Statement for the Record

Submitted to the

U.S. House Financial Services Subcommittee on
Investor Protection, Entrepreneurship and Capital Markets

"A Notch Above? Examining Bond Rating Industry"

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On behalf of

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The American Council of Life Insurers appreciates the opportunity to share our views on S&P's proposed insurer risk-based capital adequacy methodology ("the proposal"). Life insurance companies have been part of America's economy for more than 175 years. Today, life insurers pay out $2.4 billion to our customers every day, compared to the $3 billion paid by Social Security each day. The business model that makes life insurance companies this sort of stalwart is founded on the certainty that life insurers will maintain the financial solvency to deliver on our promises now, and in the long run.[1]

Mr. Chairman, 90 million families nationwide – people you and your colleagues in Congress represent – depend on the life insurance industry to protect their financial future, for whatever life brings. Life insurance, annuities, disability insurance, paid medical leave and other products make certain they can take time off if they're sick or injured, and care for themselves and their loved ones in good times and bad. Our policies often stay with families for decades, and our long-term investments underpin the promises we make to show up when it counts.

When the pandemic hit, life insurers were there. The pandemic hit many industries hard – airlines, retail, restaurants. We are the industry that was writing checks and paying out to families and loved ones during that time. We were there when the worst came for too many. Benefits paid out by life insurers in 2020 were the highest in history – $90 billion were paid in individual and group life insurance benefits. The increase in claims over 2019, a 15.4 percent jump, was the largest year-to-year increase since the Influenza Epidemic of 1918.

Recognizing the financial hardship COVID-19 created for so many families, life insurers quickly established extended grace periods. We worked together with state officials so policyholders can make payments later and keep coverage now. Life insurers also actively worked to help families understand and obtain the relief provided by the Coronavirus Aid, Relief, and Economic Security ("CARES Act"), which expanded access to retirement funds and provided a critical lifeline to those struggling to make ends meet.

But life insurers do more than pay claims. Life insurers also invest $7.4 trillion in the U.S. economy – $572 million every day – making life insurance companies one of the largest sources of investment capital in the nation. Our investments do more than protect our policyholders. They drive economic and job growth in every corner of the country. Life insurers invest in agricultural loans, education bonds, residential and retail mortgages, and other foundational investments that help businesses and communities open their doors, fund infrastructure, and grow their workforce.

As the trade association representing a major source of long-term capital in the U.S., ACLI engages when something could adversely impact how our members invest. In December 2021, S&P issued a request for comment ("RFC") on an extensively revised insurer risk-based capital adequacy methodology ("the proposal" or "the capital model"). Changes to financial strength rating

[1] Strict state laws govern solvency and capitalization, and companies make sure they always have sufficient funds to pay claims without assistance from state or federal governments. Key to this process is the investment of premiums received on policies, annuity contracts and other products, and setting aside assets in reserve to meet obligations whenever they arise.

methodologies are highly important to our members because they are an opinion of whether a life insurer can honor its promises now and in the future.

Financial strength ratings are so critical that insurers will often shape their long-term capital investments and capital strategies to conform with rating agency capital model requirements. Furthermore, given the role of life insurers as one of the largest sources of investment capital in the United States, a significant change in how the world's largest rating agency treats insurers' investments could reverberate through the U.S. economy. As such, any proposed capital model changes should be transparent and supported by objective, empirically supported data. This is especially true if a proposed methodology diverges significantly from the U.S. regulatory framework or would result in the notching of broad swaths of insurers' portfolios. The former requires vigilance to ensure long-term products remain available and accessible to American families, and the latter could jeopardize competition in the rating industry.

To be clear, ACLI is not opposed to rating agencies updating their capital models or asset charges. ACLI recognizes the need for rating agencies to periodically review and update their capital adequacy methodologies. ACLI supports several of S&P's stated objectives in the RFC, including the desire to improve the transparency and usability of the insurer capital adequacy methodology. ACLI submitted comments and we appreciate S&P's willingness to thoughtfully consider feedback on the proposal. We welcome S&P's announcement to withdraw portions of the RFC related to notching and mapping. We look forward to continuing a constructive dialogue with S&P regarding their proposed insurer capital model. Below, we have highlighted a few of our concerns to share with the subcommittee.

