Draft Pending Adoption

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Valuation of Securities (E) Task Force
Virtual Meeting *(in lieu of meeting at the 2020 Fall National Meeting)*
November 18, 2020

The Valuation of Securities (E) Task Force met Nov. 18, 2020. The following Task Force members participated: Robert H. Muriel, Chair, represented by Kevin Fry (IL); Doug Ommen, Vice Chair, represented by Carrie Mears (IA); Lori K. Wing-Heier represented by Wally Thomas (AK); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kathy Belfi and William Arfanis (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Carolyn Morgan (FL);Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary Anderson represented by John Turchi (MA); Chlora Lindley-Myers represented by Debbie Doggett (MO); Bruce R. Ramge represented by Lindsay Crawford (NE); Marlene Caride represented by John Sirovetz (NJ); Linda A. Lacewell represented by Jim Everett (NY); Jessica K. Altman represented by Kimberly Rankin (PA); Texas represented by Amy Garcia (TX); Tanji J. Northrup represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Tim Hays (WA); and Mark Afable represented by Randy Milquet (WI). Also participating was: Dale Bruggeman (OH).

1. Adopted its Sept. 29 and Summer National Meeting Minutes

The Task Force met Sept. 29 and took the following action: 1) adopted its 2021 proposed charges; 2) adopted a proposed amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to add instructions for exchange-traded funds (ETFs) that contain a combination of preferred stocks and bonds; 3) received an updated proposed amendment to the P&P Manual on guidance for working capital finance investments (WCFIs) consistent with the Statutory Accounting Principles (E) Working Group's adoption of changes to *Statement of Statutory Accounting Principles (SSAP) No. 105R—Working Capital Finance Investments*; and 4) received a referral response from the Statutory Accounting Principles (E) Working Group on the proposed P&P Manual amendment to update instructions for nonconforming credit tenant loan (CTL) transactions that relied upon credit ratings.

Ms. Clements made a motion, seconded by Mr. Thomas, to adopt the Task Force's Sept. 29 (Attachment) and Aug. 7 minutes *(see NAIC Proceedings – Summer 2020, Valuation of Securities (E) Task Force)*. The motion passed unanimously.

2. Adopted an Amendment to the P&P Manual to Update Guidance on Methodologies and Documentation for Initial and Subsequent Annual Filings

Mr. Fry said at the Summer National Meeting, the Securities Valuation Office (SVO) proposed an amendment to the P&P Manual to update guidance on initial and subsequent annual filings, methodologies and documentation. The amendment was exposed for a 30-day public comment period ending Sept. 6. The SVO reported that it had experienced a few insurers declining to provide the documents necessary to analyze the investments filed, and those insurers were asking where in the P&P Manual it required these documents be submitted. This amendment clarifies that guidance and fills in any gaps that may exist in the P&P Manual regarding filing documents that are required with the SVO to review. The changes also reflect the longstanding expectation by the Task Force that insurers will provide the SVO with the materials it needs to analyze investments filed with it.

Mr. Fry stated one joint comment letter was received from the American Council of Life Insurers (ACLI), the Public Policy in International Affairs (PPiA), and the North American Security Valuation Association (NASVA). The comment letter was generally supportive of the amendment. However, the comment letter did include a request for clarity about what documents are required by the SVO to perform its analysis for both initial and subsequent filings. In response, SVO staff have since added a list of general types of documents required for filings on their web page.

Ms. Mears made a motion, seconded by Mr. Thomas, to adopt the proposed amendment to the P&P Manual to update guidance on methodologies and documentation for initial and subsequent annual filings (Attachment). The motion passed unanimously.

3. Exposed an Updated Proposed Amendment to the P&P Manual on Guidance for WCFIs Consistent with the Statutory Accounting Principles (E) Working Group Adoption of Changes to SSAP No. 105R

Mr. Fry said the SVO drafted a proposed amendment on guidance to make the P&P Manual consistent with the Statutory Accounting Principles (E) Working Group's adoption of changes to SSAP No. 105R. This revision addresses issues identified in the ACLI's comment letter dated Aug. 17. This updated amendment was included in the meeting materials for the Sept. 29 meeting, but it was not exposed for comment. As mentioned during that meeting, the SVO had been working with industry on the amendment, but it ran out of time and there were still some unresolved issues. There is now a separate agenda item to discuss and consider the primary remaining unresolved issue, which was an initiative to come up with a policy to rely upon the parent entity's rating for its unrated subsidiaries for WCFIs. What is in front of the Task Force today reflects the discussions the SVO staff had with the ACLI in August regarding its comment letter. The SVO agreed that a number of items could be further refined, and this revised amendment reflects the changes necessary to remove any inconsistencies between the adopted revisions to SSAP No. 105R and the WCFI section of the P&P Manual.

