Framework for Regulation of Insurer Investments – A Holistic Review

Executive Summary

- Recent initiatives to address gaps in the regulatory framework for insurer investments have received much attention by a variety of stakeholders.
- While the broader commentary has included many misconceptions around these initiatives, it has also included constructive feedback with themes and observations that many regulators have shared.
- At the most basic level, the question has arisen – **what is the most effective use of regulatory resources in the modern environment of insurance regulation for investments?**
- The historical focus of the SVO has been on risk assessment of individual securities, with filing exempt securities blindly reliant on credit rating providers (CRPs) for designations.
- The SVO currently lacks the tools to provide due diligence and assessment over the use and effectiveness of CRPs, or to conduct enterprise- or industry-wide risk analytics.
- Rather than a framework that utilizes valuable SVO resources to prioritize synthesizing CRP functions, a more effective use of those resources would be to prioritize the establishment of a robust and effective governance structure for the due diligence of CRPs.
- Further, with investment in modern risk analytics tools, the SVO could provide invaluable risk analysis capabilities to better support the risk-focused approach to supervision, at both a micro- and macro-prudential level.
- This memo provides concrete proposals envisioning a modernization of the role and capabilities of the SVO in a way that correlates with the observed shift towards more complex and asset-intensive insurer business strategies.
- It also provides high-level guidelines for considering consistency of capital across assets as the investment RBC initiatives move forward, recognizing the practical limitations of absolute capital parity.

Background

The NAIC is the U.S. standard-setting and regulatory support organization created and governed b the chief insurance regulators of the 50 states, the District of Columbia and the five U.S. territories. NAIC Designations are produced solely for the benefit of NAIC members in their capacity as state insurance regulators as a tool to help assess insurer's solvency.

There are several workstreams underway related to investments, which are meant to address a material, observable shift in insurer investment strategies – primarily but not limited to life insurance/reinsurance – toward more private assets, more structured assets and more complex assets. The workstreams are not meant to be punitive for the sake of being punitive, or to discourage innovation in insurers' investment strategies, but they recognize existing frameworks did not contemplate these investment strategies and will need to be enhanced to appropriately incorporate their characteristics into the regulatory framework.

While this goal is largely accepted by all interested parties as being necessary, the details of various proposals and the processes by which they have been undertaken have received an immense amount of attention from industry, other supervisory stakeholders and special interest groups, with stark divides in approval or disapproval of various initiatives. The collective commentary has included a significant amount of constructive feedback and valid critique, but has also been marked by misconceptions and competitive dynamics.

Recent comments have referred to these projects as "piecemeal" and "disjointed" and recommended a pause to all such workstreams. Others have suggested that these efforts are motivated by objectives other than enhancing regulators' ability to protect policyholders. In reality, what is being observed is the natural strain that results from solving complex problems through open and democratic processes. A number of ~~compounding~~ factors contribute towards making these projects particularly challenging endeavors:

(1) **Highly technical nature –** the ability to assess risk and design a regulatory framework for structured assets is highly dependent on the ability to model collateral performance through the capital structure of an extremely wide variety of securitization types. This requires highly specialized expertise. With experts from a divided group of stakeholders providing differing assessments of the modeled data, it is difficult for policy-making regulators to parse without conducting an impartial analytical study.

(2) **Separate working groups –** the state-based framework has long utilized a "three-legged stool" approach to addressing accounting, risk assessment, and capital, which are governed by separate working groups. While all three legs of the stool have always needed to contemplate what the other legs were doing in order to have a cohesive regulatory framework, a project of this magnitude that spans all three legs requires a much more intensive level of coordination~~, which is further challenged by its exploratory nature~~.

(3) **Exploratory nature –** assessing risk and capital is a balance between being too broad, and failing to appropriately capture material risks, and being too detailed, such that the framework is impractical to apply and too complex to be understood. Finding this balance is an iterative process of developing proposals, soliciting feedback, and adjusting or replacing proposals in response. This process inherently takes time and involves uncertainty around final outcome, but it also is not well understood by all stakeholders. This can result in disproportionately adverse reactions rather than the productive feedback that is necessary to reach what are often the common goals of all stakeholders. It also makes the coordination of working groups challenging, as the end state of each working group's initiatives is unknown while in process.

(4) **Capital parity –** as a number of stakeholders have pointed out, the capital framework should have a goal of assigning "equal capital for equal tail risk". While this goal is likely non-controversial in the abstract, it doesn't address the practical limitations of achieving this goal in absolute terms. First are the balancing considerations noted elsewhere here. But it also implies that all risks must be holistically evaluated at the same time, in order to prevent a change for one asset class from disadvantaging another by comparison. There is no question that these impacts are very important to consider as updates are made, and mitigating unequal treatment to the extent possible should be a goal. However, practical constraints may prevent this aspiration from being realized to the satisfaction of all parties.

