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You need to calm down… About the principles-based bond regulation

Quick hits from the National Association of Insurance Commissioners (NAIC) Fall Meeting, held in Denver on November 16-19, 2024.

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Here's what you need to know

1. **Principles-based bond definition (PBBD) implementation is a heavy lift but is aided by the newly-adopted PBBD Q&A document and financial impacts should be limited.** After months of analyzing individual Schedule D securities for continued bond treatment, insurers appear ready to implement PBBD on 1/1/25. To aid in the analysis, regulators in the Statutory Accounting Principles (E) Working Group (SAPWG) provided implementation guidance in the adopted Q&A document and remain available for continued consultation in 2025. The consensus is that there will not be widescale movements from Schedule D to BA, with the exception of 1) unitranche/lowest rated tranche CMBS single asset, single borrower (SASB) transactions; 2) non-agency mortgage passthroughs; 3) select hybrids; and, 4) certain mezzanine ABS that may not have substantive credit enhancement. For securities that transition to Schedule BA and are subject to onerous RBC charges, regulators have provided various avenues to mitigate the financial impacts; for example, allowing for bond capital charges via the Securities Valuation Office (SVO) review and designation process (life insurers only) and modeling individual CMBS SASBs by the Structured Securities Group (SSG).
2. **Risk Based Capital Investment Risk & Evaluation (E) Working Group (RBC IRE) 2025 priorities include a review of funds and development of CLO RBC factors.** With the goal to ensure RBC consistency across structures, in 2025, regulators, in conjunction with the American Council of Life Insurers (ACLI), will review three structures that have similar underlying assets but different RBC charges, statutory schedules and accounting treatment: 1) bond ETFs; 2) SEC-registered bond mutual funds; and 3) private bond funds. After a delay, the American Academy of Actuaries (AAA) has begun to analyze and determine comparable attributes/risk inputs for CLOs, which would ultimately be used in the development of RBC factors across debt and residual tranches.
3. **Valuation of Securities (E) Task Force (VOSTF) warns of missing private letter ratings (PLR) rationale reports that could lose NAIC designations.** In 2025,

barring no major systems issues, regulators will deactivate PLRs on securities issued post 2022 if required rating rationale reports are not filed. Notably, there are approximately 1,700 private securities that fall under this category where rationale reports have not yet been received by the SVO.

4. **More granular RBC charges and an alignment of RBC practices by insurance types likely on the horizon by Capital Adequacy (E) Task Force (CATF).** Various self-directed and recommended RBC initiatives include new RBC factors for non-bond debt securities and collateral loans on Schedule BA, a review of non-investment components of the RBC formula (including C2 and C3 for life insurers) and allowing P&C and health insurers to benefit from the SVO designation process for certain Schedule BA assets.
5. **A coalition of state regulators from Connecticut, Iowa, Wisconsin, New York, and California, alongside Nuveen, hosted a special session on impact investing.** There is momentum and alignment across various industry bodies to identify ways to pair capital from insurance companies and other catalytic sources to make investments that have a positive societal impact on people and the environment—while also meeting the need for stable, secure investments that insurance companies require.

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.

SAPWG adopted PBBD Q&A document

During the SAPWG meeting, regulators adopted the Q&A document (with updates from industry), which provides interpretations on how the principles-based bond guidance should be applied to specific structures or investment characteristics. A set of 11 questions covers asset classes such as foreign governments, municipals, CMBS single asset, single borrower (SASB) transactions and interest only (IO) strips, hybrids and sports deal transactions, as well as topics such as assessing the substantive credit enhancement and meaningful cash flow requirements of asset-backed securities (ABS). Three notable items to highlight in the Q&A document include:

- **CMBS SASB transactions.** According to regulators, CMBS SASB transactions qualify as ABS, not as single operating entities under ICOs. As such, they require substantive credit enhancement to qualify as bonds. Unitranche SASBs, as well as the lowest (i.e., most junior) tranches of multi-tranche SASBs lack substantive credit enhancement as the investor in the securities is not in a different economic position than if they held the underlying mortgage loan directly. These securities would then be reported on Schedule BA as non-bond *debt securities that lack substantive credit enhancement*.
- **Meaningful cash flow considerations for non-financial ABS.** Regulators provided commentary to aid insurers in evaluating the requirement that collateral supporting non-

financial ABS must produce meaningful cash flows other than through sale or refinancing. Specifically, regulators stated that all cash flows available to creditors may be included in the assessment of meaningful cash flows, including rights to future contracted cash flows. Non-contractual cash flows (e.g., from future leases arising from a security where the lease duration is shorter than the duration of the debt security) cannot be considered under the practical expedient. However, a full analysis can be performed to determine that all lease cash flow (current and future, including potential unleased time) will satisfy the interest and at least 50% of original principal, thus concluding there are meaningful cash flows.

- **Admittance of non-bond debt securities.** According to regulators, for securities that no longer qualify as bonds (i.e. because they did not reflect a creditor relationship, have substantive credit enhancement or meaningful cash flows), the underlying collateral must qualify as an admitted asset in order for the non-bond security to be admitted. As an example, if an ABS backed by railcar leases does not qualify as a bond on Schedule D, then that debt security on Schedule BA will be a non-admitted asset as railcars are not admitted assets. Conversely, if a unitranche CMBS SASB transaction does not qualify as a bond on Schedule D, then the non-bond debt security and the underlying mortgage loan that supports it would remain admitted assets. As such, an insurer's statutory capital and RBC ratio could be negatively impacted under PBBD by both higher RBC charges and/or the non-admittance of certain assets.

Insurers' accounting teams, with the help of internal and external asset managers, consultants and third party vendors, as well as insurance company peers and regulators, have done significant preparation for the 1/1/25 PBBD effective date, including ensuring existing bond holdings qualify for continued bond reporting (as issuer credit obligations or asset-backed securities), developing policies for new bond purchases and sourcing information for new reporting requirements effective in 2025. During the SAPWG meeting, however, regulators cautioned insurers using third party vendors to comply with PBBD, stating that they must own the process and not blindly accept the results of automated, "pass/fail" type tools. Regulators remain willing to work with interested parties in 2025 on any needed clarifications that emerge, and could reconvene regular meetings, if needed.

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

The RBC IRE (E) Working Group met in October ahead of (and in place of) the Fall meeting in Denver. As was previewed during the Summer National Meeting in August, the RBC IRE (E) Working Group will review the RBC treatment of funds to ensure consistency of structures. Instead of taking a holistic view of all structure types as was initially desired, regulators will focus their attention on three structures that have similar underlying assets but different RBC charges, statutory schedules and accounting treatment: 1) bond ETFs; 2) SEC-registered bond mutual funds; and 3) private bond funds; with only bond mutual funds not allowing for bond RBC treatment. Regulators, in conjunction with the ACLI, will analyze these structures and the underlying risks to develop principles that can be expanded to other funds as needed.

While the fund initiative will be impactful, the most meaningful takeaways of the most recent RBC IRE (E) Working Group meeting were: 1) the lack of RBC initiatives related to PBBD; and 2) the slow progress toward new long-term RBC factors for ABS, and specifically, CLOs. Upon PBBD implementation on 1/1/25, for securities that transition to Schedule BA as non-bond debt securities (from Schedule D), the main path available for life insurers to receive bond RBC treatment is through SVO-assigned NAIC designations (either existing or new filings). Non-bond debt securities without designations, as well as for P&C and health insurers, will incur punitive RBC charges for these securities on Schedule BA at 30% for life insurers and 20% for P&C/health insurers. The RBC IRE (E) Working Group would be tasked with assigning bond-like RBC factors for these transitioned debt securities, however, to-date there has been no referral by the "parent" CATF to take such action.

During the RBC IRE (E) Working Group meeting, 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. With historical loss history data on CLOs and underlying collateral from Moody's Analytics now in hand, the AAA will begin the process of analyzing and determining comparable attributes/risk inputs for CLOs. These attributes would ultimately be used in the development of RBC factors across debt and residual tranches, ideally in a matrix approach similar to how RBC factors are calculated for commercial mortgage loans based on property type, loan-to-value (LTV) and debt service coverage ratio (DSCR). The AAA should be able to give an update on their work during the Spring 2025 National Meeting.