Charles A. Therriault (NAIC) said a lot of documents were included with this agenda item to provide a full history of the original industry request, the referral to the Working Group, the adopted changes by the Working Group, the initial revisions to the P&P Manual, additional changes requested by industry, and finally this revised amendment conforming the P&P Manual to the adopted SSAP No. 105R changes. SVO staff carefully reviewed the ACLI comment letter on the initial amendment and agreed with many of its proposed edits during the Task Force's Aug. 26 meeting. As noted in the memorandum in the meeting materials, the industry recommendations fell into essentially three categories: 1) those that removed inconsistencies between SSAP No. 105R and the WCFI section of the P&P Manual, which the SVO incorporated into this revised amendment; 2) those that would alter the WCFI analysis provisions in the P&P Manual that are intentionally not included in SSAP No. 105R or the *Accounting Practices and Procedures Manual* (AP&P Manual) because they are an analytical task and not an accounting standard. Removal of these sections would impede the SVO's ability to assess investment risk in WCFI transactions; and 3) the last item being discussed separatelytoday, relying upon the rating of a rated parent entity for unrated subsidiaries.

Mr. Therriault said it is important to recognize that the instructions and guidance in the P&P Manual are not intended to be a duplication of the AP&P Manual. The AP&P Manual is not the governing document within the NAIC for the assessment of credit risk; that is the P&P Manual. It is why there are differences between the two as they perform different functions. The SVO has recommended that each of the following sections be retained in the P&P Manual because they are integral to its analysis function; they were requested to be removed in the industry proposal.

The request was to remove a section for the certification paragraph, which is in paragraph 102, bullet five from an insurance company investment officer. This section states that the insurance company in its capacity as an investor is not affiliated with the obligor or with any supplier in the working capital finance (WCF) program and that the WCF program does not include any insurance or insurance-related assets. This certification is important to the SVO review to ascertain one of the requirements in SSAP No. 105R stating that there are no insurance assets in this relationship.

The next item was the request to remove the Process and Methodology section (paragraph 121), which states the designation shall be assigned to the WCF program on the basis of a thorough assessment of credit, dilution, operational and other risks, and assessment of the protections provided by operative documents to the investor and the quality of the transactions participants. This is a part of the core assessment process of the SVO, which is why it should remain.

The Credit Risk section (paragraph 122) states the NAIC designation for a WCF program shall be linked to the credit quality of the obligor, which may be determined by reference to a credit rating assigned by an NAIC credit rating provider (CRP) or by an NAIC designation assigned by the SVO. Credit risk is assessed by the SVO analyst in accordance with any permitted methodology set forth in the P&P Manual for corporate obligors. The assessment of credit is a core component of the SVO investment risk assessment for WCFI transactions and does not conflict with SSAP No. 105R.

The Dilution Risk section (paragraphs 107, 121 and 123) is crucial for an accurate assessment of investment risk because it is necessary for the SVO to consider the risk that disputes or certain contractual provisions may reduce the amount of the obligation owed by the obligor to the supplier and thereby affect the insurance company investor.

The Operational Risk section (paragraphs 111, 121 and 124) is crucial for an accurate assessment of investment risk because it is necessary for the SVO to consider the risk that the parties involved in the program will not fulfill their contractual responsibilities.

The SVO's recommendation is to retain all of these investment risk assessment-related functions within the WCFI section of the P&P Manual and recommend that the remaining changes be adopted as soon as possible to conform the P&P Manual to the AP&P Manual. Mr. Fry said this section takes the amendments authorized by the Statutory Accounting Principles (E) Working

Group and puts them into SSAP No. 105R.This will make the guidance uniform while adding to the general analytical framework. The Task Force plans to expose this and have SSAP No. 105R and the P&P Manual in sync.

Mr. Everett asked if the unrated subsidiary language is being incorporated with these materials. Mr. Fry said the unrated subsidiary piece is not in this exposure. There is another exposure that the Task Force will discuss in the next agenda item that narrowly covers the unrated subsidiary piece. That way, the Task Force can move along with syncing up the frameworks in this agenda item. In the next agenda item, the Task Force can deal with a policy decision about unrated subsidiaries.

Mike Monahan (ACLI) said the ACLI will respond with comments once the amendment is exposed.

Mr. Fry directed SVO staff to expose this updated amendment to the P&P Manual on guidance for WCFIs consistent with the Statutory Accounting Principles (E) Working Group's adoption of changes to SSAP No. 105R for a 60-day public comment period ending Jan. 18, 2021 (Attachment).

4. Exposed a Proposed Amendment to the P&P Manual to permit the SVO to Rely Upon the Unrated Subsidiaries of a CRP-Rated Parent Entity for Only WCFIs

Mr. Fry said industry has requested that for WCFIs, the SVO should have the discretion to rely on the unrated subsidiaries of a rated parent entity.

