National Association of Insurance Commissioners
& The Center for Insurance Policy and Research

MEMORANDUM

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) regarding a possible Valuation of Securities (E) Task Force directive to the SVO to rely on unrated subsidiaries in WCFI transactions.

DATE: October 16, 2020 (Updated June 14, 2021)

1. Summary – The SVO has received comments by some insurers and other industry participants that it should assign NAIC Designations to issues of non-guaranteed, unrated subsidiaries of NAIC Credit Rating Provider (CRP) rated parent entities, based on implied support from the parent to the subsidiary. This topic is most relevant to Working Capital Finance Investments (WCFI) with unrated obligors which are wholly owned, but not guaranteed, by CRP rated parent entities. Without legally-binding support, such as a guarantee, parental support of a subsidiary is entirely discretionary and ultimately reliant on the best interest of the parent. The SVO contends that no generally accepted analytical technique or methodology supports the assumption that a parent entity will necessarily support its subsidiary in times of financial distress. The SVO has reached this conclusion based on its previous legal study of support obligations and on its examination of CRP methodologies and examples of parents not supporting subsidiaries.

2. CRP and NAIC Methodologies – Rating agencies are generally consistent in their approach to rating parents and subsidiaries. To give credit to one entity's relationship with another it is necessary to first determine the stand-alone credit profile of both entities and then to notch up or down based on various factors explained in the various rating agency methodologies[1]. These factors include, among others, determinations of the parent's willingness and ability to support its subsidiary (Moodys[2]), strategic importance and core versus non-core businesses (S&P[3]), and

[1] Fitch Ratings provides one exception to this general approach. Pursuant to Fitch Ratings methodology it is possible to rate a subsidiary issuer without standalone financial information or a parent guarantee when an issuer (subsidiary) had long-term public bonds outstanding at the time it was acquired by an acquiring company (parent). Fitch clarifies that this exception is not meant to be an alternative to its general parent-subsidiary linkage methodology, nor does it apply to new debt issues. ("Parent and Subsidiary Linkage Rating Criteria," Fitch Ratings, 26 August 2020.)

[2] "Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence of Legally Binding Parent Support," Moody's Investors Service, December 2003. Though originally published in 2003, Moody's maintains this article on its website.

[3] "Parent and Subsidiary Ratings," S&P Global, August 29, 2000. Though originally published in 2000, S&P Global maintains this article on its website.

legal, operational and strategic ties between the parent and its subsidiary (Fitch[4]). Neither S&P nor Fitch directly addresses the question of whether an unrated, non-guaranteed subsidiary should or should not be assigned a rating based on implied support from its parent. Rather, they make the determination of stand-alone rating a key starting point for determining parent and subsidiary ratings, meaning a subsidiary for which they cannot determine a stand-alone rating would receive no benefit from its parent. Moody's, however, provides a persuasive explanation of the problems with implying a parent's support for its subsidiary in the absence of a legally-binding support agreement:

> During 2002, there were four instances[5] in which highly rated parent companies opted to maximize shareholder value by curtailing investment in wholly or partially owned subsidiaries that failed to produce or show any prospects of generating satisfactory returns on investment. As a consequence, the subsidiaries ultimately defaulted on their debt despite, in several cases, public assurances by the parent of continuing support given the ongoing strategic importance of the underlying subsidiary to its parent. While the subsidiaries ultimately defaulted, it should be noted that the cessation of funding weak non-return producing subsidiaries was ultimately a positive credit event at the parent level[6].

In its methodology Moody's draws on the empirical evidence of four examples of parents letting their respective subsidiaries fail, to demonstrate that non-legally binding promises of support are entirely discretionary and should not be the basis for a rating. Moody's further adds that in each of the four examples, "the parent company elected to discontinue support notwithstanding having: (1) made sizable initial and, in some cases, certain follow-on investments and (2) publicly articulated the 'strategic' nature and ongoing support for their subsidiary issuers."

