Date: 12/17/2020

Conference Call

VALUATION OF SECURITIES (E) TASK FORCE

Friday, December 18, 2020

3:00 p.m. – 3:30 p.m. ET / 2:00 p.m. – 2:30 p.m. CT / 1:00 p.m. – 1:30 p.m. MT / 12:00 pm. – 12:30 p.m. PT

ROLL CALL

Robert H. Muriel, Chair	Illinois	Gary Anderson	Massachusetts
Doug Ommen, Vice Chair	Iowa	Chlora Lindley-Myers	Missouri
Lori K. Wing-Heier	Alaska	Bruce R. Ramge	Nebraska
Ricardo Lara	California	Marlene Caride	New Jersey
Andrew N. Mais	Connecticut	Linda Lacewell	New York
Trinidad Navarro	Delaware	Jessica Altman	Pennsylvania
David Altmaier	Florida	Kent Sullivan	Texas
Dean L. Cameron	Idaho	Todd E. Kiser	Utah
Vicki Schmidt	Kansas	Scott A. White	Virginia
James J. Donelon	Louisiana	Mike Kreidler	Washington
Al Redmer Jr.	Maryland	Mark Afable	Wisconsin

NAIC Support Staff: Charles A. Therriault, Marc Perlman

AGENDA

1. Consider Editorial Edits Updates to the Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Include Instructions for Financial Modeled RMBS/CMBS Securities to Map NAIC Designations to NAIC Designations Categories — Attachment A & A - 1
   —Kevin Fry (IL), Charles Therriault (NAIC), Eric Kolchinsky (NAIC), Marc Perlman (NAIC)

2. Discuss Financially Modeled RMBS/CMBS Price Break-Points and Other Issues Surrounding Securities That Have Zero-loss in 2020
   —Kevin Fry (IL), Eric Kolchinsky (NAIC)

3. Adjournment

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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)

CC: Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO)
Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Updated Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Include Instructions for Financial Modeled RMBS/CMBS Securities to Map NAIC Designations to NAIC Designations Categories

DATE: February 10, 2020 (Updated 5-14-2020, 12-14-2020)

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1. Summary – On the Feb. 4, 2020 interim meeting of the Valuation of Securities (E) Task Force NAIC staff were directed to draft and expose a P&P Manual amendment retaining the Financial Modeling and book/adjusted carrying value price ranges for modeled RMBS/CMBS securities but add mapping instructions from the resulting NAIC Designation to produce an NAIC Designation Category so that insurers can report an NAIC Designation Category. This mapping from an NAIC Designation to the NAIC Designation Category midpoint would be a temporary measure until new Risk Based Capital factors are adopted for each NAIC Designation Category and new price ranges can be developed. As requested by the Task Force, there would be no regulatory capital impact from this proposed change.

Update 12-14-2020: Through discussions with industry it appears there is the potential for some zero-loss securities to have their regulatory capital impacted in ways not intended by the Task Force. This proposed editorial update would eliminate that potential regulatory capital impact and calibrate the reported NAIC Designation Category for the entire population of zero-loss to be consistent with their overall equivalent CRP rating risk level that would be applied under Filing Exemption (FE).

2. Recommendation – The IAO staff recommend these updated instructions be adopted by the Task Force to provide insures and their system vendors guidance for year-end. It also recommends referring this amendment, if adopted, to the Statutory Accounting Principles (E) Working Group to inform them that there would be no change to SSAP 43R - Loan-Backed and Structured Securities, at this time.

3. Proposed Amendment – The following text shows the revisions needed in Part Four with edits in red-underline.

PART FOUR
THE NAIC STRUCTURED SECURITIES GROUP

27. The NAIC Designation and NAIC Designation Category for a given modeled RMBS or CMBS CUSIP owned by a given insurance company depends on the insurer's book/adjusted carrying value of each RMBS or CMBS, whether that carrying value, in accordance with *SSAP No. 43R—Loan-Backed and Structured Securities*, paragraphs 25 through 26a, is the amortized cost or fair value, and where the book/adjusted carrying value matches the price ranges provided in the model output for each NAIC Designation and the mapped NAIC Designation Category, reflected in the table below, to be used for reporting an NAIC Designation Category until new Risk Based Capital factors are adopted for each NAIC Designation Category and new prices ranges developed; except that an RMBS or CMBS tranche that has no expected loss under any of the selected modeling scenarios and that would be equivalent to an **NAIC 1** Designation ~~**and NAIC 1.A Designation Category**~~ if the filing exempt process were used, would be assigned an **NAIC 1** Designation and **NAIC 1.D~~A~~ Designation Category** regardless of the insurer's book/adjusted carrying value.

NOTE: Please refer to the detailed instructions provided in SSAP No. 43R.