1. **Permitting Nationally Recognized Statistical Rating Organization's ("NRSROs") to automatically notch securities without empirical evidence could jeopardize financial strength ratings, harm capital markets, and restrain competition.**

S&P's original RFC would have automatically notched or disregarded credit ratings from other NRSROs, as well as the NAIC Securities Valuation Office ("SVO") on non-S&P rated assets, when determining the appropriate amount of risk-based capital that insurers should hold against bonds or securities on their balance sheets. When an asset on an insurance balance sheet is "notched" by S&P, the insurer must hold additional capital against the asset. In some cases, the proposed notching would result in an investment-grade asset being assessed a 100-percent capital charge without any clear reason for the notching, other than the fact it was not rated by S&P.

a. Asset-risk charges should be empirically supported

Asset-risk charges should reflect a data-driven analysis of the assets' credit quality and other intrinsic factors. An independent, third-party review of available data indicates that the proposed notching of non-S&P rated assets was not supported by available data.[2] Absent further empirical support for the notching, it appears that the notching would have introduced non-economic factors that were unrelated to the asset's credit risk into the insurer capital

[2] Investment Bank Research, "Analysis of Historical NRSRO Ratings Data," received March 2022.

model. Introducing non-economic factors would potentially compromise the integrity of life insurer financial strength ratings.

ACLI does not oppose treating an asset as lower-quality than its rating by another NRSRO if it is justified by the underlying economic facts - such as the probability of default. However, ACLI disagrees that it is appropriate to notch an asset, or in the case of a structured product, apply a BB or CCC charge, solely because the product was not rated by a particular NRSRO.

b. ACLI supports competition among NRSROs

ACLI supports competition among NRSROs, as well as the development of processes to reconcile any significant differences in ratings between different NRSROs, where they exist. Rating agencies should, as a rule, use complete mapping schemes in capital models. Failing to map to all NRSROs and lumping the NAIC Securities Valuation Office in with non-mapped NRSROs, would impair competition among NRSROs.[3]

Competition and diversity between NRSROs benefit the insurance industry, capital markets, and the economy. Effectively forcing insurers to acquire securities in asset classes rated by a particular NRSRO would reduce bond-issuers freedom to choose among NRSROs based on price, quality and efficiency. There are also some attractive asset classes that certain NRSROs may not invest in the staff and resources needed to develop a particular methodology or expertise in rating. But competition in the marketplace has created opportunities for other NRSROs to focus these asset-classes.[4] S&P's notching proposal raises the question of whether insurers will continue to have the same access to these assets.[5] Such a result would be contrary to the goals of the 2006 Credit Rating Reform Act,[6] in which Congress sought to increase transparency and competition among NRSROs.[7]

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[3] Mapping is the process of establishing a correspondence table that can be used to statistically map assets rated by another rating agency to the S&P Global ratings scale.

[4] This is understandable given that each NRSRO is a business and needs to make decisions on where to allocate its scarce resources. For example, an NRSRO may decide not to rate an asset class because it is too small to justify the investment or because a competing NRSRO already has differentiated expertise.

[5] Examples of these asset classes include: (i) Private credit in the form of private placements (Reg D) and directly sourced financing arrangements with privately owned companies or public companies that do not seek out public ratings – this category also includes the growing category of impact investments; (ii) Community banks, capital securities issued by community banks, and trust preferred (TRUP) CDOs (*i.e.*, securitizations of community bank securities); (iii) Securitizations of an ongoing stream of consumer loans originated by a given lender that might ramp up over time as loans are made according to defined set of credit rules. A large portion of the loans to U.S. consumers are financed through these vehicles; (iv) Firms that originate consumer loans through a bank partnership model (*e.g.*, Affirm, Upstart, etc.); (v) Ginnie Mae early buyouts; (vi) Certain assets supporting the clean energy transition (*e.g.*, solar or PACE assets); (vii) Whole business securitizations of restaurants and other businesses.

[6] Crediting Rating Agency Reform Act, Pub. L. 109-291 (2006).

[7] On 3/5/2021, now-SEC Chair Gary Gensler wrote to the Senate Banking Committee stating that "Promoting competition in the credit ratings agencies . . . is critically important to the SEC's mission" and that "[w]eaknesses at credit rating agencies contributed to the 2008 financial crisis as the 'issuer pays' model led to conflicts and potentially misaligned incentives." Similarly, in 2016, the European Securities and Markets Authority noted that "[o]ne of the objectives of the EU's regulation of credit rating agencies . . . is to stimulate competition in the credit rating industry."

c. *Automatic notching would distort financial strength ratings, disrupt markets, and ultimately harm consumers.*

