Part 1, into two sections: Issuer Credit Obligations and ABS.

- Related initiatives include revisions to Schedule BA referenced above and relevant for investment vehicles beyond residual interests, as well as changes to Schedule BA that have additional categories for debt securities that do not qualify as bonds (e.g., those that do not reflect a creditor relationship in substance).
- An additional proposal out of the VOSTF may have added fixed-income analytical risk measures reported if adopted.

2.2 Revisions to the definition and oversight of ratings-based designation

A desire to move away from NRSROs since the financial crisis and NAIC staff stated concerns over ratings lacking comparability across NRSROs had VOSTF's 2023 mandate updated to include establishing criteria to permit staff's discretion over NAIC rating-based designations (also referred to as 'filing exempt'). The stated objective is to ensure greater consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives. Two related proposals continue to be deliberated on that dovetail with the E-Committee memo's stated concern over "blind" reliance on the agency ratings that we now explore in greater detail: (1) **Defining NAIC designations and other non-payment risks** and (2) **Procedures for the SVO's discretion over NAIC designations**.

2.2.1 Defining NAIC designations and other non-payment risks

As part of efforts to set standards over designations, VOSTF has been working with the SVO to appropriately define designations and articulate the risks that are intended to be captured. The Summer Meeting revisited the latest proposal to redefine NAIC Designations that was previously discussed at their July 13 meeting. There are two elements to the proposal:

- The definition of a designation.
- Instruments that exhibit 'other non-payment risks' would receive a Subscript S, where NAIC staff would be allowed discretion over notching their designation. For context, it has been argued that features, such as payment-in-kind (PIK) interest, pose additional risks that may not be captured in some agency ratings.

The 2023 Summer Meeting discussion mirrored that of the prior meeting, with concerns raised over the chosen language, including the question of how 'tail risk' is defined and the extent to which it causes a deviation between ratings and designations. Commenters reiterated a call to make the definition as clear and simple to understand as possible. Discussions touched on similar issues the Securities and Exchange Commission (SEC) Office of Credit Ratings (OCR) are challenged by when overseeing NRSROs and credit ratings. The SEC's definition is intended to support the notion of benefits to varying opinions when assessing credit risks, with each NRSRO defining their respective credit rating measure in conjunction with disclosed methodology and rating performance. Analogous to definitions used in other jurisdictions and by rating agencies, technical issues such as tail risk are detailed in the modeling frameworks and deliberately excluded from the definition to avoid confusion. Comments related to the proposed discretion with classifying assets as having 'other non-payment risks' and their notching mirrored comments pertaining to procedures for the SVO's discretion over NAIC designations. A receptive Task Force instructed SVO staff to update the definition:

- Finding an alternative mechanism to provide regulators transparency on assets with uncertain timing of cash flows, replacing the proposal to use subscript S for assets with 'other non-payment risks.'
- Incorporating recovery/loss-given-default in the definition of designation where relevant.

2.2.2 Procedures for the SVO's discretion over NAIC designations

For context, this proposal was initiated by several concerns, including reliance on agency ratings argued to be inapplicable for regulatory purposes and capital arbitrage, and has evolved. Early versions of the proposal included restricting the use of agency ratings for NAIC designations of debt issued by investment vehicles, including feeder notes, with arguments for NAIC model-based designations similar to those justifying NAIC CLO model-based designations (ART Newsreel | March 23). This most recent proposal outlines a process by which state regulators and NAIC staff may challenge public and private ratings along with an appeal process (ART Newsreel | May 18).

Deliberations at the Summer Meeting related to extending the SVO discretion over designations aligned with posted comment letters (see meeting [Materials]) with concerns raised by a group of members from the US Congress, industry, trade groups, and other interested parties that included:

- Lack of SVO oversight and a need for an independent third party to facilitate checks and balances.
- Lack of transparency, including limited visibility on methodologies employed by the NAIC**.** Noteworthy comments included the proposal requiring the SVO to have access to data not currently available, raising concerns over the sequence of what is being proposed and its validity.
- Lack of 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. Several letters point to the magnitude of shifts already experienced.
    - One comment letter, for example, points to the NAIC's negative bias towards smaller rating agencies, having insurance companies placing a moratorium on their use, and in part, resulting in a recent substantial drop 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 one large agency has experienced a growth in the number of issues rated over the same period (details covered in ART Newsreel | August 3, 2023).
    - An interesting practical point was raised that, for public securities, the instigation of a designation review may constitute material nonpublic information in specific assets and broader asset classes, meaning it may be illegal for the firm supporting the review to trade these assets.