Mr. Fry said both he and the SVO had received comments from some insurers and other industry participants that in WCFI transactions, the SVO should assign NAIC designations to issues of non-guaranteed, unrated obligors, which are subsidiaries of rated parent entities, based on an implied support from the parent to the subsidiary. This topic is most relevant to a subset of WCFI transactions with unrated obligors that are wholly owned, but not guaranteed, by CRP-rated parent entities.

Given the short payment terms of underlying receivables, WCFI investors' option to stop funding a program, and the importance of WCF programs to obligors due to obligors' reliance on their suppliers, Mr. Fry said he sees a low probability of default of WCFIs and thinks the likelihood of a rated parent supporting its unguaranteed subsidiary as very likely where there are strong linkages between the parent and subsidiary. However, the SVO does not have a methodology to apply in these situations. One solution the SVO has proposed is to have the Task Force direct the SVO, through a policy statement to imply such support in its assessment of WCF programs. By incorporating a Task Force directive into Part One of the P&P Manual, the SVO will be able to move forward in designating these types of transactions, but it will do so having made clear to the Task Force and industry that it does so only because of the policy directive and not because of an analytical methodology. As the Task Force considers this issue, it should also refer it back to the Statutory Accounting Principles (E) Working Group for comment.

Marc Perlman (NAIC) said the SVO takes the position that it cannot rely on any implied parental support for an non-guaranteed subsidiary because 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 believes 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 and reached that conclusion based on its previous legal study of support obligations (which was done for the credit substitution guidance in the P&P Manual) and on its examination of rating agency methodologies, which include examples of parents not supporting subsidiaries.

The 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. These factors include: a parent's willingness and ability to support its subsidiary; strategic importance and core versus non-core businesses; and legal, operational and strategic ties between the parent and its subsidiary. While neither Standard & Poor's (S&P) nor Fitch Ratings (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, they do make the determination of the stand-alone rating a key starting point for determining parent and subsidiary ratings. This means 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. Moody's writes:

During 2002, there were four instances 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.

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."

Additionally, reliance on implied support of a parent for its subsidiary conflicts with the P&P' Manual's credit substitution guidelines, 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 (LOC) must be in place. The guidelines 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 similar statements of intended support. While guarantees can allow for full credit substitution, comfort letters, by which an entity promises support of a limited kind to an affiliate or subsidiary, only allow 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 P&P Manual. This rule precludes the SVO from analytically deriving a designation for a subsidiary from its parent when the subsidiary has no stand-alone rating or NAIC designation. The SVO is aware that some in industry and some regulators have a different opinion on this topic. Therefore, if the Task Force deems it essential that the SVO be able to assign designations to WCFI transactions with unrated, non-guaranteed obligors, and based on the outcome of a referral to the Statutory Accounting Principles (E) Working Group, the SVO proposed an amendment to Part One of the P&P Manual by which the Task Force directs the SVO to rely upon the rating or designation of a WCFI obligor's parent entity.

Ms. Belfi said that for the Statutory Accounting Principles (E) Working Group, if a subsidiary is not a rated entity, it was one of the criteria for WCF notes. The Working Group talked about parental guarantees and concluded that the industry could not give a formal parental guarantee, which is a huge barrier for these notes. She asked if the SVO could provide some type of a rating to these subsidiaries that are not rated and if it is going to be based upon information from their parent. She also asked if this was being worked on in conjunction with Working Group to make sure that it is on board with this change.

Mr. Fry said one of the hallmarks for these WCFIs is the obligor being investment grade. Many of the parent companies are investment grade. They issue bonds, and they are clearly identifiable as investment grade. They might own a subsidiary that they just never had a reason to get a rating because it does not issue debt in and of itself. In that case, the SVO would be given a policy to where it could rate this in the context of this is a program that has a very tight framework with a lot of protections in place. The SVO would look at some principles to make sure that the unrated subsidiary has a certain importance in the organization or a certain size within that organization, which would support that the parent would not turn its back on the subsidiary and not pay its obligations.

Ms. Belfi said she thinks the Task Force should work together with the Working Group to make sure it will be on board with this. Mr. Fry said he agrees and that the Task Force would send a referral back to the Working Group. He said it is his understanding that this issue was one of the requests by industry that the Working Group did not address in its amendments. The Task Force does have the jurisdiction to give the SVO purview to rate these subsidiaries and that is what is being exposed now, a policy to permit the SVO to do that. There could be comments for and against this approach in the exposure period.

Mr. Everett said to the best of his knowledge, he thought that unrated subsidiaries were rejected at the Working Group. Given that this is inconsistent, it would then be inconsistent with the proper interpretation of SSAP No. 105R. He asked if the Task Force could do this since the Task Force is supposed to be looking at the credit side of the accounting piece and that there is not a credit substitution methodology. Given that the 50 basis points (bps) to 100 bps, the notes are short term, but companies are buying into a long-term commitment to take part in the programs. However, the notes that they hold are finance inventory, which other regulators, the Federal Reserve and the Office of the Comptroller of the Currency (OCC) have said require a full understanding of the industry by the investor. The investments are also the lowest priority in the case of an insolvency. Given

that, funds in the most recent round of amendments can be commingled. Before referring back it back to the Working Group seems precipitous, given they had considered it and not included it in the return to the Task Force.

