Letter to the NAIC VOSTF regarding its proposal on structured equity and funds

Dear Mr. Therriault, Ms. Mears, and VOSTF members:

We greatly appreciate the opportunity to comment on your proposal on structured equity and funds. We support your mission of promoting transparency and enhancing risk assessment for statutory solvency purposes. We believe that not all structures create statutory "capital arbitrage" nor are intended to do so. In fact, the intent of many of these vehicles is to create a more operationally efficient way for insurers to access certain asset classes, with the added goal of doing so in a manner that results in similar capital treatment to that of the underlying assets. One unintended consequence in our view is that lack of these structures could make smaller insurers less competitive, as they are forced to hold assets directly on balance sheet via separate accounts. Most times only larger insurers have the scale and operational infrastructure required to do so. The rationale is akin to insurers investing in ETFs, and the NAIC's ETF designation accomplished a sensible positive change for smaller insurers.

We recognize that insurers can submit funds for SVO designations, but unfortunately those designations only provide RBC relief for life insurers. Although not the focus of this comment letter, we believe that lack of fund RBC benefit for non-life insurers has a knock-on impact on the utility and value of feeder notes. An adjacent issue is Schedule BA limits. Once again, we find smaller insurers are at a competitive disadvantage for investing in fixed income assets, i.e., they are filed on Schedule D Part 1 as bonds if held directly, but they must be filed on Schedule BA if held in a fund format. And these structures can help close that disadvantage somewhat, though usually not entirely.

We fully agree with the NAIC's focus on substance over form and that capital charges should reflect the underlying risk exposure. This should mean focusing truly on the substance of the investment, and if there is a fund vehicle in the structure, the assets within that fund. A fund is merely a wrapper and is not indicative of the investment risk taken, a conclusion the NAIC similarly reached on ETFs. We recognize that there could be abuses of feeder notes and related structures, whether to accomplish capital arbitrage or to wrap assets that would otherwise be non-admitted. We believe these cases are the minority, and therefore it would be more sensible to create a framework that captures likely abuses, as opposed to making thousands of securities no longer Filing Exempt (FE). The latter seems like an extreme action that would be impractical and difficult to implement. It seems unreasonable and unpractical to ask the NAIC to re-assess the designation of thousands of securities, especially considering the resources required. In addition, the NAIC would likely need to establish a variety of new methodologies and detailed public disclosures, whereas existing NRSROs have invested heavily in people and methodologies to analyze private and structured assets properly. A much better solution, in our view, would be to create a practical framework that could help root out abuses. We would recommend utilizing the set of red flags already developed by the SVO and SSG back in 2019, specifically:

1. Rating from a single rating agency
2. Private letter rating
3. Assets backing the security were primarily owned by insurer or affiliates before that transaction and reported differently
4. Assets backing the security may not generate bond cash flows (i.e., contractual requirements to pay periodic principal and interests) or they are equity securities
5. The insurer or affiliated group are the sole investors in security

6. The affiliate of company is underwriter or sponsor of the security

A practical approach might be by utilizing the above red flags, one can create a framework to better bucket the respective investments and take appropriate actions. The mechanism could be simply based on the number of red flags, a combination of the flags, or a more quantitative scoring system. Tripping a single flag on its own may not necessarily be problematic, but some combinations thereof may warrant review by the SVO. We would like to work with the industry and the respective working groups to align on what falls into each respective bucket and subsequent actions to be taken if any. The bucketing framework could be along the lines of:

- Unlikely abuse: security remains FE eligible and maps to the CRP rating
- Potential abuse: security requires SVO validation to utilize the CRP rating for FE purposes. This may mean a quick review by the SVO, e.g., if they are rated debt securities, applying the WARF methodology to validate the reasonableness of the CRP rating
- Likely abuse: security must be submitted to the SVO for a full review, and the SVO may adjust the NAIC designation, statutory filing schedule, or status as admitted/non-admitted

Another critical aspect of all this is transparency. The NAIC and state regulators have made it clear how important it is for insurers to provide greater transparency about their investments, and likewise we believe the industry deserves transparency from the NAIC on these potential regulatory changes. Most notably, these processes and any potential changes to investment RBC must be clear, with much greater detail on how the SVO and SSG would capture potential abuses and potential RBC or accounting adjustments. If changes were to be made as reflected currently in the structured equity and funds proposal, we fear it creates an unreasonable and challenging dynamic for insurers, since they may be forced to make investment decisions with considerable uncertainty around statutory capital. We hope you would agree that a more practical solution that could mitigate that uncertainty yet also remove abuses is one that best meets the needs of both the industry and regulators.

Sincerely yours,

PineBridge Insurance Solutions and Strategies

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