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Ms. Carrie Mears, Chair
Valuation of Securities Task Force (VOSTF)
National Association of Insurance Commissioners (NAIC)
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Practices & Procedures (P&P) Manual Amendment Authorizing the Procedures for the Securities Valuation Office's (SVO's) Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears:

The undersigned (ACLI, PPIA, NASVA, SFA, MBA, and CREFC) appreciate the opportunity to comment on the exposure referred to above that was released for comment by the VOSTF on May 15, 2023. We generally like to provide constructive comments on VOSTF exposures and provide support wherever possible. Regarding this exposure, the undersigned have concerns with the proposal and believe additional transparency is warranted. We also recommend changes that are necessary to avoid significant unintended consequences.

Prelude

As discussed at the NAIC Spring National meeting, the undersigned recognize that VOSTF seeks additional information on certain types of insurer investments, with the SVO acting as the “eyes and ears” for Regulators. Further, we recognize that some Regulators may want to grant the SVO some latitude in challenging rating agency ratings if they are deemed not fit for NAIC purposes (“not fit for purpose”). The undersigned stated at the NAIC Spring National meeting, and this was further supported by Texas Regulator, Jamie Walker, that full transparency is warranted for both the NAIC (including the SVO) and the insurance industry, but that is not present in this proposal.

The undersigned appreciate the opportunity to comment and would like to highlight some significant, specific concerns with the exposure. In recent years, the NAIC has made several changes to increase reporting regarding insurer investments, including requiring rating rationale reports as part of the filing exemption (FE) process. As outlined in greater detail below we recommend that any additional changes to the FE process first identify specific ways that NRSRO methodologies are not fit for purpose for a given asset. We also recommend that the NAIC/SVO be transparent about their specific concerns that would warrant such significant changes. Given the magnitude of the potential impacts of this exposure, we also recommend that Regulators convene to study the issue in depth like the study commissioned by the VOSTF in 2008 (referred to in our Subscript S letter dated June 29, 2023). In the interest of providing constructive feedback, the undersigned outline additional transparency and oversight measures below that can mitigate our concerns and help minimize downstream impacts of the proposed exposure. The

undersigned believe it is in the best interest of all parties – Regulators, NAIC staff, insurance companies, rating agencies, and capital markets participants – to have complete procedural transparency.

Concerns

- 1) The exposure currently places the right to challenge a rating or methodology, and the ability to make a final decision on such rating or methodology, solely with NAIC staff and potentially with just one regulator. There is no requirement for oversight from VOSTF, or another sub-group of regulators, to ensure consistency of process or to provide an independent view, should NAIC staff and insurers disagree. This poses due process problems, as well as potential extra-territorial application of one state regulator’s decision over insurers domiciled in other states.
- 2) In the exposure a ratings challenge from NAIC staff starts with staff’s view on a designation, having only had access to the Credit Rating Provider (CRP) rating and rationale and to Schedule D information. NAIC staff would lack access to critical information provided in a full security filing when they first determine their proposed designation. Practically speaking, the insurer would then need to informally file the security for a more thorough review from NAIC staff, should the insurer wish to engage in a fully informed dialogue about the security with the SVO or SSG. The exposure treats this subsequent filing and dialogue as a ratings appeal, rather than recognizing that NAIC Designation filings and appeals are separate processes.
- 3) Should the VOSTF proceed with this proposal, the undersigned believe that there must be a separate appeal process in place, with oversight from an independent party, to ensure due process for insurers. The exposure provides limited transparency to insurers (and to their capital markets counterparties) regarding the SVO’s/SSG’s rationale supporting a CRP ratings challenge. The only envisaged disclosure is for a challenged rating to be flagged in the NAIC Automated Valuation Service (AVS+). However, there is no requirement for NAIC staff to provide public disclosure regarding why they are uncomfortable with a rating. Instead, such information can only be obtained with a phone call between the filing insurer and the SVO analyst. This is problematic, because other insurers who hold the same security (and other interested capital markets participants) may not be privy to some of the one-off, undocumented discussions. Lack of consistent, public disclosure of the NAIC’s concerns leaves room for guessing and misinformation within the capital markets. This could result in market uncertainty and increased illiquidity. The current exposure has already had a negative effect on capital markets. Several transactions have been put on hold, as insurance company investors are sidelined from certain investments, due to the lack of transparency in the current exposure. To date, NAIC staff has provided only limited examples of types of transactions they are concerned about. The lack of further clarity regarding NAIC staff’s scope and method of review has created risk-based capital uncertainty for portfolio investments (both current and future). Insurers have a strong need to understand what the NAIC’s concerns are with a given rating—especially when NAIC staff are deeming a rating methodology as unfit for regulatory purposes.
- 4) The exposure does not require staff to publicly report aggregate statistics for ratings challenges. Staff are only required to provide an annual report at VOSTF’s request, and even then, such a report would not be shared publicly.