NAIC Designation Determined by Modeled Price Ranges	Mapped NAIC Designation Category
1	1.D
2	2.B
3	3.B
4	4.B
5	5.B
6	6

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Michael Monahan
Senior Director, Accounting Policy
(202) 624-2324 t
mikemonahan@acli.com

December 17, 2020

Mr. Kevin Fry, Chair
Ms. Carrie Mears, Co-Chair
NAIC Valuation of Securities Task Force
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: 2020 Modeled Securities Mapping Process and CMBS Model Results

Dear Mr. Fry and Ms. Mears:

ACLI appreciates the opportunity to share our additional views with you on this important matter.

What are the Issues:

1. The Purposes & Procedures Manual guidance for mapping financially modeled securities showing zero expected losses ("zero loss securities") has been updated to require a two-step evaluation introducing a previously undisclosed austerity that only AAA rated securities may be considered for automatic mapping to the highest NAIC Designation Category; causing many of zero loss securities to now be mapped to NAIC 2-4 designations and imposing unanticipated and substantial operational strain on filing insurance companies.

2. Modeling results in CMBS appear to be disconnected from intrinsic credit fundamentals, creating large increases in securities showing some loss in at least the most severe modeled scenarios and precipitating incredible migration out of the zero loss security classification;

again causing many previously zero loss, high quality, investment grade securities to be downgraded to NAIC 2-5 designations.

3. The combination of the two issues above has created a distorted representation of risk and artificial RBC strain at a time when the insurance industry is already enduring real stress and regulator attention is best directed towards managing real risks. This has also created a large and highly visible wave of non-economically induced sales of high-quality bonds by insurance companies introducing pressures and distortions to the systemically significant CMBS market.

Our Ask:

We agree that further discussion is merited as to the efficacy of the NAIC Solvency Framework for capturing risks to the mortgage backed securities sector, including new dynamics resulting from the global pandemic; however allowing these outsized RBC severities to stand for the year end 2020 filings would do significantly more harm than good. We request that the Valuation of Securities Task Force ("VOSTF") consider immediate implementation of guidance to assuage these distorted and unnecessary strains for the 2020 filings.

1. VOSTF immediately adopt the editorial change proposed by the NAIC IAO Staff for the 12/31/20 filings that zero-loss securities that would be equivalent to any NAIC 1 Designation Category if the filing exempt process were used be mapped to an NAIC 1.D Designation Category. This is easily implementable with the simple replacement of a few words in section 4, paragraph 27 of the amended P&P manual as highlighted later in this document.

2. VOSTF immediately provide temporary policy directive instructing that NAIC IAO Staff retain the "zero loss" classification and indicator for any securities that were modeled zero-loss in 2019 and remain rated AAA-A- (NAIC 1 equivalent) by NAIC approved credit rating providers as of 12/31/20 in the financial modeling output files provided to insurance companies for year-end 2020. By applying the rating condition recommended, VOSTF would ensure that only securities that remain of high credit quality after accounting for the effects of the pandemic would qualify for this temporary treatment.

New Mapping Process:

- *Issue description*
    - Existing process thru 2019 was that zero-loss bonds were automatically mapped to NAIC 1.
    - New process for 2020 requires that zero-loss bonds be bifurcated: AAA-rated bonds are mapped to NAIC 1-A, and non-AAA rated bonds are mapped based on breakpoints in the same way that non-zero-loss bonds are mapped.

- *Why is that a problem*
  - This new process was not openly discussed with industry - in fact, industry became widely aware of it only in mid to late November. Industry's impression from the original discussion on the topic with SVO/SSG was that all zero-loss bonds will be mapped to NAIC 1-A, which seemed the reasonable approach in a modeled securities framework.
  - Operationally, vendors are not equipped to process this bifurcation, and this will create an enormous burden on companies that will have to rely on manual, error-prone processes in order to comply, which will create serious internal control issues for companies.
  - More importantly, this is causing that a significant portion of formerly NAIC 1 securities migrate to NAIC 2-4 categories this year. Original discussion at VOSTF was that the NAIC Designation Category mapping guidance for 2020 filings was intended as purely administrative instruction and would not have any RBC impacts. Further, these are some of the highest-quality securities in insurers' portfolios, and in many cases will receive a worse RBC treatment than lower quality BBB and even BB-rated bonds, introducing the wrong incentives for insurance companies.

  - For insurance companies this would be akin to changing the rules of the game after the game started. Bonds that were purchased prior to this new process with the expectation of receiving an RBC charge consistent with the risks will now receive an unexpectedly punitive RBC.