Mr. Fry said he thinks the Task Force can weigh the response from the Working Group when it receives it. The Task Force seems to have the jurisdiction to decide whether the SVO can evaluate investment risk in these cases. Alternatively, the Task Force is only accepting credit ratings. If the Task Force has a policy and has VO staff oversee it, that adds a little comfort.

Ms. Belfi said she agrees but believes Mr. Everett's point is that the Task Force needs to work in conjunction with the Working Group. The Working Group may still come to the same conclusion after going through all this. Ms. Mears asked to clarify that this policy to use a parent rating for an unrelated subsidiary would only be narrowly applied to these WCFIs based on this proposal. The Task Force would not be implementing that kind of guidance broadly. Mr. Fry said it is narrow because of the framework, the short-term nature and all the policies that are in place.

Mr. Everett asked what provides the extra assurance in the notes that would be lacking from an unrated subsidiary in other situations. Mr. Monahan said the backbone of these programs is the unrated subsidiaries. If there is not a policy directive in accepting these unrated subsidiaries, insurance investors are hamstrung and will be deprived from entering this market. Unrated subsidiaries refer to the wholly owned entities that are affiliated with the enterprise entity that has a public rating. This is their supply chain. These are the people they pay first. For example, Walmart pays for its bills as soon as they are due. The finance agents that arrange the financing and deal the paper to the investors do not make distinctions. The legal agreements that document these arrangements detail provisions and operating requirements that enable the controls to tie these affiliates together, which are able to look through to the rated entity. The ACLI strongly supports exposure of this item.

Mr. Everett said the OCC has indicated that these programs are generally entered into when firms have reached the end of their credit lines with banks The banks then use them to extend funds that otherwise would be prohibited. That would suggest that the later credits get lesser priority as this is inventory financing.

Ms. Belfi said she would support going forward with this because this program does not work without it. She said she has been involved with these investments for years trying to figure them out. The Working Group went through a lot of work on this and emphasized the need to work with the Working Group to make sure it is also on board.

Adam Dener (Fermat Capital Management/ACLI) said these have been filed consistently by several different institutions. Herecommends any individual who wants to review this topic to look at the filings made with the SVO to see the legal contracts. He also noted that the reference to the OCC may be inaccurate and offered to review it.

Mr. Fry directed SVO staff to expose this amendment to rely upon the unrated subsidiaries of a CRP-rated parent entity for only WCFIs for a 60-day public comment period ending Jan. 18, 2021 (Attachment) and refer the amendment to the Statutory Accounting Principles (E) Working Group requesting its comment.

5. Discussed Bespoke Securities and NAIC Reliance on CRP Ratings

Mr. Fry said while it is important that the NAIC rely on credit ratings in its frameworkit should not blindly rely on credit ratings. Mr. Fry explained that how the NAIC uses credit ratings will be discussed next year. The Task Force first started talking about bespoke securities on Aug. 14 2019, at the Summer National Meeting. The Investment Analysis Office directors, Mr. Therriault and Eric Kolchinsky (NAIC) gave a presentation on bespoke securities and the risks that they have seen with some different securities going through the filing exempt (FE) process. Out of that presentation, they created an issue paper, which was exposed May 14 for a 90-day public comment period. Two comment letters were received: 1) from the ACLI, NASVA and PPIA; and 2) from the American Property Casualty Insurance Association (APCIA).

Those comment letters were concerned about moving too fast and casting too wide a net as the Task Force attempts to identify bespoke securities. There was a little concern that certain markets might be spooked. At the same time, they offered transparency with the private letter ratings. Often, a bespoke security has a private letter rating. It is a transaction that has only a few parties involved, and it is not a really syndicated market. There are certain characteristics and any one characteristic in and of itself is not necessarily bad, but when combined, certain securities create a heightened risk. It goes along with the theme that a lot of people associate that by get a rating on security, it automatically means it is a bond reported on Schedule D and gets a certain treatment. The Task Force's statutory framework has a lot more to it than just getting a rating and automatically going on Schedule D and superimposing all the other rules that are part of that. Given the comment letters, people might wonder what is the direction for next year. Subsequent to receiving these two comment letters, the Task Force also received a

memorandum from the Financial Condition (E) Committee that directed a new charge for next year to implement policies to help the SVO administer the FE process and look at ways the SVO can have discretion in its administration of the FE process.