Collectively, the issues highlighted above serve to create a process that, if implemented, would lack transparency, sufficient checks and balances, and the opportunity for insurers (and ratings agencies) to present their data, information, and ratings rationales in a fair, open forum. For example, assume there is an Asset-Backed Security (ABS) where the rating agency rating assumes 10% appreciation in the underlying collateral, but the SVO assumes 0% appreciation and believes their approach is more fit for purpose. The proposed exposure, where any single security rating is challenged based on a methodology concern, would cause several significant problems:

- a. One state, working with the SVO, could dictate NAIC Designations for companies in other states where the same security is held.
- b. Further, such a security would not be in isolation. The ratings challenge would presumably apply to all similarly situated, rated securities. The challenge would create significant market uncertainty, as it would be unclear to industry and interested parties whether the SVO's concern applied to just:
 - i. One CRP's rating methodology, or other CRPs' methodologies as well (i.e., other rating agency methodologies may also assume collateral appreciation, but at different levels).
 - ii. That particular legal structure or type of ABS,
 - iii. A subset of that particular ABS type,
 - iv. A specific, unique structural feature or anomaly in that ABS, specifically (or that would also potentially apply to other ABS as well), or
 - v. A general matter of difference in professional judgment of the particular analyst.

Changing any particular security rating within AVS+ would create problems and would not achieve the stated goals of consistency, uniformity, and appropriateness necessary to achieve the NAIC's financial solvency objectives. Ultimately, this would create significant capital markets disruption. The undersigned would like to recommend some changes that we believe would help strike the right balance between the NAIC's need for ratings oversight and with industry's and capital markets' need for transparency and due process.

Suggested Changes to Improve Transparency

Should the VOSTF choose to proceed, we believe a robust and transparent process is warranted. The process should make clear whether a rating is challenged due to (1) a CRP's rating methodology being deemed unfit for purpose, or (2) as a matter of professional judgment (we believe the latter would be relatively rare). The SVO should publicly identify rating agency methodologies that they do not believe are fit for the NAIC's purpose and provide analytical support for such view on each respective CRP methodology in question. Whenever the SVO challenges a rating based on differences in professional judgment, it should provide insight on its own approach for assigning a designation to that security. More specifically, the undersigned's proposed solution includes the following:

- 1) Whenever a CRP rating is challenged in AVS+, not only should the security's rating be flagged, but there should also be an area in the system that provides a written rationale for why the rating is being challenged. The AVS+ system should include a field that carries a single category description for ease of use in future reporting (e.g., methodology not fit for NAIC purposes, or professional judgment). However, that alone is not a sufficiently transparent explanation. There should also be an attached report or link to a publicly available rationale where the SVO analyst highlights:

- a. Key factors considered in the SVO analysis, and the methodology utilized;
 - b. A rationale as to why the CRP's methodology is not fit for purpose (if applicable) or where the SVO analyst's view differs materially from the CRP (if a difference in professional judgment), and
 - c. The scope of the population of securities for which the change applies.
- 2) When NAIC staff challenges a CRP methodology as being unfit for purpose, these challenges should be disclosed publicly and brought to the VOSTF for approval prior to any ratings change. This should include the rating methodology or methodologies (if multiple rating agencies) deemed not fit for purpose, along with a robust rationale, as well as what securities are impacted. Impacted insurers and the relevant CRPs can then present their analyses, including relevant data and security information, models (if applicable) and rationale publicly to VOSTF, and VOSTF can serve as the ultimate arbiter after hearing views from both sides. Benefits of a public discussion include:
 - a. Prevents one regulator and the SVO from unilaterally making regulatory decisions that potentially impact other state regulators, other insurers, and other similar securities;
 - b. Provides transparency to the Capital Adequacy Task Force (CATF), as it is CATF's responsibility to determine appropriate RBC charges and model factors;
 - c. Ensures all enacted changes are in line with the stated goals of consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives;
 - d. Aligns the VOSTF's stated goal of engaging further with the CRPs as a consumer of ratings to gain a better understanding of their process, methodologies, and regulatory oversight.
 - e. Provides appropriate checks and balances, affording due process for insurers and transparency to all stakeholders.
- 3) In the case of differences in professional judgment (which we believe would be relatively rare, especially considering the proposed three-notch threshold for a ratings challenge), the SVO/SSG should be required to perform a full security filing review and disclose to the insurers the SVO's or SSG's own applicable methodology, laying out the key considerations and rationale that NAIC staff considers for similar securities.