Automatic notching is not harmless. If it is applied without consideration to the quality of the underlying asset it could distort financial strength ratings, disrupt markets, and harm the economy by potentially disrupting a portion of the $7.4 trillion invested by life insurers. In its original form, the proposal would have notched large swaths of bond portfolios, and deemed structured products not rated by the three largest NRSROs, as no better than CCC.[8]

This type of notching potentially harms both insurers and consumers by requiring insurers to choose between holding artificially elevated levels of capital or to forgo yield on high-quality assets because they were rated by one of an NRSROs competitors. This may disrupt markets and impair liquidity and asset valuations, because it is reasonable to assume that insurers may feel compelled to sell or avoid investment-grade assets to avoid the threat of onerous capital charges. That, in turn, would have encouraged issuers to seek out S&P ratings, increased S&P's market share and potentially eliminated the checks and balances created by competition in the NRSRO market.

Other additional considerations include:

- Insurers play a significant role in financing vast segments of the economy through the investment debt markets. These segments include corporate bonds and loans, residential and commercial real estate loans, and consumer credit offerings (*e.g.*, credit cards, car loans, etc.). The notching proposal would have artificially dampened insurers' interest in assets rated by other NRSROs. If adopted as proposed, this would ultimately drive higher funding costs for borrowers as the market reprices assets not rated by S&P – and not because the assets are implicitly riskier, but because these assets, post-notching, would consume much more capital on insurers' balance sheets.

- If the original notching proposal was adopted, it would have an outsized effect on fixed income structured products. In 2021, approximately 58 percent of North American issuances of asset-backed securities and mortgage-backed securities were not rated by S&P (per Green Street here).

- As noted above, S&P's original proposal would likely reduce the universe of high-quality fixed income assets that would receive appropriate capital charges, making it harder for insurers rated by S&P to achieve target yields. This creates a real risk that life insurers would have to offer less attractive long-term insurance products, or even limit product availability and offering. It could also reduce the diversification of assets held by insurers, if insurers concentrate on assets and asset classes rated by a particular NRSRO to avoid unduly onerous asset charges.

[8] S&P's definition of a "CCC" security is "[a]n obligation [that] is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation."

- The proposed application of a "CCC" rating input for structured securities rated by certain NRSROs and the NAIC SVO appears to be rooted in S&P's reluctance to complete a full mapping of all NRSROs and the NAIC SVO. Instead, the original proposal replaced certain NRSROs ratings with a "CCC," as an apparent stand-in for a completed mapping process.[9] ACLI believes there is sufficient data available for S&P to complete a full mapping. If S&P finds the available data lacking, they could consider utilizing well-accepted and commonly used analytical frameworks provided by third parties. Alternatively, they could also consider consulting with Canada's Office of the Superintendent of Financial Institutions ("OSFI") and/or the Joint Committee of the European Supervisory Authorities (European Banking Authority, European Securities Market Authority and European Insurance Operations and Pension Authority), both of whom successfully completed a recent mapping exercise that included a variety of credit rating agencies, including new market participants.[10,11]

d. The notching's disregard of state insurance regulators expertise and oversight is troubling.

The ACLI is highly concerned about the original proposal's treatment of securities that are otherwise unrated by an NRSRO, but have undergone a comprehensive evaluation by the NAIC Securities Valuation Office (SVO) and received an appropriate designation category (e.g., private placements, certain asset-backed securities, etc.).[12] These assets would have received a severe notching and a correspondingly punitive capital charge.[13] The application of CCC or BB capital charges for instruments deemed very high quality by regulators – whose primary interest is to preserve the solvency of insurers and protect consumers – is counterintuitive. The SVO is an established part of the regulatory framework in the United States; insurers are required to adhere to its designations (comparable to ratings) and set aside capital on securities based on the risk-based factors assigned to these designations.

[9] The December 21 proposal mapped S&P ratings to the two other large NRSROs and mentions the possibility of mapping to a third NRSRO in the future but does not include any plans to complete a full mapping of all NRSROs. Instead, S&P is using a "CCC" as a placeholder for structured securities rated by unmapped NRSROs and the NAIC SVO.

[10] *See* OSFI Capital Adequacy Requirements (CAR) Chapter 4 – Credit Risk – Standardized Approach (osfi-bsif.gc.ca) 171, section 4.2.3.1. The CAR requirements apply to banks (including federal credit unions), bank holding companies, federally regulated trust and loan companies (retrieved May 7, 2022).