What's new? NAIC staff attempted to appease concerns with refinements to the posted proposal to extend discretion over rating-based designations. Notable, staff proposed refinements were not posted but rather presented through oral, prepared remarks:

- **The process**. SVO staff further explained the process of flagging rating-based designations of concern and subsequent notching, which would take up to a year to reach a final determination. Insurers would have options, including securing an additional rating to avoid further scrutiny – which may ease concerns around third-party review. They also outlined potential disclosures to maximize transparency without compromising confidentiality agreements, e.g., providing annual statistics on challenges and appeals and obfuscating the precise securities being scrutinized.
- **The meaning of an NRSRO**: Staff took pains to point out that the SEC requires NRSROs to disclose methods and governance and is not, in fact, a guarantee of the veracity of any specific rating. Noting that it is left up to the consumer of a rating to assess its appropriateness given those disclosures. Interestingly, staff painted the NAIC as a consumer of ratings rather than the insurers - potentially highlighting one of the conceptual problems of having a regulator issue their own designations rather than simply supervising the use of designations, as with many other regulatory jurisdictions.

Deliberations proved contentious, with the industry and interested parties noting that their primary concerns remain unaddressed, each with elements related to the points above.

What's next?

The task force was receptive to comments and instructed staff to update the draft to address some of the concerns around transparency and process, as well as to consider the engagement of a third party to support governance and oversight - although this would require Executive Committee approval. The Chair also noted that the wide-ranging E-Committee memo may impact this process. New drafts are exposed to be shared at subsequent VOSTF meetings.

2.2.3 NAIC model-based designations for CLOs

As part of the longer-term initiative to move away from agency ratings and toward NAIC model-based designations, the VOSTF adopted intrinsic-price modeled-based designations with a year-end 2024 timeframe. The approach is outlined in Instructions for the Financial Modeling of CLOs and will follow that of CMBS and RMBS. It has authorized the CLO Modelling Ad hoc group, which includes NAIC staff, interested regulators, and key stakeholders, to work through the various issues to achieve consensus over technical modeling details.

What's new? The Ad-Hoc CLO technical group provided a brief update at the VOSTF meeting (also referenced below), noting that they are proceeding without modeling prepayment and below-par investment which we cover in greater detail in Newsreel Update | July 13, 2023. The following steps will include initiating the design of economic scenarios that will feed into the model. Technical material can be found on the Collateralized Loan Obligations website. The next Ad-hoc meeting will likely be scheduled after Labor Day.

2.3 Our opinion- overseeing designations

2.3.1 A spectrum of nuances to be considered with ratings, and their appropriate use

Fundamental to prudent risk management is the need for measuring risks from multiple perspectives, with incumbent opinions not de facto being favored. There should be a deliberate avoidance of mechanistically relying on any single model or statistic. The framework should ensure that no single point of failure will lead to systemic events.

In the context of credit measures, the NAIC should encourage using multiple perspectives of risk and avoid the mechanistic reliance on a single ubiquitous model. 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 GAP, which assesses solvency with CECL considering future credit loss, and capital requirements that are managed completely differently and provide a different lens.

That said, and as highlighted in the E-Committee memo, a robust due diligence framework must be in place and reduce/eliminate "blind" reliance on rating agencies. Those governance standards for credit measures should rely on key principles:

1. The onus should be on insurers to ultimately defend the use of an agency rating in business applications beyond regulatory compliance, demonstrating their genuine belief of the risk assessment to be 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 might not be practical given proprietary elements. Rather, using an agency rating is aligned with benchmarks and appropriately audited. More on this point in our next report – stay tuned!
2. Regulators should be provided with the tools and transparency to assess the appropriateness of use without undue burden.
3. Align incentives, and ensure standards are met, addressing concerns over incentives to 'race to the bottom' with the potential for agencies gaining market share by assigning overly favorable ratings.
4. Oversight should be sensitive to proprietary elements of ratings and structured to address concerns with:
    a. Private ratings lack credibility because of a lack of market oversight, given their private nature.
    b. Limits to the disclosure required by the SEC often provide insufficient transparency with methodologies, with some having proprietary elements.