If the SVO and impacted insurers are unable to reach agreement on an appropriate designation during the initial challenge process, then it is important for the insurer to have some method of appeal beyond NAIC staff to provide appropriate independent review and ensure consistency to the designation process. The undersigned would not expect insurers to appeal every ratings challenge (nor would it be practical for VOSTF to hear to every such appeal), but there are expected to be key instances where insurers feel strongly that an additional third-party's viewpoint (beyond the SVO/SSG and the original CRP) is needed and helpful. Ultimately, such discussions may help Regulators as well, as it would help them develop a deeper understanding of how investments are viewed by insurers, capital markets participants, and the rating agencies, as well as by the SVO. More discussion is merited on whether the appropriate appeals board should be the VOSTF or some subset thereof. However, the appeals process should include people who are willing to independently consider all views, and who can set policy across all states consistently.

- 4) As a best practice, all SVO designation methodologies, and a description of the NAIC's process of reviewing and approving these methodologies, should be posted publicly on the NAIC's website. We recognize that the SVO and SSG will not have models or methodologies covering the full bond population. Indeed, no CRP can rate the full bond population, given the sophisticated data gathering, modeling, analytical software and other resources required to rate certain types of securities. However, posting methodologies publicly would highlight areas where the SVO/SSG do not have designation methodologies in place, such as ABS or (currently) Collateralized Loan Obligations (CLOs), and help ensure that those methodologies which do exist are consistently applied, providing transparency to insurers and to capital markets.
- 5) The undersigned believe industry should be provided with an overall assessment of how this ratings challenge program progresses and is enforced. Aggregated statistics, shared publicly each quarter, would help both Regulators and industry alike to understand the scope of the issues and how the program is progressing. NAIC staff should provide quarterly reports for both VOSTF and the public, highlighting the following for securities challenged:
 - a. Number of ratings challenged, for each challenge type;
 - b. Number and dollar-amount of CUSIPs challenged;
 - c. Outcome of SVO/SSG challenges:
 - i. Percentage of CRP ratings affirmed vs. percentage of SVO designation overrides;
 - ii. Number of challenges appealed to VOSTF and percentage of appeals where NAIC staff's recommendation to overturn a rating the was affirmed by Regulators vs. percentage of appeals where the original CRP ratings were affirmed;
 - d. Average number of notches that ratings were reduced, both on an incident- and dollar-weighted basis.

Further Considerations

The undersigned suspect one concern VOSTF may have with our proposal centers around confidentiality associated with private ratings. However, we think confidentiality concerns are manageable. Federal law requires that NRSROs disclose and maintain their methodologies publicly, and rating methodologies can be found directly on CRP websites. Any questions on such methodologies can be answered through discussions with CRP analysts. Therefore, for situations where NAIC staff is challenging a methodology as not fit for purpose, staff should be able to discuss the methodology that the CRP employed and discuss where the NAIC takes issue with that methodology, without disclosing non-public information. When NAIC staff is challenging a rating based on differences in professional opinion, the underlying CRP rating can be expressed in terms of an NAIC-equivalent designation (as opposed to disclosing the CRP rating directly), and the details of the issuer or structure can be genericized enough to mask the specific security, yet still provide key insights into the reason and rationale for ratings challenges. In fact, the SVO has successfully done this with some limited examples in the past.

