Valuation of Securities (E) Task Force
Virtual Meeting (in lieu of meeting at the 2021 Spring National Meeting)
March 22, 2021

The Valuation of Securities (E) Task Force met March 23, 2021. The following Task Force members participated: Dana Popish Severinghaus, 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 (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Carolyn Morgan and Ray Spudeck (FL); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary D. Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak (MD); Chlorinda Lindley-Myers represented by Debbie Doggett (MO); Bruce R. Ramge represented by Lindsay Crawford (NE); Marlene Caride represented by Nakia Reid and John Sirovetz (NJ); Linda A. Lacewell represented by Jim Everett (NY); Doug Slape represented by Amy Garcia (TX); Jonathan T. Pike represented by Jake Garn (UT); Mike Kreidler represented by John Jacobson (WA); and Mark Afable represented by Randy Milquet (WI). Also participating was: Dale Bruggeman (OH).

1. Adopted its Feb. 18, 2021; Dec. 18, 2020; and 2020 Fall National Meeting Minutes

The Task Force met Feb. 18, 2021; Dec. 18, 2020; and Nov. 18, 2020. During its Feb. 18, 2021, meeting, the Task Force took the following action: 1) received a proposed amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to update the financial modeling instructions for residential mortgage-based securities (RMBS)/commercial mortgage-based securities (CMBS); 2) discussed comments received and adopted a proposed amendment to the P&P Manual to require the filing of private rating letter rationale reports; 3) received a referral from the Statutory Accounting Principles (E) Working Group on nonconforming credit tenant loans (CTLs); 4) received a proposed amendment to the P&P Manual to update the list of NAIC credit rating providers (CRPs) to reflect nationally recognized statistical rating organization (NRSRO) changes; and 5) discussed U.S. Securities and Exchange Commission (SEC) Rule 18f-4 under the federal Investment Company Act of 1940 related to the use of derivatives by registered investment companies. During its Dec. 18, 2020, meeting, the Task Force took the following action: 1) exposed an updated amendment to the P&P Manual to include instructions for financially modeled RMBS/CMBS to map NAIC designation categories for a three-day public comment period ending Dec. 22, 2020; and 2) discussed financially modeled RMBS/CMBS price breakpoints and other issues surrounding securities that have a zero-loss in 2020.

Mr. Thomas made a motion, seconded by Ms. Clements, to adopt the Task Force’s Feb. 18, 2021 (Attachment One); Dec. 18, 2020 (Attachment Two); and 2020 Fall National Meeting minutes (see NAIC Proceedings – Fall 2020, Valuation of Securities (E) Task Force). The motion passed unanimously.

2. Adopted an Amendment to the P&P Manual to Update the Financial Modeling Instructions for RMBS/CMBS Securities

Mr. Fry said at the end of last year, there were some unusual results through the financial modeling process due to the economic scenarios. It produced more securities with losses that were previously zero loss securities that now needed to use the price breakpoint methodology. Coupled with lower interest rates, these securities also traded at a premium. The Task Force did some work last year to temporarily fix the issues with the price breakpoint methodology for year-end 2020, and it was agreed that a longer-term fix was necessary. In front of the Task Force now is that fix to the price breakpoint methodology for securities prior to 2013 and for securities after 2013—move away from price breakpoints and use more of a single-designation process.

Eric Kolchinsky (NAIC) said the proposed amendment P&P Manual is to move to two types of information. For legacy securities, those prior to 2013, the Task Force will continue to provide breakpoints for more post-crisis securities. The process of calculating the expected losses would be the same, except now, instead of converting the intrinsic price into breakpoints, it would be converted into a designation for non-legacy securities—those after 2013. The Structured Securities Group (SSG) believes it to be a good approach to minimize the convexity experienced in the zero loss securities and standardize reporting. The SSG would like to implement this for year-end but realizes that there may be some technical issues for the NAIC and application vendors. Therefore, it is open to a potential 2022 implementation.