- *Proposed solution*
  - Have all zero-loss bonds mapped to NAIC 1-D. This is consistent with the existing process, mitigates operational risks, and will be appropriate in a modeled securities framework without favorably or adversely impacting RBC in 2020.
  - This is easily implementable with the simple striking of a few words in section 4, paragraph 27 of the amended P&P manual as highlighted in red below:

    The NAIC Designation and NAIC Designation Category for a given modeled RMBS or CMBS CUSIP owned by a given insurance company depends on the insurer's book/adjusted carrying value of each RMBS or CMBS, whether that carrying value, in accordance with SSAP No. 43R—Loan-Backed and Structured Securities, paragraphs 25 through 26a, is the amortized cost or fair value, and where the book/adjusted carrying value matches the price ranges provided in the model output for each NAIC Designation and the mapped NAIC Designation Category, reflected in the table below, to be used for reporting an NAIC Designation Category until new Risk Based Capital factors are adopted for each NAIC Designation Category and new prices ranges developed; except that an RMBS or CMBS tranche that has no expected loss under any of the selected modeling scenarios and that would be equivalent to an NAIC 1 Designation ~~and NAIC 1.A Designation Category~~ if the filing exempt process were used, *would be assigned an NAIC 1 Designation and NAIC 1.D~~A~~ Designation Category regardless of the insurer's book/adjusted carrying value.*

<u>CMBS modeling results:</u>

- *Issue description*
  - The new modeling results for CMBS imply losses to commercial mortgages that are disproportionately higher than what market participants may conservatively expect after accounting for the effects of the pandemic. We speculate this may be attributable to changes in the vendor model, but don't have enough transparency to fully ascertain.
  - One critical impact of these new modeling results is that there has been substantial migration out of the category of zero loss securities, as model austerities, even if only in one of the more extreme scenarios with lower relative assigned weighting, can technically result in at least some (very small) modeled losses on even very high quality securities – meaning that the entire security is no longer considered a zero loss security and must be subjected to the "breakpoint" mapping process.
  - These conditions, combined with the fact that most CMBS is a long duration, fixed rate product in a declining rate environment, meaning higher quality CMBS are naturally priced at a premium, have caused a large portion of high-quality securities to now receive a punitive RBC due to the breakpoint mapping process.

- *Why is this a problem*
  - The RBC treatment for many bonds that remain highly rated will now be orders of magnitude higher than what they were last year, without a proportionate change in their risk profile. For example, over 50% of non-AAA bonds that an industry participant holds and received an NAIC 1 treatment last year, this year will receive NAIC 2-4 designations (mostly NAIC 3). Nearly 100% of these bonds remain rated AA-A but will receive a worse RBC than many BBB and BB rated bonds.
  - There's been a wave of sales by insurance companies – broker-dealers estimate around $2B over the last 2-3 weeks as a result of this shift in modeling results. Insurers are shedding high-quality assets with attractive cash flow profiles, and this is benefiting market participants like asset managers that are not subject to these same rules.
  - Given the relevance of insurance companies in the CMBS market, we're already seeing a decrease in demand for certain CMBS bonds that may get caught in this new modeling trap. This is likely to reduce the liquidity available for these bonds - many of which are still owned by insurance companies.
  - Timing of this issue is troublesome, when regulators and policymakers are trying to ensure that there are no disruptions to the funding markets that may exacerbate the economic fallout of the pandemic. Hastily applying the new results this year is likely to cause significant negative unintended consequences for industry participants and the overall CMBS market.

- *Proposed solution*
    - Given the tight timing to prevent serious issues with 2020 RBC, we recommend that for this year any bonds that were modeled zero-loss in 2019 and that remain rated AAA-A in 2020 the SSG overrides the zero-loss indicator to Y this year and have them flow through the normal mapping process.

We also suggest the VOSTF reconsider existing standards for ensuring they are presented with the objective, complete and transparent information that will enable VOSTF members to execute the prudential regulation that they have been appointed to oversee and that only their unique experience, savvy and expertise can satisfy.

- Provide projected cumulative pool losses for each scenario on each modeled bond. This would allow for a much more informed dialogue with industry on an ongoing basis.

- In addition to projected property value changes, provide annual updates on any changes to BlackRock's commercial real estate assumptions under each scenario.

- Establish a formal comment period and approval process once the details outlined above are publicly released and allow enough time before year-end for any required adjustments to be adopted.

We stand at the ready to engage with the VOSTF in earnest and thorough examination of the underlying issues during 2021, so that a more "real-risk" calibrated methodology can be installed prior to the materialization of sectoral shifts (if any) as the longer term impacts to our economy become more distinct and definite.

Sincerely,

MMonahan

Mike Monahan
Senior Director, Accounting Policy

cc: Charles Therriault, Director-Securities Valuation Office
Eric Kolchinsky, Director-Structured Securities Group