Josh Bean (Transamerica, representing the ACLI) said the ACLI, NASVA and PPIA share a common interest in keeping the playing field level, particularly for the vast majority that operate within the regulatory objective. He said that they acknowledge the importance of upholding that regulatory objective for safeguarding the overall health of this industry and its beneficiaries and that they are on board for rooting out abusive practices. He said that he wants to emphasize and make sure this messaging is clear that they never intended to suggest diminishing existing Investment Analysis Office (IAO) authority, as outlined in the P&P Manual. He said the IAO is a great counterpart that has proven time and again to be both highly competent and committed to its executive agency functions of implementing and enforcing the directive of the Task Force. As such, Mr. Bean said they continue to support the IAO in such endeavors.

Mr. Bean said as suggested in their comment letter, it should be clearly identified for the Task Force, and ideally all public stakeholders, whenever the IAO is recommending that the Task Force approve expansion of the IAO's description and/or influence over filing requirements or designation determinations beyond what is prescribed by the P&P Manual . Mr. Bean said the ACLI, NASVA and PPIA suggest that would cover any such expansion, whether labeled administrative discretion or some form of regulatory authority. Finally, he said their comment letter makes clear their appreciation for the Task Force. Mr. Bean said they understand that the Task Force has a tough job, adding that it takes a rare combination of insight, integrity, savoir faire, appropriate risk classification and adequate transparency. At the same time, he said their comment letter praises the Task Force for being careful to avoid stifling innovation and valuable investment opportunities, roiling the broader capital markets or imposing undue uncertainty, and restriction or resource burdens on insurance providers.

Mr. Bean said the Task Force chair has done a nice job of outlining this new charge that the Task Force now faces, which is complex, to manage optimal engagement and optimal leveraging of the IAO as a technical support agency. On the one hand, needing to leverage the IAO analysis and insights to the benefit of the regulatory objectives gives it additional analytical discretion to do so. At the same time, the Task Force understands the need to steer the IAO around the pitfalls of becoming logistically overextended or drawn into an unfamiliar and unfair position of having to account for the broader prudential considerations that accompany the exercise of regulatory authority. Mr. Bean said it is comforting to know that the Task Force has the experience and the savvy to smoke out the bad guys without setting fire to the whole village. It is also comforting that the Task Force understands that the prudential realities of resolving these very valid concerns about blind rating agency reliance are much more nuanced than a simple binary decision between unmitigated risk on the one hand and the granting of unilateral authority to an enforcement agency on the other.

Mr. Bean said it is critical to ensure all parties involved in this effort have acted in a 360-degree view of the issue, as well as the opportunity to entertain and consider the broad range of options available to create a more refined and efficient means of filling any actual gaps in the existing solvency safety net. He said as outlined in their comment letter, the most practical first step on that journey entails providing the information necessary for the Task Force and their technical support agency to more precisely identify characteristics of credit rating methodologies and/or transaction structures, which are perceived to be incongruent with the regulatory objective embodied in the investment filing and reporting guidance of today's NAIC solvency framework. Mr. Bean said he is pleased to see that in the next item on today's agenda the IAO's first raw draft proposal has, to a limited extent, been informed by their comment letter's offer of a one-time filing of private rating letters, the underlying analysis to facilitate this review of existing transactions, and to facilitate the identification of discrete patterns in either rating methodologies or transaction structures that merit a suggestion of further consideration by the Task Force.

Mr. Fry said it is important to strike the right balance as the Task Force moves forward, finding new ways to do things but being mindful of the impact.

6. Exposed a Proposed Amendment to the P&P Manual to Require the Filing of Private Rating Analysis

Mr. Fry said the proposed amendment to the P&P Manual requires the filing of private rating analysis. The Task Force formed a subgroup to look at private letter ratings and studied those for two or three years. The subgroup came up with some recommendations, one of which was to get all the private letter ratings filed with the Task Force. The Task Force has better access at the SVO to the private letter rating, which is usually just a one-page letter that is not really informative other than describing the Committee on Uniform Security Identification Procedures (CUSIP) and what the rating is. It does not really talk a lot about the methodology of the analysis and all the things underneath that. Mr. Fry said one of the first steps going into next year is getting a policy in place, such as this, that can require the filing of not only the rating letter, at least initially, but also the supporting methodology and analysis behind the letter so the Task Force can get a flavor for what sits behind these private letter ratings.

Mr. Therriault said this proposal would require the rating rationale report to be filed with the SVO for privately rated securities. The rating rationale report must provide a more in-depth analysis of the transaction, the methodology used to arrive at the private rating and, as appropriate, discussion of the transaction's credit, legal, and operational risks and mitigants. With both the private rating letter and the private rating letter rationale report, the SVO would be able to determine two criteria:1) whether the private credit rating is an eligible NAIC CRP rating, meaning the security type is eligible to be reported on Schedule D. This would make it appropriate for a nationally recognized statistical rating organization (NRSRO) credit rating to be used to determine the NAIC designation for the security; and 2) whether the SVO agrees with the private credit rating assessment.