Reliance on implied support of a parent for its subsidiary also conflicts with the "Credit Substitution" guidelines in Part Three of the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "Purposes and Procedures Manual") which were developed from a legal study of the enforceability of various types of support obligations. These guidelines plainly state that for the SVO to rely on the creditworthiness of an entity other than the issuer, a credit substitution instrument, such as a guarantee or letter of credit must be in place. The Credit Substitution guideline further align with Moody's methodology in that both distinguish between guarantees and non-legally binding support, such as comfort letters, keep-well agreements or other such statements of intended support. While guarantees, when consistent with the Purposes and Procedures Manual guidance, can allow for full credit substitution, comfort letters, by which an entity promises support of a limited kind to an affiliate or subsidiary, only allows the SVO to notch-up from the stand-alone NAIC designation of the issuer, and even then, only in limited circumstances. Moody's writes, ". . . the fact that some parent companies decided to discontinue investment in their subsidiaries after determining that such funding would fail to produce satisfactory return illustrates the low intrinsic value of non-legally binding support such as comfort letters, keep-well agreements, letters of moral intent, or verbal support."

The general rule among rating agencies that the strength of a parent can, at best, be used to *notch up the subsidiary's stand-alone rating* supports the similar approach found in the Purposes and Procedures Manual's credit substitution guidelines. This rule precludes the SVO from analytically deriving a designation for a subsidiary from its parent when the subsidiary has no stand-alone CRP rating or NAIC designation or for which the SVO cannot derive one.

3. Examples -

The following are examples provided by Moody's to support its determination not to imply a rated parent's support for its unrated, non-guaranteed subsidiary.

Decisions by the parents to cease support were based on the following:

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[4] "Parent and Subsidiary Linkage Rating Criteria" Fitch Ratings, 26 August 2020.

[5] BCE Inc.; AT&T Corp.; Verizon Communications, Inc.; and TXU Corp.

[6] Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence of Legally Binding Parent Support," Moody's Investors Service, December 2003

• BCE Inc. decided after a review of strategic alternatives that the incremental investment required to support its subsidiary, Teleglobe Inc., to a self-sustaining status in the deteriorating long-haul telecommunications sector was very unclear, and therefore so was the likelihood of earning an adequate return on its marginal investment.

• AT&T Corp. decided not to make further marginal investments in its partly owned subsidiary, AT&T Canada Inc., (ATTC) likely because the facilities based competitive local exchange carrier (CLEC) business was unable to support existing debt levels. Moreover, regulatory pricing changes in 2002 did not make economic the reselling of the incumbent telcos' own networks by ATTC.

• Verizon Communications, Inc. made a decision to curtail further investment in Genuity Inc., a leading provider of enterprise IP networking services. Verizon opted not to exercise its option to acquire and reintegrate Genuity after reevaluating Genuity's growth prospects in light of the significant slowdown in IT spending and order rates.

• TXU Corp. discontinued financial support for its subsidiary, TXU Europe Ltd., despite publicly stating its willingness to do so, after determining that further funding of TXU Europe would not maximize shareholder value and recognizing that TXU Europe Ltd. was putting the ratings of its other subsidiaries at tremendous risk. TXU Europe's operations were hampered by the effects of increasing competition following deregulation of UK power markets, declining wholesale power prices, and contracts to purchase power at prices above market[7].

4. **Recommendation and proposed amendment** – The SVO is aware that some industry participants and certain regulators have a different opinion than the SVO on the likelihood of parental support for their unrated, non-guaranteed subsidiaries and think such implied support exists and should be recognized in NAIC designations. Therefore, if the Task Force deems it essential that the SVO be able assign designations to WCFI transactions with unrated, non-guaranteed obligors, the SVO offers the following proposed amendments to Part One and Part Three of the Purposes and Procedures Manual. Pursuant to the amendment the Task Force would, in Part One, direct the SVO, in regards to WCFI transactions with unrated obligors, to rely upon the NAIC designation or the NAIC designation equivalent of a CRP rating of the obligor's parent entity but authorizes the SVO, based on its analytical judgement and in its sole discretion, to notch such NAIC designation. In Part Three the definition of WCFI "Obligor" would be revised to permit the SVO to follow the directive in Part One. The following text in red shows the proposed revisions in Part One and Part Three.

[7] Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence of Legally Binding Parent Support," Moody's Investors Service, December 2003

PART ONE

POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE

WORKING CAPITAL FINANCE INVESTMENTS (WCFI)

Description

116. As described in *SSAP No. 105R - Working Capital Finance Investments*, WCFI represents a confirmed short-term obligation to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program for which an NAIC Designation is assigned by the SVO. Pursuant to the working capital finance investment program, this short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third-party investor.