The only downside the undersigned see in such approach is additional effort required of the SVO/SSG, but the benefits are many. Enhanced transparency is generally good for any system, but here, it is imperative for insurers to understand what types of investments or ratings methodologies concern the NAIC to limit

negative downstream consequences for insurers. This also is necessary to limit capital markets disruption and prevent both investment bankers and insurers from arbitrarily rejecting established private placement debt types as a viable option for insurers' portfolios. Absent more transparency, the market could potentially deem the entire privately-rated debt universe as problematic when Regulators and the SVO have only expressed concerns with a targeted subset of that universe. Insurers need to understand what is and is not problematic, and why, as well as how, the SVO or SSG might view certain types of securities. Further, without transparency, the public debt market (particularly the 144A space) could also experience significant disruption, which could cause unnecessary negative impacts to insurers' investments in such instruments. Any reasonable cost associated with providing transparency and oversight, as outlined in our solution above, would be supported by industry. It is likely minimal in relation to the significant benefits that transparency affords to all stakeholders.

Conclusion

The undersigned stand ready to discuss these ideas further with Regulators and with the SVO/SSG; we are willing to begin discussions immediately. We ask that adoption of the exposure be postponed until the significant philosophical and procedural issues highlighted above can be resolved.

Given the magnitude of this proposed change, and the potential effect on insurers and capital markets, the undersigned believe that this process may be best suited for a comprehensive study by Regulators across disciplines. A working group could be established with members from the NAIC's CATF, Risk-based Capital Investment Risk and Evaluation Working Group, Life Actuarial Task Force, and VOSTF, to holistically address what we understand the broader regulatory concern to be: Whether the NAIC investment risk-based capital regime has kept pace with market innovation. This approach could be patterned after the previously mentioned study commissioned by the VOSTF in 2008 that met extensively over an approximately eight-month time period to define and evaluate perceived shortcomings and issue a formal report. In this instance, a report should have specific recommendations that address defined problems holistically and transparently. The following are some of the issues that the working group could consider:

- Define areas of concern raised by the SVO and by some Regulators with as much precision as possible to properly scope the project;
- Identify whether there are any investment types with significantly different risk characteristics which may warrant additional investment RBC factors (as was suggested by Moody's Analytics at the time of development of current investment RBC factors);
- Identify additional asset classes, if any, where modeling may be appropriate, such as with CLOs; and
- Evaluate any input from the VOSTF Ad Hoc Rating Agency Review group.

Lastly, we also think it is important to recognize that credit analysis is both an art and a science; differences of professional opinion are unavoidable. No one organization (whether an insurer, a CRP or the SVO/SSG) has a monopoly on perfect accuracy when assessing risk. An institution's ability to assess credit risk will inevitably be shaped by unique organizational experiences, risk tolerances, and resources or tools brought to bear in the risk assessment process. Furthermore, each CRP (and NAIC staff) has certain areas of relative strength and expertise and areas where their resourcing and expertise is weaker. Therefore, in addition to defining the concerns with as much precision as possible at the outset, ongoing transparency is key to any process. Industry is, and has been, committed to transparency, as evidenced by our willingness to

submit ratings rationale reports and provide transaction documents upon NAIC staff's request. We ask for the same level of transparency from the NAIC.

The current exposure grants the SVO significant unilateral powers, with very little transparency, and without sufficient due process or checks and balances. This proposal, if adopted, would be materially disruptive to the insurance industry. Rather, the undersigned propose that the identified concerns with reliance on CRP ratings be addressed in a holistic way, backed by disciplined and rigorous analysis, with output that is transparent to all parties. This would address Regulator concerns without creating undue market disruption and the other shortcomings that the undersigned have identified in this letter.

The undersigned stand ready to assist in this process in a meaningful way, but we believe that is best done transparently and through collaboration. We believe Regulators understand the importance of transparency and would like to achieve a transparent outcome as well. We appreciate the opportunity to participate in this ongoing process.

Sincerely,



Mike Monahan
ACLI

Tracey Lindsey

Tracey Lindsey
NASVA

John Petchler

John Petchler
on behalf of PPIA Board of Directors



Lisa Pendergast
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Michael Bright
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cc: Charles Therriault, Director, Securities Valuation Office
Eric Kolchinsky, Director, Structured Securities Group

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The National Association of Securities Valuation Analysts (“NASVA”) is an association of insurance company representatives who interact with the NAIC Securities Valuation Office (“SVO”) to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC’s ISIS electronic security filing system, and commenting on year-end processes.

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