Mr. Therriault said the proposal would grant the SVO discretion, based on its reasonable review of the private rating letter and the supporting rationale report, to: 1) assign an NAIC designation equivalent to the CRP private letter rating; 2) require the security to be filed for review by the SVO; or 3) decline to assign any NAIC designation. The proposal would require the filing or submission of a rating rationale report for all CRP privately rated securities each calendar year or whenever there was a material credit event, whether filed through VISION or received through a data feed.

The proposal directly addresses two issues identified in the *Bespoke Securities and NAIC Reliance on CRP Ratings* issue paper: 1) improving the transparency of privately issued and rated securities and unrated securities. This will improve transparency to the regulators through proxy of the SVO and will provide the SVO oversight and discretion over ratings, in this case private ratings. The SVO thinks this is an incremental approach consistent with the directions given by the Task Force and the Financial Condition (E) Committee. The proposal includes a recommended effective date, but that is just an estimate at this point that may need to change based on the Task Force's ability to actually develop technology processes to support this proposal and obviously whatever direction the Task Force would like to take in terms of transitioning to such a state.

Ms. Belfi said she thinks the first step is to get all this information with the additional information that is critical and then get an overview from the SVO. She said it is going to be more of a collection and then a review instead of discretion upfront.

Mr. Fry said that it is worth pointing out there are a lot of ways to do this. The SVO would realize a trend in certain securities or different investments and come to the Task Force in a public way. Those can be discussed, and everyone can know their concerns and then decide a certain course of action, in a transparent process. What the SVO is suggesting is, on a case-by-case basis, looking at something without going back to the Task Force and either notching the security, requiring it to be filed or taking other action.

Mr. Therriault said that would be the goal. There are several thousand rating methodologies that are out there from each of the eight rating agencies used today. They all come up with different answers, depending on how they are applied to the security that is being looked at. Mr. Therriault said that going to the Task Force each time there is a disagreement with a particular outcome would be problematic at best and logistically impossible. The SVO sees this on a regular basis, almost daily, where privately rated securities come into the office for review that have ratings that would be inconsistent with methodologies the SVO would apply. The SVO does not have a mechanism or any ability to apply any judgment, oversight or discretion over what it is seeing. The SVO just mechanically processes ratings, no matter what its opinion may be as to the value of the rating. This recommendation, at least for the privately rated securities, would start putting some oversight, discretion and judgment over the ratings that are received as opposed to mechanically taking any answer and just translating.

Ms. Belfi said it sounds like the securities are unique. She said it would be nice for the Task Force to understand if there is some commonality of issues among them. She said she thought that was going to be the first step.

Mr. Therriault said that the SVO could review these securities with the Task Force in regulator-to-regulator session, but it would not be something it could do publicly because these are privately rated securities. The SVO had discussed some of these securities with the Task Force during the recent educational seminar. Those were several good examples of things that the SVO is seeing, but there are certainly many others.

Mr. Belfi said she suggests a regulator-to-regulator session to go through this so that the state insurance regulators understand what the SVO is seeing before considering the second half of this proposal.

Mr. Fry said if the Task Force can just get the documentation, it can start to see the trends or even see individual examples and then couple that with data. The Task Force would find it useful to know how ratings are being used now in the context of a big bond portfolio with a lot of issuers, how many of them have multiple ratings and how many of them have a single rating that is private. If all of this is put together, then the Task Force can develop the policy part. It might be a case-by-case basis, or they might involve themes. It might be safer to quickly get the mandate to get this documentation and start studying the data and

then set the policy as the Task Force moves forward in 2021. Ms. Belfi and Ms. Mears agreed. Mr. Fry said the quicker the Task Force gets that requirement, the quicker the Task Force can make that important policy decision.

Mr. Therriault said as an option, the comment letters can make suggestions or edits to the proposal, and it could be tweaked from there. Mr. Fry said the Task Force could get a lot of comments about this topic, so it would be simpler to adjust the comments.

Mr. Monahan said he agrees with Ms. Belfi and Ms. Mears to not only expose the unfettered decision making at this point in time, but also to get the documents in-house and look for trends. He said he think that is the simplest way to move forward.

Mr. Therriault said there would be a systems development regardless if it is just the documents being required for any of the privately rated securities. Mr. Therriault said there will be a technology build necessary to keep in mind. Mr. Fry said with what is already out there for getting the letter itself, that is not expansive enough after accommodating this documentation. Mr. Therriault said it would require a way to get the analysis associated with the private rating. Not all the privately rated securities get filed with the SVO; some came in on electronic feeds that the SVO has even less visibility to.