[11] The Joint Committee (JC) of the European Supervisory Authorities (ESAs) is mandated under Article 136(1) of the CRR to provide a correspondence ('mapping') between relevant credit assessments of ECAIs and Credit Quality Steps (CQS). The JC's latest report, which was updated to include mapping for a new European Credit Assessment Institutions (ECAI) demonstrates the achievability of a transparent mapping process for all NRSROs. Available at https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2021/JC Final Reports on the draft ITS ECAIs mapping /1014540/JC 2021 38 %28Final Report Amendment ITS ECAIs mapping CRR art 136%29.pdf (retrieved May 7, 2022).

[12] The NAIC SVO performs several key functions on behalf of regulators, including the evaluation of securities that have not received an NRSRO rating, and to assign appropriate risk-based capital charges based on NAIC designations.

[13] Consider the potential treatment of an otherwise unrated structured security that has undergone a rigorous analysis and review by the NAIC SVO and been designated as an NAIC SVO Category 1. A NAIC SVO category 1 designation has traditionally mapped to an "AAA" charge. However, the initial S&P proposal declined to map to the NAIC SVO and instead proposed assigning a "CCC" capital charge to such securities, which corresponds to a 100% capital charge. An otherwise unrated fixed interest bond designated as Category 1 by the NAIC SVO would have received a BB charge under the initial proposal, regardless of the NAIC SVO designation.

The NAIC was also troubled by this approach, as noted in its letter to House Financial Services Chairwoman Waters and Ranking Member McHenry:

"[F]or those investments not otherwise assigned a rating by the NRSRO's (e.g., private placements, certain asset backed securities, etc.), the NAIC SVO staff do conduct a detailed analysis to evaluate the risk and develop an appropriate NAIC designation for use by state insurance regulators. This, coupled with investment oversight laws, give state regulators comfort to allow or disallow such investments and ensure they are backed by sufficient capital for claims paying purposes. This is a critical regulatory function that allows the insurance sector to invest its substantial resources in a diverse cross section of the U.S. economy while prioritizing the strength of insurers to pay claims. We are troubled that S&P's proposal lumps NAIC designations assigned by the SVO staff, designed by and for regulators, in with NAIC designations derived from ratings provided by S&P and its for-profit competitors, with no input from SVO staff. Doing so could disrupt a critical source of diversification and investment for the U.S. insurance sector. We urge S&P to reevaluate that approach." [14]

2. The methodology's potential impact on consumers and the competitive global insurance market merits additional evaluation.

The RFC explained that some changes to the methodology were made to "enhance global consistency." The desire for globally consistency is understandable. It is also a goal that international standard setting bodies have sought – and struggled with – for years because of differences between regulatory, accounting, and valuation frameworks across jurisdictions. These differences make it extremely challenging to apply identical factors across regimes without penalizing jurisdictions or products because of their regulatory, accounting or valuation framework. Well-intended methodologies also sometimes fail to recognize how key features of certain products can vary in different markets.

Some elements of S&P's proposed capital model may not reflect key differences among regimes and products. Other elements of the model may benefit from additional analysis because of their impact on long-term products. These issues were not addressed by the recent partial withdrawal of the RFC and may merit additional consideration by S&P. We have highlighted several examples below:

- The model's calculation of Total Adjusted Capital ("TAC") disadvantages companies using U.S. statutory reporting compared to those using GAAP/IFRS when assessing capital adequacy.[15]

[14] NAIC letter to House Financial Services Committee and Senate Banking Committee, available at https://content.naic.org/sites/default/files/government-affairs-letter-s%26p-proposed-capital-model-house-financial-services-cmte-030922.pdf (retrieved March 18, 2022).

[15] The calculation of TAC under the S&P's current methodology provides some benefit for insurer's dividend liability in order to put GAAP/IFRS and statutory filers on the same footing. Under the current methodology, statutory filers could include 50 percent of their dividend liability in TAC – which matched the same treatment of dividend liabilities under GAAP/IFRS. The proposal now eliminates the inclusion of dividend liabilities for statutory filers – but does not eliminate it for GAAP/IFRS filers. This puts U.S. statutory reporting insurers at a disadvantage compared to those using GAAP/IFRS in capital adequacy assessments, because GAAP includes 50 percent of the dividend liability within GAAP equity.