Obligor

117. The Obligor for WCFI transactions is the party that purchases the goods or services that generates the original supplier receivable (which is the payable for that Obligor). The obligor must have an NAIC Designation of "1" or "2" or an ~~Eligible~~ NAIC Credit Rating Provider (CRP) Rating equivalent.

Unrated Subsidiaries

118. Many WCFI programs are structured in a way whereby unrated subsidiaries of a rated parent entity are involved as transaction participants, including as the Obligor. Such programs may have strong operational and strategic linkages between the rated parent entity and its unrated subsidiaries.

119. Given (i) the short-term (less than one year) payment terms of each of the underlying receivables arising from the sale of goods or services, (ii) WCFI investors' option to stop funding a working capital finance program, and (iii) the necessity of working capital finance programs to obligors due to obligors' reliance on their suppliers, the Task Force has concluded there is a low probability of default of WCFI investments. Accordingly, the Task Force deems it reasonable to establish a principle to direct the SVO, in its assessment of WCFI programs, to rely upon a parent entity's rating for purposes of determining the NAIC Designation of the overall WCFI program.

120. Solely for purposes of WCFI transactions, the Task Force directs the SVO to rely upon the NAIC Designation or ~~Eligible~~ NAIC CRP Rating equivalent of the obligor, subsidiary or affiliate's parent entity if~~:~~

~~a)~~ the obligor, subsidiary or affiliate does not have an ~~Eligible~~ NAIC CRP Rating and the SVO cannot assign an NAIC Designation to it~~, and~~

b) ~~each relevant obligor, subsidiary or affiliate constitutes a substantial portion of its parent entity's operations representing at least twenty-five percent (25%) or greater of the parent entity's assets, revenue and net income~~.

~~121. The Task Force authorizes the SVO, based on its analytical judgement and in its sole discretion, to notch such NAIC Designation based on factors including, but not limited to, whether:~~

~~a) the unrated subsidiaries or affiliates that serve as key transaction participants can reasonably perform the functions expected of them; and/or~~

~~b) the rated entity has documented operational control over the performance of the unrated subsidiaries or affiliates that also serve as obligors in the program; and/or~~

~~c) there is documentary evidence in the program documents or appended thereto that sufficiently demonstrates the importance of the inter-relationship between the rated entity and the unrated subsidiaries or affiliates.~~

122. For the avoidance of doubt, ~~while~~ though the Task Force directs the SVO to use the NAIC Designation or ~~Eligible~~ NAIC CRP rating equivalent of the obligor's parent entity, due to the SVO's authority to notch such NAIC Designation or rating, the SVO, based on its analytical judgement and in its sole discretion, may assign an NAIC Designation to the obligor which differs from the correlated ~~Eligible~~ NAIC CRP rating equivalent of the obligor's parent entity or choose not to assign any NAIC Designation to the working capital finance program, based on aspects of the working capital finance program which are unrelated to the relationship between the obligor, subsidiary or affiliate and its parent entity. ~~Also, for the avoidance of doubt, the SVO may, based on its analytical judgement and in its sole discretion, choose not to assign any NAIC Designation to the working capital finance program, based on other attributes of the working capital finance program which are unrelated to the obligor or its parent entity.~~

123. The Task Force acknowledges that reliance upon the NAIC Designation or ~~Eligible~~ NAIC CRP rating equivalent of the obligor's parent entity in the absence of a binding legal obligation for the parent to assume the financial obligations of the obligor, such as a guarantee, is not a generally accepted technique or methodology (as explained in "Use of Generally Accepted Techniques or Methodologies" in Part One of this Manual) and is inconsistent with the credit substitution guidelines detailed in "Credit Substitution" in Part Three of this manual, but it is directing the SVO to so rely.

NOTE: See "Working Capital Finance Investments" in Part Three for filing instructions, documentation requirements, definitions and methodology applicable to Working Capital Finance Investments.

PART THREE

SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

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110. **Obligor** – An entity that purchases the goods or services from the Supplier and thereby generates the original supplier receivable—and which Obligor has, or can be designated, **NAIC 1** or **NAIC 2** by the SVO or has been assigned an equivalent credit rating by a NAIC CRP or, if not so designated, the SVO can imply such designation, as directed by the VOS/TF pursuant to the "Working Capital Finance Investments (WCFI)" section in Part One of this Manual.

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