Regulatory Update: Insurers and Risk-Based Capital

Pending changes by the National Association of Insurance Commissioners will require that insurers shift to a principles-based approach for bond classification and risk-based capital in their regulatory statements.

Authors	Date	Topic
Ed Martin, CFA	8/22/2024	Insurance

Key takeaways

- Schedule D, Part 1 is being split into two sections, with new bond descriptions and added visibility. New categories and required data will add demands on staff near term.
- Some securities may no longer qualify as bonds and will move to Schedule BA. The overall impact will vary by insurer.
- Regulators are also moving toward eliminating regulatory arbitrage, which may increase risk-based capital. The asset class most in focus is collateralized loan obligations.
- Regulators may require enhanced analysis of privately rated securities.
- Allspring is committed to helping all our clients prepare for and navigate regulatory changes as they arise, and we will continue to provide updates as this issue unfolds.

Regulatory update: Insurers and risk-based capital

It may be true that change is the only constant in the financial markets, but that maxim hasn't generally applied to the regulatory filings that insurance companies are required to make every year. While minor updates to the regulatory requirements are made frequently, it's rare to see a substantial change in the investment schedules accompanied by a new set of rules on classifying investments. That's now in the works under changes enacted by the National Association of Insurance Commissioners (NAIC). This note explains what insurers need to know about pending changes.

The rule changes mark a philosophical shift for the regulators, where the classification for bonds will take a "principles-based" approach. Today's formulaic regulatory approach had advantages: The rules were codified in statutory accounting procedures, intended to enhance consistency across companies by eliminating the need for judgment. But over time, regulators began to worry about how some securities were being recorded based on the existing rules and have set several changes in motion.

Changes to Schedule D

The first of these changes is to update Schedule D, Part 1 (long-term bonds) by splitting it into two sections. Section 1 is for issuer credit obligations, defined as debt instruments where the repayment of the instrument is supported primarily by the general creditworthiness of an operating entity or entities. Section 2 is for asset-backed securities backed by collateral that provides cash flows to service the debt. The new Schedule D will be used for reporting starting at the beginning of 2025.

Within Sections 1 and 2, revised category descriptions for different types of bonds will be updated for better clarity. Visibility will also be increased into the types of affiliated investments.

The principles-based approach follows a decision process that is represented by a pair of flowcharts that have been shown in regulatory presentations. When criteria are debatable or require a judgment call, there will be more work to evaluate the terms and characteristics of individual deals. Certain investments will no longer automatically qualify as bonds, including collateralized fund obligations (CFOs). In addition, the new schedules ask for more data, which will increase demands on staff who prepare the schedules.

When a security doesn't qualify as a bond, it will be recorded on Schedule BA (for example, where an asset-backed security lacks "substantive credit enhancement"). Schedule BA is being revamped along with Schedule D, again being modernized while responding to the new classification scheme.

Ratings oversight and CLO designations

Regulators have also enabled a mechanism whereby the Securities Valuation Office (SVO) can require enhanced analysis of privately rated securities or ultimately modify its NAIC designation. The regulators have grown concerned about the increased use of private letter ratings; analysis shows that ratings tend to be higher than those assigned by the SVO itself. The number of privately rated securities has increased to 8,152 at year-end 2023, compared with 2,850 at year-end 2019. Ten insurer groups accounted for 51% of the industry's exposure to privately rated securities at year-end 2023.

With respect to NAIC designations, the asset class most in focus is collateralized loan obligations (CLOs). One change that will likely impact all CLO holdings is that CLOs will become modeled securities for the purpose of deriving a NAIC-designated rating. Because the modeling methodology has not been finalized, the Valuation of Securities Task Force adopted a proposal to postpone the effective date for CLO modeling until year-end 2025.

Regulatory arbitrage and RBC factors

Regulators are also moving toward eliminating regulatory arbitrage. The basic concept is that a company could put a set of assets into a structure and the risk-based capital (RBC) for the debt and equity issued by the structure would be favorable compared with owning the investments directly.

Regulators are working with the American Academy of Actuaries (AAA) on a project to determine the appropriate RBC factors for CLOs. Change is not imminent, as the AAA is still gathering facts and establishing principles for this work. Insurers own a significant part of the mezzanine or AA to BBB rated portion of the CLO market, and the rule changes could have an impact on the buyer base for CLOs.

Another area of activity and debate between regulators and interested parties is the RBC requirement for the residual, or equity, tranches of structured deals. The RBC factor for life insurers is scheduled to increase to 45% for 2024, which is higher than the 30% for common equity. Property and casualty and health insurers will have a factor of 20% for year-end 2024. The American Council of Life Insurers (ACLI) requested data from 32 insurers who hold 95% of residuals in the life industry, which amounted to $11.5 billion. This is not a significant amount compared with the assets of the life insurance industry.

These changes are expected to have an uneven impact on insurers. The new layout and data items on statements require an investment of time by the teams that prepare these statements. Allspring is actively working with our clients to help facilitate this process. While CLO modeling requirements will impact many clients, the RBC questions around residual tranches will be felt mostly by a smaller group of insurance companies.

Allspring is committed to helping all our clients prepare for and navigate regulatory changes as they arise, and we will continue to provide updates as this issue unfolds.