Mr. Fry said the Task Force will be in a better position later this year to know whether it can implement by year-end 2021 or if a 2022 implementation is needed, which will give more than enough time.
Mike Monahan (American Council of Life Insurers—ACLI) said the ACLI would suggest setting a 2021 implementation date. The Task Force will know in a couple of months whether that is reachable by the vendors and by the SSG staff, and it can revisit the issue, if needed.

Francisco Paez (MetLife) said the ACLI is going to be focused on the implementation and making sure that this is done in an orderly way. The proposal is something that is supported. The proposal moving away from the breakpoints, viewed in conjunction with the anticipated change of through the cycle of modeling for CMBS, will avoid some of the distortions to risk-based capital (RBC) experienced for modeled securities at the end of last year. It accomplishes the stated purpose, and it is a positive step to having a longer-term solution for modeled securities. He said there are two points that the ACLI and the National American Securities Valuation Association (NASVA) want to raise. First, the price breakpoints concept, as a concept, is a sound one, and it aligns the incentives in a way that is prudent. Mr. Paez encouraged that this be an open dialogue in the future and evaluate if there are ways to incorporate that concept in a way that deals with some of the distortions experienced last year. There are a few options that could be studied. Realizing that this is a longer-term type of project, he said he wants to see if there are other more workable solutions with respect to price points, given the soundness of the concept and the history of how those breakpoints really played such a key role in helping an orderly navigation during the great financial crisis for insurance companies. The second point is in regard to transparency. Acknowledging all the extensive work that the SSG has undertaken on this front, which is appreciated, he asked to continue this dialogue and to try to identify additional disclosures that may be possible, both in terms of the assumptions and in terms of the results at a more granular level than today so that insurance companies can better understand the drivers of their RBC results at the end of the day. He said he would like insurers to get some discussion on the frequency of these disclosures to have a better sense of the direction of RBC ahead of year-end rather than waiting towards the end of the year.

Mr. Fry said the Task Force always looks for procedures and improvement. He said there will be more time in the future to look at the items mentioned, but for now, these are the right steps to address the problems and get rid of some of the results that are not logical. Mr. Fry asked Charles A. Therriault (NAIC) if the amendment were adopted, is there a part about when it is implemented or is that was something that the Task Force can set along with the motion to adopt. Mr. Therriault said the Task Force can adopt it with a year-end effective date. He said if later this year there is a technology implementation problem, that effective date can be changed to 2022. Mr. Kolchinsky said the SSG staff will work on transparency and, if the Task Force directs it to do so, work on another methodology.

Mr. Everett asked how the cutoff date for the changeover was chosen. Mr. Kolchinsky said the cutoff date is already in the P&P Manual regarding legacy securities for the purposes of re-REMIC (real estate mortgage investment conduit) securities. He said it seemed as good as any date, and it avoids having several legacy dates.

Tracey Lindsey (NASVA) asked, from a vendor’s perspective, when the cutoff date would be to make that decision should there be difficulties with technology. Mr. Kolchinsky said the SSG was committed to working with industry, their vendors and NAIC technology. There are some possible changes on the technology side. If together the opinion is that this is doable, it will move on, and if is not doable, it will come back as soon as possible to the Task Force for their advice and consent.

Mr. Thomas made a motion, seconded by Mr. Kozak, to adopt the amendment to the P&P Manual to update the financial modeling instructions for RMBS/CMBS securities. The motion passed unanimously.

3. Discussed Comments Received for an Updated Proposed Amendment to the P&P Manual to Require the Filing of Private Rating Letter Rationale Reports

Mr. Fry said the next item on the agenda is to discuss comments received on a proposed amendment to require the filing of private rating letter rationale reports. The Securities Valuation Office (SVO) worked with the ACLI, NASVA and the Private Placement Investors Association (PPIA) to update the amendment and resolve some of the operational issues that were raised during the Task Force’s Feb. 18 meeting. Mr. Fry asked Mr. Therriault to review the updated amendment.

