



October 9, 2023

VIA ELECTRONIC SUBMISSION

Director Elizabeth Kelleher Dwyer
Chair, Financial Condition (E) Committee
Commissioner Nathan Houdek
Vice-Chair, Financial Condition (E) Committee
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Framework for Regulation of Insurer Investments – A Holistic Review

Dear Members of the Financial Condition (E) Committee:

The American Investment Council (“AIC”)¹ appreciates the opportunity to comment on the draft *Framework for Regulation of Insurer Investments – A Holistic Review*² (“Framework Memo”) that was exposed during the Financial Condition (E) Committee’s August 15, 2023 meeting. We agree that a comprehensive, methodological and holistic review of the myriad of recent investment-related initiatives undertaken by various National Association of Insurance Commissioners (“NAIC”) working groups and task forces is necessary. We commend the E Committee for recognizing the need to conduct a holistic review of those initiatives. However, we remain concerned that the Framework Memo leaves open the possibility that the NAIC Securities Valuation Office (“SVO”)³ will begin financially modeling collateralized loan obligations (“CLO”) for purposes of risk-based capital (“RBC”) treatment. We understand that the E Committee has indicated that the CLO modeling work will continue, and respectfully suggest that decision be re-considered in light of the factors we raise below.

¹ The American Investment Council, based in Washington, D.C., is an advocacy, communications, and research organization established to advance access to capital, job creation, retirement security, innovation, and economic growth by promoting responsible long-term investment. In this effort, the AIC develops, analyzes, and distributes information about private equity and private credit industries and their contributions to the US and global economy. Established in 2007 and formerly known as the Private Equity Growth Capital Council, the AIC’s members include the world’s leading private equity and private credit firms which have experience with the investment needs of insurance companies. As such, our members are committed to growing and strengthening the companies in which, or on whose behalf, they invest, to helping secure the retirement of millions of pension holders and to helping ensure the protection of insurance policyholders by investing insurance company general accounts in appropriate, risk-adjusted investment strategies. For further information about the AIC and its members, please visit our website at <http://www.investmentcouncil.org>.

² The Framework Memo is available at: <https://content.naic.org/sites/default/files/inline-files/Framework%20for%20Investments%20Exposed%20by%20E%20Committee.pdf>.

³ Except where otherwise noted, references in this letter to the SVO also refer to the NAIC Investment Analysis Office and/or the NAIC Structured Securities Group, as applicable.

As explained below, the NAIC’s current plans to begin financially modeling CLOs in January 2024 is inconsistent with the E Committee’s observations, as set out in the Framework Memo, and recent presentations by the American Academy of Actuaries (“Academy”) to the NAIC on this topic. This timeline also relies on what we believe is a flawed CLO modeling methodology.

In light of these concerns, we respectfully request that the E Committee revisit its current plans and timeline for requiring the financial modeling of CLOs. More broadly, we respectfully encourage you, as members of the E Committee, to continue to actively supervise the “intensive level of coordination” that is required with respect to the “highly technical,” and interrelated accounting, risk assessment, and capital activities of the E Committee’s investment-related subordinate committees. We are hopeful that the Framework Memo will support a more methodical and transparent approach to assessing those interconnected workstreams.

While the focus of this letter is to express our concern with the financial modeling of CLOs and its current timeline for completion, we also want to take the opportunity to note our concerns with (i) the proposed amendments to the *Policies and Procedures Manual of the NAIC Investment Analysis Office* (“IAO”) that would provide the SVO discretion to adjust NAIC Designations that are assigned through the NAIC Filing Exempt (“FE”) process and mapped to credit rating provider (“CRP”) ratings (“FE Proposal”), and (ii) the NAIC’s action to impose a 45% RBC charge beginning in 2024 on asset backed security residuals (“Residuals Charge”). With respect to the FE Proposal, we appreciate the Framework Memo’s acknowledgement that various stakeholders have raised a number of valid concerns related to these issues, and its directive to the Valuation of Securities (E) Task Force (“VOSTF”) to continue deliberating and to incorporate stakeholders’ constructive feedback.⁴ We also appreciate the NAIC’s willingness to engage with stakeholders on the Residuals Charge, but we remain concerned by the decision to impose a 45% charge without first conducting a full analysis or providing a clear path to develop and analyze independent tail risk or performance data.⁵ We will continue to engage with the NAIC on these issues.

