Fall 2022 NAIC Update

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With the NAIC's recent adoption of expanded bond RBC factors, some might have assumed we would lack exciting new regulatory updates to anticipate for a while. Far from it! While none are quite on the same scale of ambition, 2022 has brought progress on a variety of investment-related regulations, some with pending effect, others with likely years before final adoption. In this paper we'll review this recent activity. In the world of NAIC investment regulations, there is always something to look forward to.

Principles-Based Bond Definition & Schedule D-1 Revision

To add clarity about how securities should be classified and add detail in annual reporting of holdings, the Statutory Accounting Principles Working Group has released a proposed overhaul for the categorization and reporting of bonds in Schedule D Part 1. **This contemplates dividing the schedule into two sections, one encompassing issuer-backed securities (including most corporate and municipal bonds), and the other holding asset-backed securities** (this term is used here to include all structured bonds, not just those backed by non-mortgage loan types like in other contexts). The full listing of the new sections can be found at the end of this paper, but **the key takeaway is that it results in a more natural and intuitive**

grouping of bonds by type, and includes breakouts for some categories that were not previously identifiable, including separating General Obligation vs Revenue muni bonds, and putting BDC/REIT bonds into their own category.

Another important facet of this development is an updated “principles-based” bond definition, spelling out in detail what characteristics cause a security to fall into one of the two major categories of bonds on Schedule D-1. This is intended to reduce the need for case-by-case review of esoteric security designs by better outlining the required prerequisites for bond treatment; we’ll have more to say momentarily about the NAIC’s efforts to discourage regulatory arbitrage via complex security designs that receive bond treatment while incorporating equity-like risks.

This proposal is currently in a comment period lasting until 10/7/22.

Anticipated implementation: year-end 2022

Creation of Ad Hoc Credit Rating Provider Group

The NAIC has taken note of variation across bond ratings agency methodologies, and seeks to ensure fair and consistent ratings are being issued across all credit rating providers (CRP’s). An Ad Hoc group has been formed to review this issue and identify any recommendations for adjustments to the Filing Exempt process that may be warranted. **Possible outcomes include excluding certain ratings agencies from FE consideration if their ratings are found to be out of alignment with industry standards, requiring multiple independent ratings to support an FE rating, or establishing criteria for how securities should be evaluated by CRP’s that wish to be eligible for FE treatment.** This can be seen as adjacent to the recently-established policy requiring greater disclosures around Private Letter ratings, as the NAIC frankly wishes to ensure insurers aren’t exploiting excessively generous ratings from specific CRP’s to artificially minimize RBC charges.

The Valuation of Securities Task Force has issued a proposal to add “Establish criteria to permit staff’s discretion over the assignment of NAIC designations for securities subject to the filing exempt process (the use of credit rating provider ratings to determine an NAIC designation) to ensure greater consistency, uniformity and appropriateness to achieve the NAIC’s financial solvency objectives” to the task force’s objectives.

Anticipated implementation: difficult to estimate given limited information, but 2023 at the earliest.

Proposed Revision of ABS/CLO RBC Charges

Collateralized Loan Obligations (CLO’s, structured bonds holding pools of floating-rate bank loans to businesses) have become a major focus for the NAIC, especially small/private CLO deals with high yields and complex structures, which have been used by some insurers (especially Life) to boost investment returns in the pre-2022 low rate environment. The NAIC is concerned that the current ratings process is not adequately capturing the tail risks embedded in these securities, resulting in insurers applying insufficient capital charges for the potential losses they represent.

During the summer the Valuation of Securities Task Force proposed that CLO ratings be determined by a modeling process comparable to that used for MBS. An initial round of stress testing on insurer CLO holdings was performed, and comments from interested participants collected. At the summer meeting the VOSTF responded to comments and concerns, and recommended moving forward with the general framework. Several major steps remain: drafting policy language, identifying and validating scenarios to test, and responding to industry feedback at each stage. Final implementation is anticipated no earlier than year-end 2023, and possibly 2024. Note that the updated Schedule D-1 breakout discussed earlier now groups non-agency CLO's into their own subcategory, which should make it easier to apply a different ratings methodology to this sector (and perhaps others in the future if needed).

High-yielding, opaque CLO's are not very widely held, so while this change should not impact most insurers too heavily, one interesting consequence will be how this affects the recent trend of PE firms purchasing Life liabilities and using esoteric investments to try to out-earn traditional insurer portfolios. The NAIC doesn't necessarily object to this, but they are clearly focused on ensuring that these novel investment strategies aren't built around regulatory arbitrage and that embedded risks are properly accounted for.

Anticipated implementation: year-end 2023 or 2024.

Adding Fixed Income Analytical Measures to Schedule D-1

The Securities Valuation Office is proposing to add a variety of fixed income analytical measures to annual reporting, including items like market yield, duration, average life, and yield spread over Treasuries. **These will permit much richer analysis of insurer risks and exposures, and provide important context to the CRP ratings when evaluating risks; for example, a holding with a higher spread than bonds of similar rating and duration may indicate the presence of credit risk that wouldn't previously have been detectable.** This ties into the NAIC's overall focus on improving the measurement of investment risks beyond simply relying on CRP ratings as a catch-all.

The current focus is whether these analytics should be produced by the SVO itself, or provided by the insurers in their reporting. Both approaches have pros and cons; a comment period on these alternatives was recently concluded and the results and next steps should be published in coming weeks.