Mr. Therriault said this proposed amendment would require the rating rationale report to be filed with the SVO for privately rated securities. The rating rationale report should provide a more in-depth analysis of the transaction structure, the methodology used to arrive at the private rating, and, as appropriate, a 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 will be able to better understand the security.
During the Task Force’s Feb. 18 meeting, interested parties raised several issues. The SVO staff held a follow-up meeting with the ACLI, NASVA and the PPiA on Feb. 22 to discuss the issues and revise the amendment based on that discussion. They also met March 4, March 18 and March 19 to review the changes and receive further feedback. The updated amendment reflects many, but not all, of the changes. Summarizing the changes that are in in the revised amendment, Attachment Five in the package, the first change was to the transition language in paragraph 11 to permit an option to companies that cannot provide the ratings rationale due to confidentiality or contractual reasons. The next issue, which was an extended discussion during the the Task Force’s Feb. 18 meeting, related to the disclosure as to why something was ineligible. An update was made to paragraph 21 for a new brief disclosure visible to all filers in VISION for two specific situations: 1) the security type is ineligible for filing exemption (FE) according to the P&P Manual list of “Specific Populations of Securities Not Eligible for Filing Exemption”; or 2) the security is of a type outside the scope of Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds, SSAP No. 32R—Preferred Stock or SSAP No. 43R—Loan Backed and Structured Securities, which would also make it ineligible for FE. This requires a VISION technology change, and it has already been added to the development queue. The last update was to paragraph 22 to provide a reporting option if the private rating rationale report cannot be provided for reasons other than confidentiality or contractual limitations after Jan. 1, 2022.

Another issue raised during the Task Force’s Feb. 18 meeting but is not in the updated amendment relates to the required content of the rating rationale report. Rating agencies are in the business of publishing credit analysis opinions and should be familiar with what they typically publish for a specific asset type. The SVO is expecting something comparable to their public reports. Rating agencies often mention that their private ratings are equivalent to their public ratings in terms of the analysis performed. The SVO is looking for something comparable to the publically rated securities. It was mentioned possibly using the SVO’s regulatory treatment analysis service (RTAS) letter as a benchmark. That is not a good comparison because it is just a summary of what the reporting treatment would be for the security, but it does not go into an in-depth analysis of the credit or methodology. There are few changes that still need to be made to the amendment and worked through with the ACLI, NASVA and the PPiA, specifically to the transition period and confidentiality provisions. With the Task Force’s permission, the SVO would like to continue working with industry and expose a clean version of the amendment with those revisions and expose it for a short public comment period.

Sasha Kamper (PPiA) said there have been multiple meetings to discuss this amendment and agreed in concept during March 19’s meeting to a workable solution. There are a few more changes needed to the amendment that will lay out some of those details.

Mr. Fry directed the SVO to continue working with industry on the amendment to require the filing of private rating letter rationale reports with the SVO and expose a clean version of the amendment, when it is ready, for a 30-day public comment period.

4. **Adopted an Amendment to the P&P Manual to Update the List of NAIC CRPs to Reflect NRSRO Changes**

Mr. Fry said this agenda item is to discuss comments received and consider for adoption a proposed amendment to update the list of CRPs to reflect NRSRO changes. The proposed amendment reflects the merger of Morningstar and DBRS, and the name update for the Kroll Bond Rating Agency LLC.

Ms. Kamper asked for clarification. She asked if this amendment is to recognize the merger of DBRS and Morningstar or the Kroll Bond Rating Agency name change. Mr. Therriault said on the original exposure, there was a different name for Kroll Bond Rating Agency, which was what was reflected on SEC’s Office of Credit Rating (OCR) website. The amendment was revised to correct Kroll’s name to reflect what is on their Form NRSRO. The rest of the amendment relates to the DBRS/Morningstar merger and a few other minor CRP name changes. Kroll was only highlighted because it was a change from the last time this amendment was discussed by the Task Force.

Mr. Thomas made a motion, seconded by Ms. Mears, to adopt the amendment to the P&P Manual to update the list of NAIC CRPs to reflect NRSRO changes. The motion passed unanimously.

