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A new bond definition... Are you ready for it?

Quick hits from the National Association of Insurance Commissioners (NAIC) Summer Meeting, held in Chicago on August 12-15, 2024.

Lara Devieux, Senior Managing Director, Head of Insurance Advisory & Product

Here's what you need to know

1. **The Valuation of Securities (E) Task Force adopted the Securities Valuation Office (SVO) discretion proposal, giving regulators a 'backstop' to override NAIC Designations they believe are inappropriate.** After a year of industry feedback and regulator collaboration, the current version of the initiative is more palatable to insurers, with increased transparency and greater participation in the process, along with recognition that it will only be used in rare cases. The formal adoption by the Financial Condition (E) Committee is expected to occur in a separate meeting on August 29.
2. **The new principles-based bond definition goes into effect January 1, 2025, necessitating insurers to review their existing structured credit portfolios.** The definition was adopted last year and requires insurers to evaluate bond portfolios, in particular public and private asset-backed securities, for continued bond treatment on Schedule D. Given the practical challenges of implementing a principles-based regulation, during the Statutory Accounting Principles (E) Working Group meeting, regulators adopted an issue paper and exposed a working Q&A document for comment which outlines key provisions of the new bond definition and offers implementation guidance.
3. **The 45% risk-based capital (RBC) charge for residuals will be in place for a relatively long "interim period".** With the American Academy of Actuaries (AAA) noting a delay in the project to develop RBC factors for asset-backed securities (ABS) during the Risk Based Capital Investment Risk and Evaluation (E) Working Group meeting, the capital charge for residuals will remain in place for the foreseeable future. In what would be a welcome (and overdue) development, the new priority for the working group is to holistically review the RBC treatment of bond funds to ensure consistency across structures.
4. **The Financial Condition (E) Committee has begun to act on its holistic investment framework, with a focus on the use of credit rating providers (CRPs).** The group issued a draft request for proposal (RFP) in search of an independent consultant to develop a due diligence framework for the ongoing regulatory use of CRPs. As heavy consumers of ratings, regulators want to develop parameters for CRPs in the NAIC

designation process, while also having the ability to perform individualized credit assessments and utilize discretion when needed.

Interested in diving deeper? Below are detailed meeting notes and takeaways on these important investment regulatory proposals. As always, I would be happy to engage directly with anyone interested in discussing these topics further.

SVO discretion initiative adopted in "friendlier form" for insurers

During the Valuation of Securities (E) Task Force (VOSTF) meeting, regulators adopted the highly discussed and hotly debated proposal to give the SVO discretion in reviewing and overriding NAIC designations in the filing exempt (FE) process. The original proposal introduced in late 2022 to remove the FE status of structured equity/funds was broadened to incorporate all FE securities in August 2023, but since then has undergone several iterations in response to industry concerns and feedback. While the universe of potentially impacted securities and the factors to flag them remain broad and vague, several improvements were made to the discretion proposal from prior versions, notably:

- **Improved transparency into the review process.** During the full review process, the Investment Analysis Office (IAO; comprising the SVO) must provide a written summary of its security analysis and why it believes the rating is an unreasonable assessment of investment risk, as well as answer any questions by the insurer(s) about its analysis. In addition, prior to the meeting with the VOSTF sub-group and SVO Credit Committee to discuss the impacted security and rating in question, the IAO must provide in writing its opinion of the appropriate NAIC designation and rationale.
- **Greater participation and inclusion of impacted parties into the process.** Insurers are able to invite other authorized parties (for example, the credit rating provider) to aid in the analysis and discussion with regulators, while the state domiciliary regulator(s) of the impacted insurer(s) are also invited to the sub-group meeting.
- **Increased anonymity and consistent treatment to protect against adverse market reactions.** The IAO will publish anonymized summaries of actions taken following individual designation overrides within 45 days and in the aggregate on an annual basis, but information on specific securities, credit rating providers or impacted insurers will not be disclosed. In addition, the initiative explicitly states that the process will be consistently applied to all credit rating providers.
- **Potential for future revisions.** Acknowledging that the SVO discretion process has not yet been operationalized, the initiative includes language that the VOSTF may review the process and recommend revisions at any time to ensure it remains effective and efficient.

Demonstrating the benefits of a collaborative and iterative NAIC regulatory process, both regulators and insurers appear to be relatively satisfied with the proposal. It provides a formal backstop to regulators as heavy consumers of ratings that was originally intended at the outset of the filing exempt process (as discussed during the Fall 2023 National Meeting). At the same time, the initiative creates a structured process with some safeguards for insurers. Regulators continue to stress that SVO reviews and overrides will be used only in rare, outlier, and individualized cases, and language to this extent was added in the adopted version of the initiative. This authority is meant to complement the initial priority under the Financial Condition (E) Committee's holistic review of insurers' investment regulatory framework to create a due diligence process for the oversight and use of CRPs (see section below).

While the SVO discretion proposal has yet to be officially adopted by its parent, the Financial Condition (E) Committee (this is slated to occur during a follow up call on August 29), the effective date would be January 1, 2026, one year later than originally proposed. Furthermore, there is the potential for the date to be amended later due to needed enhancements to NAIC's systems, resources and processes.