VOSTF provides updates on CMBS modeling and private letter ratings

The abbreviated VOSTF meeting did not have substantive regulatory developments, unlike the Summer National Meeting when the SVO discretion proposal was adopted. However, there were two interesting updates provided by the SSG and SVO. First, to mitigate the potential adverse RBC impact from CMBS unitranche SASB transactions no longer qualifying as bonds, the SSG recommended that insurers send them CUSIPs to model these individual securities for continued appropriate RBC charges. Second, the SVO provided an update on private letter rating (PLR) filings for 2024, stating that in 2025, regulators will deactivate non-waived PLR securities issued after January 1, 2022, if the required rating rationale reports are not filed. According to the SVO, there are approximately 1,700 private securities issued post 2022 where rationale reports have not yet been filed. Given prior technology/system issues, the SVO will grant a 30-day grace period to submit these rationale reports, and if widespread technology issues persist, regulators could defer enforcement for three months.

RBC changes to watch in 2025?

The Capital Adequacy (E) Task Force (CATF), the "parent" of the Life, P&C and Health RBC Working Groups, will be evaluating various self-directed and recommended RBC initiatives in 2025 and beyond. These initiatives could result in more granular RBC charges and an alignment of RBC practices by insurance type, specifically:

- Post PBBD implementation, varying interpretations of the regulatory guidance are likely, leading to different reporting classifications of the same securities by insurers. With information on the amounts and scope of non-bond debt securities that transition to Schedule BA and subject to punitive 30% (life) and 20% (P&C, health) RBC factors, CATF regulators may direct the RBC IRE (E) Working Group to develop new factors for non-bond debt securities.
- As part of the PBBD Q&A document comment letter process, SAPWG recommended that regulators in the RBC Working Groups consider more granular RBC reporting based on SVO-assigned designations for P&C and health insurers, to be consistent with the practices allowed for life insurers.
- CATF regulators plan to increase its activities to review components of the RBC formula, instead of creating a new working group (Risk Based Capital Research (E) Working Group) as was proposed in recent meetings. Regulators seek to comprehensively review the RBC formula for all insurance types; in particular, the non-investment components (such as C2 and C3 for life companies) and covariance structures that have not been reviewed since the inception of the RBC formulas in the early 1990s. In addition to maintaining accuracy by reflecting changing economic and insurance conditions, the RBC review will serve the important function of increasing transparency and documentation.
- Reporting of collateral loans on Schedule BA will be expanded in 2025 under the purview of SAPWG. With more information on the amounts and types of underlying collateral, regulators can consider potential RBC factor changes in the future from the current one factor.
- During the Spring 2024 National Meeting, regulators in CATF proposed a 45% residual RBC charge to P&C and health insurers to align with the interim factor for life insurers. The proposal was deferred indefinitely and has not been a topic for discussion in recent meetings but could be revisited in the new year.

Special session: Unlocking insurance capital for impact featuring NAIC President and Nuveen

Outgoing NAIC President and Connecticut Insurance Commissioner, Andrew Mais, hosted a special session on impact investing to discuss ways insurance company capital can drive positive social and environmental change. Commissioner Mais highlighted the collaboration between Nuveen and a coalition of state regulators from California, Connecticut, Iowa, New York and Wisconsin to develop a solution that pairs capital from insurers and other catalytic sources such as foundations, endowments and family offices, to invest for impact. During the session, five criteria were highlighted that make an investment an attractive fit for an insurance company portfolio; some of which may not be present in an impact investment which creates barriers for insurers to invest for good at scale. These five criteria include: 1) market rate of return, 2) Schedule D fixed income assets, 3) ability to invest in size, 4) asset liability matching and 5) repeatable transactions/structures. A potential impact-oriented structured finance solution that meets these criteria could accelerate investments in affordable housing; companies that are

increasing resource efficiency, mitigating carbon emissions and expanding access to affordable basic services; projects to enhance commercial real estate energy efficiency; and sustainable energy infrastructure. Unlocking insurance company capital for positive outcomes while meeting insurers' need for stable, secure investments will require partnership and collaboration between insurers and their regulators, trade group(s) and asset managers.

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