5. **Received a Request from the ACLI to Study the National Financial Presentation Standard for Spanish GAAP.**

Mr. Fry said the next agenda item is to receive a request from the ACLI to study the national financial presentation standard for Spanish generally accepted accounting principles (GAAP). The ACLI submitted a letter dated March 1 (Attachment Seven) initiating this formal request for a review by the SVO as required in Part Two of the P&P Manual. In discussions with the SVO staff, the ACLI letter satisfies the pre-condition necessary to conduct the requested study, and the SVO is ready to begin.
Mr. Monahan said that two large multinational companies have asked to have the SVO study Spain as a national financial reporting standard. The SVO has a great process in place for such a review. The ACLI is close to signing the contract with an accounting firm to assist with the study, and it just needed the Task Force’s approval to undertake the study. The accounting partners will not be flying to the U.S. to meet at the SVO office and instead will be meeting virtually via Zoom or RingCentral.

Mr. Fry said this is informational only; no action is required by the Task Force at this time. When the SVO concludes the study, the SVO will report back to the Task Force with their findings, recommendation and, if appropriate, a possible amendment.

6. Discussed and Received a Proposed Amendment to the P&P Manual to Clarify Guidance for Fund Leverage

Mr. Fry said the next agenda item is to discuss and receive a proposed amendment to the P&P Manual to clarify guidance for fund leverage. Mr. Fry asked Marc Perlman (NAIC) to provide a summary.

Mr. Perlman said the P&P Manual currently grants the SVO discretion when determining whether a fund’s use of derivatives is consistent with a fixed income like security, meaning it will generate predictable and periodic cash flows and is, therefore, eligible for an NAIC designation. Recognizing that this discretion regarding the use of derivatives by funds can lead to a possible lack of predictability when a fund is submitted to the SVO for potential inclusion on its fund lists, some members of the Task Force requested the SVO propose a P&P Manual amendment that would create a more predictable bright line test.

As explained during the Task Force’s Feb. 18 meeting, the SEC adopted a final version of Rule 18f-4 last year, which allows funds to enter into derivative transactions, notwithstanding the federal Investment Company Act’s restrictions of them, so long as funds meet certain conditions. The SVO focuses most closely on the exception to these requirements for limited users of derivatives, meaning funds that limit their exposure to derivatives with potential risk of future payment or loss (call it downside risk) to 10% or less of net assets, exclusive of certain derivatives used to hedge certain currency and interest rate risks. The SEC recognized the risk that derivative transactions pose to funds because they involve leverage or the potential for leverage, which can magnify gains and losses compared to the fund’s investment, while also obligating the fund to make a payment or deliver assets to a counterparty under specified future conditions. The SVO contends that such leverage is inconsistent with the predictable and periodic standard in the P&P Manual. As such, the SVOs recommend using Rule 18f-4’s limited user standards as a kind of guidepost for creating the requested bright line test in the P&P Manual.

Specifically, the SVO is proposing two new tests. Test No. 1: For funds on the SVO-identified Bond ETF List, the SVO-identified Preferred Stock ETF List and the NAIC List of Schedule BA Non-Registered Private Funds with Underlying Assets Having Characteristics of Bonds or Preferred Stock (each of which is granted bond treatment on their respective reporting schedules), the SVO proposes a similar, but not identical, threshold to the limited user exception in Rule 18f-4, whereby the gross notional amount of derivatives that impose no future payment or margin posting obligation on the fund (meaning there is no future “downside” risk), cannot exceed 10% of the net asset value of the fund, except for (and these are the exclusions from the 10% calculation) derivatives that are either used by funds to create more bond-like cash flows or that are common for maintenance of fund portfolios. These acceptable exemptions would include: 1) certain currency and interest rate hedges on fixed-income or preferred stock in the fund portfolio; 2) certain futures or forwards on fixed-income or preferred stock to be held in the fund’s portfolio and for which money for the future purchase have been set aside; 3) reserve-repurchase agreements associated with specific fixed income or preferred stock investments held by the fund; and 4) non-margin borrowing for purposes other than investment. While this first test, like the SEC’s, caps derivatives at 10% of net asset value (NAV), the SEC only caps derivatives with future payment or downside risk. The SVO proposes not permitting any derivatives with future payment or downside risk, other than the exempt derivatives just listed, and capping derivatives with only upside potential at 10%. The reason for capping derivatives with only potential gain for the fund is that they are still speculative and, therefore, do not meet the periodic and predictable standard.