I. The Framework Should Terminate the SSG CLO Modeling Workstream or Should at Least Delay the Development and Implementation of the CLO RBC Framework Until further Analysis and Resources are Provided

As you are aware, in 2022, the Risk-Based Capital Investment Risk and Evaluation (E) Working Group (“RBCIRE”) engaged the Academy to assist in the development of RBC factors for CLOs. Since that time, the project has expanded to include the development of RBC factors for all structured securities. To date, the Academy has given two public presentations to the

⁴ AIC echoes comments submitted by many stakeholders – including regulators, trade associations, insurers, and members of the U.S. House of Representatives – that raise a number of valid concerns regarding the expanded scope of the SVO, the ability of such a mechanism to ensure consistency across asset classes and risks, and the potential for market uncertainty and increased illiquidity. More fundamentally, we still lack a clear understanding of why the current system is considered inadequate.

⁵ Notwithstanding the compromise that was reached at the 2023 NAIC Spring National Meeting – which effectively gave interested parties until June 2024 to provide evidence that a 45% RBC charge is not appropriate – the Residuals Charge adoption process seems to have been rushed and goes against the principles enumerated in the Framework Memo. We continue to believe that a measured, fact-driven process – which has yet to be conducted by regulators or interested parties and may take longer than the allotted time to complete – is necessary.

RBCIRE: one, during the 2022 Fall National Meeting, that questioned the propriety of the CLO project and noted that a measured, deliberative process should not be sacrificed in the name of expediency;⁶ and a second, during the 2023 Summer National Meeting, that provided an overview of (i) an Academy-developed flowchart to determine whether an asset class should be modeled, and (ii) a number of Academy-supported “Candidate Principles” for use in guiding the development of RBC factors for structured securities.⁷

The Academy’s presentations raise significant questions as to whether it is prudent to direct the SVO to financially model individual CLO investments, as the NAIC is scheduled to begin doing in January 2024. While we appreciate that, as a technical matter, the Academy’s focus is on RBC factors, as the Framework Memo itself states, insurer asset modeling and risk-assessment are inextricably linked, and there appears to be no comprehensive framework for coordinating or governing those functions. *As such, we respectfully submit that CLO modeling should not continue as initially scheduled in light of the Academy’s valid concerns and recommendations and in the absence of an agreement on foundational principles to govern the CLO RBC framework.*

We also believe the plan for the SSG to begin CLO modeling in January 2024 is inconsistent with the principles and observations set out in the Framework Memo:

- The Framework Memo indicates that VOSTF will review the output of CLO/RMBS/CMBS modeling in conjunction with the Academy and RBCIRE to determine if (i) NAIC designations, (ii) dynamic ad hoc modeling/stress capabilities or (iii) a combination of both, are the most valuable use of SSG resources. *The NAIC should not continue development of the CLO methodology or begin requiring the financial modeling of individual CLO investments before such determination is made.*
- The Framework Memo acknowledges, and we agree, that finding the right balance between separate NAIC working groups when assessing risk and capital “needs to be an iterative process of developing proposals, soliciting feedback, and adjusting or replacing proposals in response.” *It will be extremely challenging for the SVO to develop an effective CLO model when the RBCIRE is just getting started on the long-term RBC factors for CLOs.*
- The Framework Memo retains the ability of the SVO to model structured assets in support of its other functions (e.g., the CRP due diligence function), but recognizes the critical need for model governance. *We agree, and as such, the NAIC should not implement a new financial model in the absence of a model governance policy and related controls.*
- The Framework Memo argues extensively for the need to expand the staffing and resources of the SVO, including the need to enhance the SVO’s structured asset modeling and model validation capabilities. *We are concerned that the SVO will not be able to effectively take on the significant responsibility of developing and validating financial models for CLOs and other structured securities without the staffing and tools to properly do so. Moreover,*

⁶ See American Academy of Actuaries, C1 Work Group (C1WG) Presentation to the RBCIRE on CLOs - Status Update (December 14, 2022), available at: https://www.actuary.org/sites/default/files/2022-12/C1_Presentation_CLOs.pdf.

⁷ See American Academy of Actuaries, Principles for Structured Securities RBC (August 13, 2023), available at: https://www.actuary.org/sites/default/files/2023-08/Life_Presentation_Principles_for_Structured_Securities_RBC.pdf.

the NAIC’s limited resources would be better served being used to develop a strong due diligence function over CRPs that would include CLO ratings, rather than have the SVO begin to model CLOs.