- Some changes in the S&P capital model are particularly impactful with respect to certain long-term financial protection and retirement security products, like variable annuities ("VAs"), that American families rely on to supplement income in retirement, pay for college, cover medical expenses, or handle unexpected expenses. Life insurers pay $1.1 billion a day in annuity payments. The treatment of VAs within the proposed capital model adds unnecessary complexity and will make capital management practices more difficult.
- The proposed calculation of TAC does not appropriately address differences in reserve calculations that are required by different jurisdictions. Most insurance regulatory regimes require insurers to hold reserves which include a margin above the amount estimated to pay future insurance obligations. U.S. regulators have determined, and ACLI agrees, that reserves should cover "moderately adverse" conditions. This allows for the inevitable ebbs and flows of claims payments over time. The amount of margin in reserves can vary by regime. Other regimes do not require moderately adverse amounts to be held in their reserves. This does not mean that U.S. insurers are necessarily better capitalized than insurers domiciled in other regimes, like Solvency II, but it does mean that a TAC calculation that ignores this fact could understate the amount of "available capital" in regimes where a portion of loss-absorbing resources reside in the reserves.
- The assumptions in the interest rate calculation also impact similar products differently - depending on where they are sold. The interest rate risk charges appear to take a punitive approach to long-term products sold in the United States. It assumes an immediate, permanent, and extremely severe shock to both assets and liabilities.[16] The assumptions in the interest rate risk calculation appear more reasonable for companies operating under a European regulatory framework, which focuses more on market-values, rather than cash flows, like the U.S. The effect is that it would penalize U.S. insurers with strong liquidity and cashflow profiles.

The differential impact of the interest rate risk calculation across jurisdictions demonstrates how an element of the proposal can include reasonable assumptions for products designed under some regulatory regimes, like Solvency II, and still be ill-suited for similar products issued under the U.S. regime.

Consider how the assumptions in the calculation work for participating policies in the U.S. and E.U. Participating policies in both jurisdictions issue policyholder dividends. But in the U.S., policyholder dividends are discretionary. They are only paid when the company is profitable – with no mandatory minimums, which means policyholders are sharing the rewards and the risks with the U.S. insurer. U.S. insurers can cut or pause the dividends in times of severe economic stress.[17] In contrast, in the E.U., participating policyholder dividends are mandatory and fixed. Companies cannot decrease them in times of severe stress. From that lens, S&P's proposed interest rate risk assumptions appear more reasonable for European participating products. Cash flows for those participating policies *are*

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[16] The S&P's proposed interest rate risk approach uses an extreme stress over a 1-year period that assumes fixed cash flows and a duration floor that is unfair for participating products that are long-term, have adjustable cash flows, and can have minimal duration mismatch.

[17] Companies have exercised the right to cut dividends before – the latest example of this occurred during the 2008 financial crisis.

fixed - they cannot be adjusted in times of stress. The same is not true in the U.S.[18] This illustrates how an apparently reasonable assumption, applied identically across different regulatory constructs, without adjustments, can result in calculations that don't reflect the economic reality.

We would expect that a credible standard would assess the capital model's performance under different circumstances and regulatory regimes to ensure it is fit for purpose. Otherwise, the capital model could penalize a large segment of the global insurance industry and discourage insurers from issuing products Americans rely on. Likewise, a transparent assessment of any capital model's treatment of long-duration products is also important to ensure that these important products remain available and affordable for all American families. We look forward to discussing these issues in greater detail with S&P.

Conclusion

Much of this is highly technical, but the details matter. They matter because individuals and families across this country are seeking certainty. And life insurers are in the business of certainty. We are there for our policyholders when they need us. We are there for communities who rely on our economic investments in their towns, suburbs, and cities, so they can fuel America's commerce and ingenuity.

A change by the world's largest rating agency in how they treat insurers' $7.4 trillion of investments will always be impactful, therefore any changes should be transparent and supported by data. We appreciate S&P's decision to withdraw portions of the RFC, as well as S&P's thoughtful consideration of comments on the RFC. We hope they will continue to consider the impact that changes to their insurer capital model may have on the long-term investments that support the U.S. economy and that make it possible for insurers to offer long-term products that Americans depend on. We look forward to continuing this dialogue and serving as a resource to S&P and this subcommittee. Thank you for this opportunity to share our views.

[18] For example, if interest rates fell to 0 percent, an insurer that issues whole life participating products in the U.S. would have the flexibility to decrease or temporarily suspend policyholder dividends (i.e., decrease the cash outflow), which would provide a buffer to the company's capital levels. S&P's proposed interest rate risk assumptions – that cash flow is fixed – doesn't match with the economic reality of U.S. participating products. In contrast, an insurer who issues whole life participating products in Europe would have less flexibility to react to the interest rate shock, because under the European regulatory framework, the insurer lacks the ability to decrease or stop policyholder dividends, even in times of stress.