(5) **Limited resources –** just as the regulatory framework is a balance between being too broad and too detailed, so too is the use of regulatory resources a balance between impartiality and practicality. State regulators have at their disposal a valuable resource in the NAIC, and SVO specifically. However, these resources are not unlimited. There should be a deliberate evaluation of the best use of these limited resources. State regulators should not develop frameworks that prioritize using such resources in reperforming functions that can otherwise be satisfied using available market mechanisms, leaving no capacity for more impactful and macro-level risk assessment and analysis.

Purpose

While much of the characterization of these ongoing projects in the broader commentary is misplaced, it is prudent to reflect periodically on a holistic basis over the course of a complex project to evaluate potential areas for process improvement to the overall regulatory framework. **The intent of this memo is to highlight areas that regulators have identified where the insurance regulatory framework for investments could be enhanced based on reflections on the past several years of work on these issues, as well as comments on individual current initiatives and how they could be improved upon by addressing certain of the challenges described above.** This memo is not directly responsive to any particular feedback from stakeholders, but draws upon the experience of regulators involved in these workstreams, as well as comment letters written on current proposals, stakeholder communications not directly related to working group exposures, and ongoing conversations among regulators and stakeholders.

Proposed Regulatory Enhancements

The goal of the Framework and its proposed enhancements is to set a long-term, strategic direction for investment regulation and ensure current and future initiatives are thoughtfully coordinated and supportive of this holistic direction. A workplan will be utilized to further consider such proposed enhancements in more detail and where appropriate, changes will be made to this to reflect the final enhancement. The Framework does not have an objective of reaching technical conclusions on ongoing initiatives. Ongoing work will continue without delay or pause. Current workstreams are directionally consistent with the Framework and are producing iterative feedback that will inform future progress towards their objectives. As is always the case, workstreams and the Framework itself are subject to future refinement based on this iterative process of incorporating new information.

A. Investment risk assessment / role of a centralized investment expertise function (e.g. SVO: IAO/SSG)

Currently, risk-based capital charges ~~The current framework~~ rel~~ies~~y upon NAIC Designations for assets reported as bonds, with limited risk assessment for non-bond holdings. NAIC Designations ~~currently~~ are either provided directly by the SVO for filed securities or by a direct translation of a credit rating from a Credit Rating Provider (“CRP”) for those securities that are exempt from filing (“FE”). There is currently a “blind” reliance on the CRP rating, with no mechanism for overall due diligence around CRP usage, nor an ability to challenge an individual rating for not conforming to regulator expectations of how it was determined. Both of these issues are potentially addressed through current initiatives of the Valuation of Securities Task Force (“VOSTF”), with multiple challenges and concerns (both warranted and unwarranted) of how they may be implemented.

Proposed Framework to modernize the SVO:

(1) Reduce/eliminate "blind" reliance on CRPs but retain overall utilization of CRPs ***with the implementation of a strong due diligence framework**.* This framework should be extremely robust with focused resources within the NAIC in its implementation and maintenance. This initiative should be a ***primary*** focus of the NAIC and ***utilize an external consultant/resource to design & implement**.* It is both inefficient and impractical for the SVO to effectively replicate the capabilities of CRPs on a large scale, and would not provide incremental benefit if the output is substantially similar. Rather, the SVO should focus primarily on holistic due diligence around CRP usage. That process must be vigorous and consequential (e.g. clear quantitative and qualitative parameters for CRPs utilized to provide ratings for use as NAIC designations).

(2) ***Retain ability*** within the SVO to perform individualized credit assessment and utilize regulatory discretion when needed, ***under well-documented and governed parameters***. This "backstop" should be embedded in the regulatory regime, but ideally would be rarely used if other governance is optimized.

(3) ***Enhance SVO's portfolio risk analysis capabilities*** with investment in a risk analytics tool and corresponding personnel, which could perform both company-specific risk analytics at the request of regulators, and industry-wide risk analytics for use in macroprudential efforts. ***Review/ increase staffing*** to include analysts with investment actuarial and risk management backgrounds that can provide dedicated investment-related support to risk-based capital and reserving teams, understanding the key functions of asset-liability management and resulting portfolio impacts. Changes to this centralized investment expertise at the NAIC will be determined based upon the needs of regulators.