- The Framework Memo proposes to reduce/eliminate “blind” reliance on CRPs but retain overall utilization of CRPs with the implementation of a strong due diligence framework. *Implementation of a strong due diligence function would eliminate any perceived need for the NAIC to conduct its own modeling of CLOs. In addition, NAIC modeling of CLOs would potentially and unnecessarily result in a lack of capital parity between CLOs and other investments and would divert important resources from the due diligence function.*
- The Framework Memo correctly acknowledges that the “project to review RBC factors for investments remains in its infancy,” while also recognizing the importance of considering “market impacts and consistency across asset classes” before implementing changes to RBC factors. *Accordingly, we agree and respectfully submit that the NAIC should assess the impact those changes will have on the RBC for other structured securities before implementing new RBC factors for CLOs.*

Implementing this fundamental change to the CLO RBC framework without first addressing these critical issues could have serious unknown consequences, unnecessarily depress insurers’ RBC, and deprive insurers of a vital capital markets tool during a time of increasing uncertainty in the broader financial markets. This fundamental change could also have a chilling effect on the capital markets themselves. Fewer insurer investments in CLOs would remove vital sources of capital for a significant number of corporate borrowers who rely on the private credit markets to operate their businesses. In fact, it was reported during the VOSTF’s August 14 meeting that the NAIC’s *mere consideration* of the broader changes to the investment framework for structured securities, and the uncertainty so associated, is already having a chilling effect on insurers’ access to capital markets.⁸ Moreover, CLOs “do not present a material risk” to current industry solvency.⁹ In fact, the issue perceived as being the most pressing regulatory concern was addressed by the NAIC’s adoption of new RBC factors for structured securities’ residual tranches during the 2023 Summer National Meeting. ***In light of these considerations, we ask that you eliminate the proposed plan for SVO financial modeling of CLOs, or at least delay it until a proper framework and governing policies have been adopted and implemented by the NAIC Membership.***

⁸ See Lease-Backed Securities Working Group (John Garrison) comments to VOSTF during its August 14, 2023 discussion of proposed changes to the IAO *Policies and Procedures Manual* to authorize SVO discretion over NAIC Designations assigned through the FE Process, available at: https://content.naic.org/sites/default/files/national_meeting/VOSTF%208.14.23%20Minutes_final.pdf.

⁹ See Academy Presentation to the RBCIRE on December 14, 2022, available at: <https://content.naic.org/sites/default/files/inline-files/Att%20C%20AAA%20C1WG%20Presentation%20to%20RBCIRE%20WG%20on%20CLOs%20vF.pdf>. See also the NAIC Capital Markets Bureau’s own analysis, which concluded that “U.S. insurer investments in CLOs remain an insignificant risk” (see NAIC Capital Markets, Special Report, *Collateralized Loan Obligation Stress Testing U.S. Insurers’ Year End 2021 Exposure*, January 5, 2023, available at: <https://content.naic.org/sites/default/files/capital-markets-special-reports-clo-stressed-analysis-ye2021.pdf>).

II. The Proposed CLO Modeling Methodology is Incomplete and Flawed

As you are aware, VOSTF and the SSG have established a CLO Modeling Ad Hoc Technical Group (“Ad Hoc Group”) that is developing a CLO modeling methodology for use by the SSG when CLOs become a financially modeled security in January 2024.¹⁰ Although the AIC is not a member of the Ad Hoc Working Group, we have attended all public Ad Hoc Group meetings and have submitted multiple comment letters to VOSTF and the SSG detailing why (i) it is neither necessary nor appropriate to subject CLOs to a new NAIC financial modeling process,¹¹ (ii) the modeling development process has made it impossible to assess the full model and the interplay between each input,¹² and (iii) the current iteration of the model is flawed.¹³ With respect to the draft CLO methodology, our specific concerns include that:

- The SSG has neither the resources nor expertise to develop a model that is fit for purpose (a sentiment that is consistent with the Framework Memo);
- The methodology fails to account for the benefits of CLO active management and other qualitative factors that are unique to CLOs (a concern also raised by the Academy in its January 2023 presentation);
- A zero purchase discount assumption is inconsistent with real-world evidence; and
- A zero prepayment assumption contradicts real-world evidence.

Our prior letters to VOSTF also flag a number of other material concerns.¹⁴

Notwithstanding our significant concerns with the methodology’s development and inputs and the lack of expertise and resources noted in the Framework Memo, the NAIC has not delayed the January 2024 implementation date. Further, the SSG has just (in the last week) released draft modeling scenarios for public comment, and no stakeholder or regulator has had the opportunity to assess the full CLO methodology with scenarios and probabilities. ***Given the foundational***

¹⁰ During the 2023 Spring National Meeting, E Committee voted to amend the *IAO Purposes and Procedures Manual* to include CLOs as a financially modeled security under the responsibility of the SSG which effectively makes CLOs ineligible to use CRP ratings to determine an NAIC designation. The amendment is effective as of January 1, 2024 and insurers are required to first report financially modeled NAIC designations for CLOs in their year-end 2024 financial statement filings.