2.3.2 Two aspects of the proposals that require consideration:

2.3.2.1 Identifying/measuring overly favorable ratings

Data and modeling requirements are significantly more extensive than what NAIC staff currently have. For example, assessments of 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 assess the credit risk of the note legitimately. 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 roughly 35 SVO/SSG staff.

Are regulators and the industry prepared to make significant investments in the needed infrastructure and prepared for a heightened level of disclosure and development of methodologies that would be required to assess the validity of ratings?

2.3.2.2 Managing and acting on overly favorable ratings

Acknowledging the need for better data and tools to identify overly favorable ratings leaves an important question about how to interpret the precision by which the SVO is able to act.

If the data and/or methodologies are not immediately accessible, how should extending the SVO notching authority be interpreted?

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 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.

2.3.3 The need to measure before managing

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. With that context, we feel that rather than fleshing out a process for extending NAIC staff discretion over notching ratings-based designations, consider first focusing on the following:

- Initiating a program to demonstrate which mechanisms can legitimately be used in identifying overly favorable ratings and, in doing so, publish data and reports that would provide regulators transparency over misuse of agency ratings.
- Develop an overarching governance structure overseeing agency ratings, encouraging new entrants while holding them to a suitably high standard.

Once the data and systems are in place that allow for the identification of overly favorable ratings, it will be more natural to explore the mechanisms by which the NAIC can manage agency ratings.

2.4 Differentiating capital for CLOs and structured assets

This subsection explores developments with efforts to differentiate capital allocated to structured assets and reviews (1) Adopted interim changes to the treatment of residual interests of structured assets and (2) A broader effort to design a capital framework for structured assets.

2.4.1 Adopted interim changes to the treatment of residual interests of structured assets

Risk-Based Capital Investment Risk and Evaluation (E) Working Group (RBC-IRE-WG) adopted interim charges to the treatment of structured assets tranche residuals held by life companies:

- For 2023, the charge will remain at 30% with a 15% sensitivity test; absent a detailed and evidence-driven alternative proposal from the industry, the charge will automatically increase to 45% in 2024 (with a 0% sensitivity).
- The adoption was a compromise, with strong and differing views expressed by a bifurcated industry and with some regulators questioning the urgency and need for an interim change, considering the longer-term and broader initiative of updating the treatment of structured assets and the need for more analysis. Others question whether life insurers should hold residual interests.

While the adopted changes are interim, posted comment letters and discussions highlighted the strong and varying views. They also highlighted the heterogeneous characteristics of tranche residuals and ABS more broadly. Notably, the case for a higher charge for tranche residuals was initially motivated by concerns over regulatory arbitrage whereby substantial capital relief can be achieved by structuring a pool of assets compared to holding the assets directly. Cases demonstrated the possibility of reverse arbitrage, whereby structuring leads to the structure receiving higher capital than the underlying. Part of the industry sees this as an opportunity to convince regulators to accept a lower charge; others may push for an even higher number. Regardless, with the commitment to accept new material, it is now incumbent on market participants to provide a detailed study to justify any alternative charge.

2.4.2 Designing a capital framework for structured assets

As part of a long-term effort to differentiate the treatment of structured assets, the RBC-IRE-WG initiated efforts with the American Academy of Actuaries to develop a framework to differentiate capital for CLOs and structured assets more broadly. The RBC-IRE-WG 2023 Summer Meeting Agenda & Materials includes a presentation from the Academy on Principles for Structured Securities RBC. The Academy traditionally provides guidance to the Capital Adequacy (E) Task Force (CATF) and its Working Groups, including RBCIREWG, on technical matters that include C-1 factors and has been a key figure in the debate on whether and how to differentiate the treatment of CLOs and structured assets more broadly.

The Academy's presentation provides a framework for determining whether and how to differentiate the treatment of a structured asset with considerations that include acknowledging the need to assess:

- Materiality or likely materiality in the future across the industry.
- Risks that need to be considered within C-1.
- The expected benefits of a more precise calculation should outweigh the expected costs.
- A flowchart of whether new C-1 factors should be developed for an asset class and whether each asset should be modeled individually (as is currently the case with, say, mortgages) with a spectrum of considerations. One in particular references CLOs and other structured assets that should be singled out from corporate bonds, where the Academy believes their tail risk increases more quickly. While references to tail risk are common throughout deliberations related to the treatment of structured assets, including the Academy's December 2022 report, we have not seen the concept well-articulated. Brett Manning provides some framing to the issue in his highly technical and exceptionally weedy ART Newsreel | August 10, 2023, *In the Weeds* column, where he explains technical nuances, including CTE, references to cliff risk, and variation in default/impairment correlation that differentiates structured credit from, say, corporate credit.