(4) ***Enhance structured asset modeling capabilities*** in line with #3 with less focus on individual designation production, but in support of the CRP due diligence function (can provide tools for validation of CRP designations), company and industry stress testing, and emerging risk identification. Provide additional resources to SSG to continue to build this capability, inclusive of ***model governance*** and validation of key parameters.

(5) ***Build out a broad policy advisory function*** at the SVO that can consider and recommend future policy changes to regulators under a holistic lens, considering input from all impacted processes. If needed, ***hire key external consultants*** to be on retainer to provide key guidance on policy related issues, assess market impact and provide recommendations. This would be akin to the use of the Academy of Actuaries or similar for risk-based capital and reserving initiatives.

(6) Consider establishing a ***broad investment working group*** under E committee that acts in an advisory capacity to various investment processes that would ultimately need more intensive regulator engagement and analysis on confidential basis (similar to FAWG/VAWG), including (1) review of bond reporting analysis under the principles-based bond definition, (2) challenges to individual designations provided by CRPs, (3) review of work provided by external consultants for investment-related projects for broad impacts to the framework (beyond the group that would have commissioned the review)

(7) If the multitude of the above recommendations are implemented, rename the SVO and VOSTF to better reflect the responsibilities of the groups beyond securities valuation. ***Empower SVO*** to utilize the tools and analysis available to raise key issues to other applicable working groups, such as SAPWG or LATF (or RBC-IRE, but also noting key support for that group via an investment-

focused actuarial team). ***<u>Reduce the size</u>*** of VOSTF membership or its successor to encourage active regulator engagement on core issues.

Impacts of Proposed Framework on Current Initiatives:

<u>VOSTF:</u>

(1) CRP Due Diligence: Re-prioritize this initiative (currently in place with limited resources) and retain an external consultant to build out the framework. Allow for engagement with CRPs in its creation.

(2) Regulatory Discretion over CRP designations: Continue deliberative process on this existing proposal to incorporate interested parties' constructive feedback on framework.

(3) CLO/RMBS/CMBS Modeling: Review output in conjunction with the Academy of Actuaries and RBC-IRE to determine if (1) NAIC designations, (2) dynamic ad hoc modeling/stress capabilities or (3) a combination of both, are the most valuable use of SSG resources, noting the request above to provide additional resources to this group.

<u>LATF:</u>

(1) SVO Staff enhanced as suggested above could be an additional resource in AG 53 type reviews, and may be able to provide validating analysis via its analytical tools.

(2) Investment actuarial staff can provide key recommendations to enhancements to asset adequacy testing based on investment characteristics identified.

<u>SAPWG:</u>

(1) No direct impact to implementation of the bond project outside of establishment of a working group that can assess specific assets for reporting purposes.

<u>RBC-IRE:</u>

(1) Increased investment actuarial and risk management could provide key support to establishment of structured asset RBC factors given the cross-functional understanding of investments and RBC parameters.

B. Risk-Based Capital for Investments

The project to review RBC factors for investments remains in its infancy, but has made considerable strides with the formation for the RBC-IRE Working Group in 2022 and the engagement of the American Academy of Actuaries to begin developing factors for CLOs. As this project moves forward, the following guidelines should be considered:

(1) Changes in RBC factors ***<u>should consider market impacts secondarily to solvency impact and consistency across asset classes</u>*** in determining when and how to implement such changes. While perfection under a principle of "Equal Capital for Equal <u>Tail</u> Risk" is likely unachievable, it should nevertheless be a goal to create consistent standards to the highest degree practicable. For example, the current work at RBC-IRE is appropriately beginning with studying CLOs for developing RBC factors for structured securities. It is possible that new factors for CLOs would be available before a determination has been made for how to extrapolate a framework to other types of structured securities. As the phases of this project progress, care should be taken to consider the impacts of changing factors for an asset class

while similar asset classes may remain unchanged. Factors to consider may include impacts to asset allocation and financial markets, in balance with the level of urgency of regulatory action.

(2) The RBC-IRE Working Group should consider and address areas where inconsistencies in treatment across asset classes ***incentivize a particular legal form***. The RBC-IRE Working Group should coordinate with the SAPWG where needed on this item. A key example of this is private credit funds, where the underlying assets are fixed income, but regulatory barriers frequently prevent them from receiving a fixed income capital charge, instead assigning an equity factor. This requires insurers to structure such investments into bond-form through securitization in order to receive a fixed income charge, which may ***"overcorrect"*** and lead to ***capital arbitrage***. Developing an avenue for such assets to receive a capital charge commensurate with the underlying asset risk would significantly reduce the need to form structured securities out of many types of private fixed income assets.