Mike Reese (Northwestern Mutual) said Northwestern Mutual offers up transparency on filing the ratings, letters and rationale. It might take some time to get the rationale. There are confidentiality agreements, and he said he agrees with Mr, Monahan and what Ms. Belfi said that the exposure to gather data is very consistent with what was said in the ACLI comment letter. Mr. Therriault talked about a thousand different rating agency methodologies. Mr. Reese asked if this is really about bespoke or trouble securities like the examples of principal protected notes (PPNs) or combo notes, which have been identified already. Mr. Reese said he only asks this question generally, believing it would inform how the Task Force responds to the exposure. The Task Force has asked for examples of other troubling securities and said he is struggling to understand bespoke securities.

Mr. Therriault said the issue paper addressed both issues. One is bespoke securities as being unique and certainly difficult to identify. The other is the reliance upon rating agency ratings in general and that there is inconsistency between the rating agency methodologies. With privately rated securities, it comes squarely into focus, as the SVO staff see some of the rating analysis. The SVO is seeing how these methodologies are applied and how the approach can be significantly different from how the SVO would approach analyzing these same types of transactions. That is how the principal protected securities got identified, how the collateralized loan obligation (CLO) combo notes got identified, and how the SVO has raised issue with both the Statutory Accounting Principles (E) Working Group and the Financial Analysis (E) Working Group. Those issues were all identified only after the SVO reviewed the analysis of those privately rated securities. This is the first time the SVO is seeing what is going on behind the scenes.

Mr. Reese said there is a concern with industry of most private letter ratings. There are securities that are not controversial, and having capital certainty on those is important. Not having capital certainty would pressure companies to allocate away from these investments. It would pressure issuers and bankers to steer these investments away from the insurance market and asset class that historically has outperformed public bonds.

Chris Anderson (Anderson Insights) said there are two different proposalsMr. Anderson said the proposal that it is on the table calls for permanent annual submissions across the board of all of these so-called bespoke securities. He said that he understands why Ms. Belfi and Ms. Mears want to have a look and decide what needs to be done. He said that it may be more appropriate to amend the proposal than to adopt a proposal or expose a proposal that calls for something that is probably premature.

Ms. Mears said she does not know that she would agree that that was her indication. She said that she appreciates that some of these deals may change or if the credit rating analysis may change over the years. It is important to expose it as an ongoing submission and gather themes from the reviews to identify issues to be brought back to the Task Force

Sasha Kamper (PPIA) said a lot of the things that Mr. Reese said about the concernsand the need for capital certainty in this marketplace. This is a marketplace that has historically not only offered additional yield to insurers above and beyond what can be obtained in the public corporate market, but also it has been found by multiple studies from the Society of Actuaries (SOA) that it has lower credit class experience as well. It outperforms the corporate public market in multiple ways. It is an important market for most insurers, and it is important to ensure that these deals stay part of the market. The concern is, as Mr. Reese said, thatif by allowing the Task Force to override ratings, not because of some large thematic concern that poses a systemic risk to industries and insurers, it might encounter a difference of professional opinion, which does happen all the time, even among rating agencies. They sometimes can have a difference of opinion on a deal that causes capital uncertainty from insurers. If one bought it thinking one is going to have to be able to carry an NAIC 2.B type of capital and then find out it is an NAIC 2.C when moved to more granularity or worse yet, it is NAIC 3.A, that has really meaningful economic impact for

insurers. It will cause insurers to want to steer away from this asset class. More importantly, it will probably cause bankers to start to advise their borrowers against this market's difficulty and steer them to the bank loan markets instead, which would deprive one of the opportunity to invest in good deals. Ms. Kamper said industry is very supportive of the idea of being transparent and is supportive of filing the private ratings letters and the rationales. She said it will take some time to work with the agencies to ensure that there are rationales for all the deals. Some of them right now just have a one-page letter with a rating and will require help in adjusting the confidentiality language to feel comfortable sharing it. She said as long as they are given time to do that, they will work towards that as they believe most of the rating agencies will accommodate. Ms Kamper said she does agree with some of the issues that Ms. Mears has raised. Ms. Kamper said she believes that maybe right now, the Task Force should focus on gathering the information and at a later time determine what the real risks are and what is the best way to fix.

Ms. Belfi said it would be more appropriate to expose a simpler version with the rationale included, have a regulator-to-regulator meeting to go through that, and make sound policy decisions.

Mr. Fry said he would work with the SVO to strip out the discretion piece and expose the revision for a 60day public comment period (Attachment).

7. Heard a Staff Report on Projects Before the Statutory Accounting Principles (E) Working Group

Julie Gann (NAIC) provided a quick update on the SSAP No. 43R Project, which is now being referred to as the Scheduled D-1 Project. During the last Statutory Accounting Principles (E) Working Group discussion on this topic, which was Oct. 13, the Working Group exposed the Iowa Insurance Commission proposal to establish principles reported on Schedule D-1, which is long-term bonds. It has been identified that there was some overlap between investments captured on *SSAP No. 26R—Bonds* and *SSAP No. 43R—Loan-Backed and Structured Securities*. By just focusing on the SSAP No. 43R side, there was some confusion. That is why the project focused first on the D-1. Although there have been some continuous discussions with industry regulators and NAIC staff since the exposure, the formal comment deadline for this item is Dec. 4.