What's next?

The presentation includes Structured Securities C-1 Candidate Principles for regulators to consider. The RBC-IRE-WG will meet again in the coming weeks to take comments on the high-level candidate principles outlined by the Academy. Once consensus is formed on principles, the Academy would presumably move forward with developing a capital framework for structured assets.

3 A long-term aspirational vision – the E-Committee memo

The investment community was undoubtedly focused on any insights and implications to the E-Committee memo it can gain at the Summer National Meeting. In its current form, this long-term initiative includes the modernization of the SVO, creating a team of expert investment risk professionals to oversee a coherent approach to evolving capital markets. To avoid confusion, SVO should be interpreted to mean the SVO, or its successor organization, as the memo suggests a potential rebranding to align with the change in focus. Reviewed in ART Newsreel | August 3, the memo suggests a broad review, acknowledging the significant multi-year updates to the RBC and STAT frameworks ranging from asset classification (i.e., proposed definitions for bonds and residual interests), designations (e.g., proposed definition), to capital assignment (e.g., CLOs and ABS).

At the most basic level, the memo explores the most effective use of regulatory resources in the modern environment of insurance regulation for investments, with aspirations of achieving the principle of "Equal Capital for Equal Risk." While it is suggested that the SVO "retain ability within the SVO to perform individualized credit assessment," it also describes this as a 'backstop' which "would be rarely used."

The proposed framework has similarities to how other rulemaking bodies in this space are structured, focusing on systematic reviews, overseeing the use of rating agencies, and supporting policy development rather than providing individual security assessments. The proposal also suggests that the NAIC specifically consider its role in macroprudential oversight and provide assessments of market implications related to guideline changes.

The E-Committee memo maps out a shift in strategy, whereby the SVO would prioritize resources to establish a robust and effective governance structure for the due diligence of CRPs, rather than synthesizing CRP functions. It lays out a *primary* focus for the NAIC to reduce/eliminate "blind" reliance on CRPs but retain overall utilization of CRPs *by implementing a strong due diligence framework.* This framework should be extremely robust, with focused resources within the NAIC's implementation and maintenance. It would also provide high-level guidelines for considering the consistency of capital across assets as the investment RBC initiatives move forward.

Deliberations at the Summer Meeting had commissioners and regulators express vocal support for the framework and a need for more transparency and oversight over the investment risks. The E-Committee Chair clarified that they "do plan to hear from all interested parties as we finalize this document, but we do not plan to stop any of the work that is currently ongoing.", Specifically citing three current initiatives (i.e., those related to CLO model-based designations, differentiation of C-1 capital for structured assets, and SVO discretion over designations.

What's next? The memo was posted for a public comment period of roughly 45 days.

3.1 Our opinion

The NAIC has an incredible opportunity to thoughtfully redesign the framework that governs investment guidelines at a time when the industry is not in crisis in a way that can support innovation and long-term growth, ultimately benefiting policyholders. Our advocacy for an overarching governance framework at the NAIC dates back to our efforts to revise the

C-1 bond factors on behalf of the NAIC and ACLI. While we acknowledge the need to tactically respond to changing market conditions, for which we have been involved ourselves, the process has left essential framework elements disjointed. The memo provides an initial framing of aspirations, which will evolve as regulators better understand nuances that will undoubtedly bubble up through communal posted comments and the natural process of working through the details. At its core, principles that extend beyond capital and designations are needed, covering the broad treatment of investments across RBC and statutory accounting, including reserves.

Stay tuned for more on the topic!

4 What are we optimistic about?

The NAIC investment framework has helped to support stability while providing consumers with excellent choices in both insurance and investment. It has done this by taking a collegiate approach with regulators working closely with the industry to understand their concerns while advocating for policyholders. This alone is cause for optimism even as we observe contentious but mutually respectful debates. However, the framework is well overdue for a review; in the last 30 years, the complexity of both capital markets and the regulatory framework have increased exponentially but often in different directions. We are, therefore, optimistic about the proactive approach E-Committee has taken to look at the system while it is financially stable rather than waiting for a crisis. This is a credit to the commissioners who have shown leadership but also to industry voices who have argued for action. We look forward to supporting all sides as this initiative develops.