Anticipated implementation: year-end 2022 or 2023

Adoption of "Intrinsic Price" Method for Rating RMBS/CMBS

Ever since the 2008/9 financial crisis the NAIC rating for non-agency RMBS and CMBS securities has been determined by comparing the carrying value to a grid of price breakpoints; the lower the carrying value (and thus the lower potential for loss), the better the rating. This was a response to the mass downgrading of these securities as the housing bubble popped, and the sudden spike in risk-based capital needed to support these investments under the previous ratings process. After the change, if a distressed security had been written down to reflect its probable recovery value it could be carried at a strong NAIC rating that reflected how it had already "taken its medicine" via impairment.

Challenges to this new approach arose during the 2020 global Covid crisis. Without going into all the technical details, it became clear that many MBS securities were suddenly receiving punitive RBC treatment due to having been purchased at premium prices, rather than any inherent underlying credit weakness. Another change was needed.

Effective year-end 2022, pricing grids will no longer be used for RMBS/CMBS issued after 2012 (legacy securities will retain the prior treatment). Instead these securities will use the "intrinsic price" method, which will be based on the modeled loss for each cusip regardless of carrying value. The primary effects of this change will be 1) all insurers will now carry the same cusip at the same rating, and 2) there will no longer be an artificial disincentive to purchase MBS at premium (>100) prices; the rating will be driven solely by modeled loss potential regardless of original purchase price. This approach strikes a prudent balance between simplifying the previous approach and solving the issues that came up during Covid, while still incorporating more nuance than the past CRP-ratings driven approach still used for most corporate and municipal bonds.

Anticipated implementation: confirmed for year-end 2022

Conclusion

These aren't the only policy updates currently underway, but we've focused on those investment-related items likely to be of interest to a broad swath of insurers. Insurance markets are constantly evolving and regulations need to keep pace. If you have any questions about how these developments may affect your portfolio, or about any other NAIC news we haven't covered here, please contact your AAM Portfolio Manager or our Business Development team and we'd be happy to give a prompt response.

Source: NAIC

Appendix: Proposed New Schedule D Part 1 Categories

Schedule D-1-1: Issuer Credit Obligations
U.S. Government Obligations
Other U.S. Government Securities
Non-U.S. Sovereign Jurisdiction Securities
Municipal Bonds – General Obligations
Municipal Bonds – Special Revenue
Project Finance Bonds Issued by Operating Entities (Unaffiliated / Affiliated)
Corporate Bonds (Unaffiliated / Affiliated)
Mandatory Convertible Bonds (Unaffiliated / Affiliated)
Single Entity Backed Obligations (Unaffiliated / Affiliated)
SVO-Identified Bond Exchange Traded Funds – Fair Value
SVO-Identified Bond Exchange Traded Funds – Systematic Value
Bonds Issued from SEC-Registered Business Development Corps, Closed End Funds & REITS (Unaffiliated / Affiliated)
Bank Loans – Issued (Unaffiliated / Affiliated)
Bank Loans – Acquired (Unaffiliated / Affiliated)
Mortgages Loans that Qualify as SVO-Identified Credit Tenant Loans (Unaffiliated / Affiliated)
Certificates of Deposit
Other Issuer Credit Obligations (Unaffiliated / Affiliated)
Total Issuer Credit Obligations (Unaffiliated & Affiliated)
Total Affiliated Issuer Credit Obligations

Schedule D-1-2: Asset Backed Securities
Financial Asset-Backed Securities – Self-Liquidating
Agency Residential Mortgage-Backed Securities - Guaranteed
Agency Commercial Mortgage-Backed Securities - Guaranteed
Agency Residential Mortgage-Backed Securities – Not Guaranteed
Agency Commercial Mortgage-Backed Securities – Not Guaranteed
Non-Agency Residential Mortgage-Backed Securities (Unaffiliated / Affiliated)
Non-Agency Commercial Mortgage-Backed Securities (Unaffiliated / Affiliated)
Non-Agency – CLOs / CBOs / CDOs (Unaffiliated / Affiliated)
Other Financial Asset-Backed Securities - Self-Liquidating (Unaffiliated / Affiliated)
Total Financial Asset-Backed Securities - Self-Liquidating (Unaffiliated / Affiliated)
Financial Asset-Backed Securities – Not Self-Liquidating
Equity Backed Securities (Unaffiliated / Affiliated)
Other Financial Asset Backed Securities – Not Self-Liquidating (Unaffiliated / Affiliated)
Total Financial Asset-Backed Securities – Not Self Liquidating (Unaffiliated / Affiliated)
Non-Financial Asset Backed Securities - Practical Expedient
Lease-Backed Securities – Practical Expedient (Unaffiliated / Affiliated)
Other Non-Financial Asset-Backed Securities – Practical Expedient (Unaffiliated / Affiliated)
Total Non-Financial Asset-Backed Securities – Practical Expedient (Unaffiliated / Affiliated)
Non-Financial Asset-Backed – Full Analysis
Lease-Backed Securities – Full Analysis (Unaffiliated / Affiliated)

Other Non-Financial Asset-Backed Securities – Full Analysis (Unaffiliated / Affiliated)
Total Non-Financial Asset-Backed Securities – Full Analysis (Unaffiliated / Affiliated)
Total Asset-Backed Securities
Total Affiliated Asset-Backed Securities
Total Long-Term Bonds (Issuer Credit Obligations & Asset Backed Securities)
Total Affiliated Long-Term Bonds (Issuer Credit Obligations & Asset Backed Securities)

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