Principles-based bond definition implementation looms large throughout meetings

The principles-based bond definition (PBBD), adopted last year by the Statutory Accounting Principles (E) Working Group (SAPWG) and effective January 1, 2025, was a topic of discussion throughout various meetings given its widescale scope and requirements, and due to numerous implementation questions as insurers evaluate the guidance in the context of their bond portfolios. During the SAPWG meeting, recognizing PBBD's complexities and areas of uncertainty, regulators adopted an issue paper and exposed for comment a working Q&A document that outline the key provisions of the new bond definition and offer implementation guidance. Debt securities that no longer qualify as bonds will transition to Schedule BA from Schedule D and will be reported on new line items that note the reason for bond treatment ineligibility and whether they have an existing NAIC designation assigned by the SVO. Over the long-run, regulators in the Risk-Based Capital Investment Risk and Evaluation (E) Working Group (RBC IRE) may consider revising the RBC factors for these debt securities to avoid a punitive 30% capital charge for other Schedule BA assets (for life insurers). In the short run, during the VOSTF meeting, the SVO highlighted that for these non-bond debt securities, life insurers will have the opportunity to obtain NAIC designations through the normal SVO filing process to seek more favorable bond RBC charges, although we note that this process is typically a lengthy one.

Holistic review of RBC treatment of funds to start by RBC IRE (E) Working Group

In a relatively uneventful meeting, the RBC IRE (E) Working Group discussed one of its next priorities on its 2024 working agenda: to holistically review the RBC treatment of funds to ensure consistency across structures. The working group provided materials (i.e., prior referrals) dating back to 2018 that addressed the need for consistent RBC treatment for funds that invest in bond portfolios, as certain funds are eligible for NAIC designations via look through treatment (for example, some ETFs and SVO-rated private funds), while others are not (including most mutual funds and closed-end funds). The main objective of this comprehensive initiative is to assign RBC factors to funds that are appropriate for the risk and aligned with the underlying assets. In addition to being welcomed by the industry, the initiative is also consistent with key provisions highlighted in the Financial Condition (E) Committee's holistic regulatory investment framework, including the principle of equal capital for equal risk (including consideration of tail risk) and recommendation to address RBC inconsistencies that incentivize certain structures/legal forms. Next steps are for NAIC staff to craft a memo to inform future work and solicit industry guidance from the American Council for Life Insurers (ACLI) and interested parties on the universe of funds and their underlying characteristics.

During the RBC IRE (E) Working Group, the American Academy of Actuaries (AAA) provided an update on its long-term project to develop RBC factors for asset-backed securities, with CLOs as the near-term priority. Notably, there has not been progress on the current AAA workstream to analyze comparable attributes/risk inputs for CLO tail risk, which are to be ultimately used in the development of RBC factors, due to issues in obtaining the necessary data. As such, the introduction of an initial framework for CLO RBC factors will be delayed until 2025 at the earliest. The practical implication of this delay is that the ABS residual RBC factor of 45% for year-end 2024 will remain in place for a relatively long "interim" period. Over the long-term, we expect differentiation in ABS residual RBC factors, including lower charges for higher quality and debt underlying collateral assets, in line with the various comment letter proposals presented to the working group in June 2024. While there was acceptance to this concept by some regulators, ultimately, these proposals were rejected by a majority on the RBC IRE (E) Working Group, instead preferring to keep the interim 45% ABS residual RBC charge until the AAA develops data-driven and analytically robust RBC factors for CLOs and other ABS securities.

First action item comes out of Financial Condition (E) Committee's holistic investment framework

Introduced a year ago ahead of the Summer 2023 National Meeting, the Financial Condition (E) Committee's framework is a long-term roadmap for investment regulation to ensure: 1) regulators have appropriate tools to monitor and assess the solvency of insurers, and 2) current and future initiatives are coordinated and considered in a holistic manner by regulators with continued transparency and engagement with industry parties. The associated work plan will guide the implementation of the investment framework on a real-time basis.

Prior to the Summer 2024 National Meeting, the first action item coming out of the investment framework and work plan was a draft RFP to hire an independent consultant to provide recommendations for a due diligence framework for the ongoing use of CRPs. With the high-level objectives of the governance framework to set minimum standards of CRPs for regulatory purposes and to determine ways to minimize the incentive for insurers to "ratings shop", the RFP outlines numerous quantitative and qualitative factors that need to be considered in the analysis of CRPs. While not an exhaustive list, some key examples include: (1) comparability of ratings methodologies by CRP by security type, sector or industry and how they should be mapped to NAIC designations; (2) differences in analysis and treatment for single rated or jointly rated securities, as well as public vs. private credit ratings; (3) incorporation of new investment types and emerging asset classes and methodologies to rate them; and (4) factors that could disqualify a CRP from NAIC use, including potential conflicts of interest. The Financial Condition (E) Committee exposed the draft RFP for comments until October 14, 2024, with feedback sought on whether the program objectives, response requirements and selection process/assessment criteria are clear and understood. Feedback will be discussed prior to or at the Fall National Meeting in November 2024, with the issuance of the RFP expected in 2025 dependent on the level and magnitude of comments received.

Concluding remarks

While the NAIC Summer 2024 National Meeting lacked the heated dialogue that we have seen in recent meetings, there were important adoptions and updates that will impact insurers' investment portfolios going forward. Specifically, the adoption of the SVO discretion proposal by VOSTF was not a surprise as regulators sought a backstop to review and override NAIC designations of individual securities. Yet, improvements to the proposal, including a stated recognition that its authority will not be used often, and a long lead time until implementation, mitigate any near-term regulatory risks. The implementation of the principles-based bond definition is a heavy lift for insurers ahead of its January 1, 2025 effective date, with potential negative RBC implications in 2025 for debt securities that no longer qualify as bonds and that do not already have SVO-assigned NAIC designations. The RBC factor for residuals for life insurers will likely remain at 45% for the foreseeable future as the long-term project to develop RBC factors for asset-backed securities has been delayed. With the Financial Condition (E) Committee taking its first action to govern the use of CRPs, the holistic investment framework will guide future regulatory initiatives through a coordinated and collaborative process to ensure insurers' solvency.

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