Ms. Gann said the next project has to do with credit tenant loans (CTLs). During the Working Group's Nov. 12 meeting, which reflected the Fall National Meeting business, the Working Group considered action on agenda item 2020-24 pertaining to CTLs. As a reminder, that was originally drafted from a Task Force referral. Pursuant to that discussion, the Working Group directed year-end reporting guidelines to clarify the inclusion of conforming CTLs in scope of SSAP No. 43R and that reporting of nonconforming CTLs that do not have an SVO-assigned designation on Schedule BA. This guidance provided a limited time provision to nonconforming CTLs to be able to be reported on Schedule D-1 if they have been assigned an NAIC designation. The Working Group also directed the referral to the SVO, requesting comments on whether it is appropriate to change the existing 5% residual threshold in determining whether a CTL is conforming. Due to subsequent questions that have been received from entities that have previously reported nonconforming CTLs on other reporting schedules, such as Schedule B, as well as a noted conflict with the policy statement that indicates that NAIC designations do not communicate statutory accounting and reporting, the Working Group conducted an e-vote to expose a tentative interpretation (INT) to clarify the guidance and exceptions for a public comment period ending Dec. 4. It is expected that the INT will be posted publicly soon and once that is posted, a formal notification will be sent out.

Lastly, in addition to those two main items, the Working Group adopted revisions to clarify guidance for participating arrangements with mortgage loans and to reflect the SVO NAIC designation mapping process for financially modeled security . The Working Group also exposed several investment-related items, but the exposed revisions are mostly minor. For example, the Working Group exposed guidance related to perpetual bonds, disclosures for bonds terminated under tender offers, accounting guidance for publicly traded preferred stock warrants, and changes in SSAP No. 43R to reflect provisions within government-sponsored enterprises and credit risk transfer items, such as Fannie Mae and Freddie Mac, to be captured in scope. All those items have been exposed for a public comment period ending Jan. 11, 2021.

8. Discussed Other Matters

Mr. Therriault said that to follow up on Ms. Gann's comments on CTLs, the SVO was requested to look at nonconforming CTL for year-end 2020. The SVO requests companies that have these securities to submit them to the SVO. He said he envisions a full filing package, including all the legal agreements, CTL forms, financial statements, property assessments and the rating agency rating analysis. As there is potential property risk associated with some of these CTLs, additional documentation may be necessary. Mr. Therriault said the SVO will be assigning a subscript "S" for these issues to indicate additional risks. The SVO is in the process of working to update the CTL forms and will have that published on the SVO web page underneath the tab labeled "Filing Info," which is where the additional document guidance is located. The SVO will also start a project to

review the 5% residual asset exposure and see if there are additional mitigants to identify that would make a CTL conform to the existing guidance, The SVO plans to report the results of that research to the Task Force and the Working Group.

John Garrison (Lease-Backed Securities Working Group) said in response to Ms. Gann's comments, he agrees with the summarization of the decision at the Working Group meeting regarding the filing of these deals for this year. However, he said his recollection is that part of that motion that was voted on was to arrange for the deals to be filed this year to make a determination of whether they would go on Schedule D or Schedule BA, and then to address the ultimate decision of where these nonconforming CTL should be and what schedule they should be on as part of the SSAP No. 43R Project.

Ms. Gann said the Working Group will continue to discuss CTL as part of the SSAP No. 43R Project that are specifically noted in the INT. One of the things that needs to be to highlighted is that the exception allowing for nonconforming CTLs to be on Schedule D-1 with the SVO-assigned designation should not provide any sort of indication that that will be the resulting final conclusion by the Working Group as part of the SSAP No. 43R Project. Ms Gann noted that this will continue to be discussed.

Mr. Bruggeman said that interpretation is through the third quarter of 2021. It provides a little incentive for both state insurance regulators and interested parties to get to the table and get these things resolved before next year end. Mr. Bruggeman said as always with any INT, there is the ability to extend if necessary, but he hopes they would not have to.

Mr. Monahan asked about the timing as to when the SVO is expecting to see documents and when companies can expect to see these designations.

Mr. Therriault said the SVO will try to get them as soon as it can. The sooner it gets the documentation, the better. In some of the original conversations, the expectations was that these would be part of the carryover of population if the SVO gets those filings before year-end. The SVO will try to complete the designation assignments the early part of next year,prioritizing them for the January and February reviews so that they may be done hopefully for Dec. 31 reporting.

Mr. Everett said there was a question earlier about a reference to the OCC. He said anyone interested can refer to the accounts receivable and inventory financing sections on page 5 of the comptroller's handbook. He said there is a discussion beginning on that page that would be most illuminating.

Having no further business, the Valuation of Securities (E) Task Force adjourned.

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