¹¹ See our letter to VOSTF dated July 12, 2023 titled *CLO Modeling Ad Hoc Technical Group Assessment of Pre-Payment and Discount Assumptions in Potential CLO Financial Model* (“July 12 Letter”), available at: <https://www.investmentcouncil.org/wp-content/uploads/2023/07/AIC-CLO-Ad-Hoc-Group-Letter-Regarding-Pre-Pay-and-Purchase-Discount-Assumptions-1.pdf>.

¹² *Id.*

¹³ See our letter to VOSTF dated July 15, 2022 titled *Comments regarding the IAO Issue Paper on the Risk Assessment of Structured Securities – CLOs* (“July 15 Letter”), available at: <https://www.investmentcouncil.org/wp-content/uploads/2022/12/AIC-NAIC-CLO-Issue-Paper-Comment-Letter-Dated-July-15-2022.pdf>.

¹⁴ Additional issues include: (i) that modeling should not be undertaken as an indirect means to alter RBC treatment of insurer investments, (ii) that it is inappropriate to use existing bond factors that force capital charge equivalence between CLOs and corporate bonds; (iii) the general approach for residential mortgage backed securities and commercial mortgage backed securities is not suitable for CLOs; (iv) it seems illogical to conclude that CRP ratings can be relied upon with respect to underlying collateral, but are flawed with respect to CLO ratings, (v) why the Moody’s CLO methodology appears to have been given priority over other CRP methodologies; and (vi) that the SSG has not quantitatively justified its stress thesis that underpins the draft CLO modeling methodology. See our July 12, and July 15 Letters.

nature of this modeling, we are concerned that a rushed process to meet a year-end timeline will result in a flawed methodology that cannot be used as the template to reliably model other structured securities in the future.

In light of these concerns, AIC has engaged FTI Consulting (“FTI”) to prepare an assessment of the SSG’s CLO methodology, which we expect to share with E Committee as soon as FTI’s report is finalized.¹⁵ However, it is impossible for FTI to conduct a comprehensive analysis of the modeling methodology when the draft methodology is incomplete.¹⁶ At this early stage, FTI has already found that, contrary to the SSG’s published findings,¹⁷ CRP CLO methodologies do take pre-payment and purchase discount assumptions into account in a material way when it is reasonable to do so.¹⁸ Despite this, and a July 2023 SSG report that there are “significant benefits” to including those assumptions in the methodology, the SSG is moving forward with a “no pre-pay/no discount” model based, in part, on the SSG’s high-level CRP methodology analysis and on the basis that the assumptions would add complexity to the model. As we previously noted to the SSG, added complexity does not justify a CLO model that fails to account for CLO prepay and discount features, among others.

III. Conclusion

For the reasons outlined above, we respectfully request that you delay the proposed financial modeling of CLOs, until a proper framework and governing policies have been adopted and implemented by the NAIC Membership. We look forward to continuing to work with you on all of these important issues.

Sincerely,

/s/ Rebekah Goshorn Jurata
General Counsel
American Investment Council

¹⁵ In the interest of time, FTI may make certain modeling assumptions or issue an abbreviated report that considers only what is known as of a certain date. We expect to offer the report to VOSTF and the SSG as well.

¹⁶ While we appreciate that modeling methodology inputs are often developed in piecemeal, the current timeline makes it highly unlikely that interested parties will be able to conduct a fulsome assessment of the modeling methodology prior to its implementation. In comparison, nationally recognized statistical rating organization (“NRSRO”) methodologies are published for public comment and scrutinized by public markets. NRSRO guidelines typically account for substantial notice and comment periods, and require the NRSRO to provide a substantial level of granular information regarding proposed changes to financial models and the underlying basis for the proposed changes.

¹⁷ See NAIC SSG *Prepay / Discount Methodology* (July 14, 2023), available at: <https://content.naic.org/sites/default/files/industry-ssg-clo-CLO-Methodology-Update-7.14.23.pdf>.

¹⁸ We recently shared FTI’s CRP prepay and discount findings with the SSG and VOSTF leadership, and would be happy to share that with the E Committee as well.