Test No. 2: Funds on the NAIC Fixed Income-Like SEC Registered Funds List are in scope of SSAP No. 30R—Unaffiliated Common Stock and reported on Schedule D, Part 2, Section 2. Based on such reporting, if the Task Force deems it appropriate, NAIC designations assigned to those funds could be permitted to include assessments of risk other than credit risk, including market and liquidity risk—both risks introduced by derivatives. This also addresses requests by several Task Force members that a wider range of funds be eligible to receive an NAIC designation. Therefore, if the Task Force thinks it appropriate, these funds could be permitted a larger derivative threshold of up to 20% of the NAV of the fund, but, unlike the first test, with no exempt derivatives. This threshold would also prevent violation of the P&P Manual fund methodology’s predominantly hold requirement that a fund will hold at least 80% of its assets in bonds or preferred stock, depending on the type of fund. For both tests, the SVO recommends incorporating an assessment of counterparty risk into its credit risk assessment. It should also be noted that these increased thresholds for derivatives might not be acceptable under certain state laws. For example, a bill under
consideration in New York would cap funds’ non-reserve investments at 10%, meaning derivatives would likely be capped at that amount.

The SVO thinks the two tests would achieve the goal of providing greater clarity and predictability to fund sponsors and investors regarding the SVO’s fund reviews while still maintaining the P&P Manual’s predictable and periodic standard. Though, it should be noted, the two tests would be more generous than the current approach in that some speculative derivatives would be permitted. While the second test may permit additional funds on the NAIC Fixed Income-Like SEC Registered Funds List, the inconsistent, and possibly punitive, RBC treatment of funds on this list versus other funds with NAIC designations is not something that the Task Force can address directly. For example, exchange-traded funds (ETFs) on the NAIC Fixed Income-Like SEC Registered Funds List would have a different RBC treatment from ETFs on the SVO Identified Bond or Preferred Stock ETF Lists. For this reason, the Task Force might consider a referral to the Capital Adequacy (E) Task Force and the Financial Condition (E) Committee requesting the assignment of bond RBC factors for all funds whose credit risk has been assessed by the SVO and assigned an NAIC designation pursuant to the Task Force’s policies, including the NAIC Fixed Income-Like SEC Registered Funds List. This would be similar to the referral the Task Force made to the Capital Adequacy (E) Task Force in 2018. Equalizing the RBC treatment for assets with similar credit risk, represented by the SVO assigned NAIC designation, would provide a consistent and uniform NAIC process consistent with regulatory needs for funds. With these amendments the Task Force would be redefining what goes on the NAIC fund lists and, therefore, redefining the fund asset. Therefore, it would be appropriate to refer the proposed amendment to the Statutory Accounting Principles (E) Working Group.

Additionally, the SVO is proposing to add an assessment of a fund’s management to the fund methodology. Under this assessment, the SVO would have the ability to consider a fund’s management and organization, including: 1) key-man risk; 2) its risk management and compliance infrastructure; 3) its credit management standards and credit research capabilities; and 4) its derivatives risk management program for funds required to have one under Rule 18f-4. Based on the management assessment, the SVO would be able to notch down from its credit risk assessment or choose not to assign an NAIC designation.

Mr. Everett asked how many states that permit bond ETFs for primary capital surplus may be affected. Mr. Therriault said given the definition change, putting a 10% speculative threshold for those that are on the bond or preferred stock ETF lists, the change is not expected to have any impact for those lists. The threshold is generally consistent with the ETF list today. The other test is a little more generous for the SEC registered fund list, which is reported on the common stock schedule.

Mr. Everett asked if it would it be the Statutory Accounting Principles (E) Working Group or this Task Force that would be looking at standards for the management assessment. Mr. Perlman said the SVO would do that. Mr. Fry said this would be just another thing the SVO assesses in the whole package of things assessed with funds.

Mr. Fry directed the SVO to expose this amendment to the P&P Manual to clarify Guidance for Fund Leverage for a 45-day public comment period ending May 6, 2021, and make a referral to the Statutory Accounting Principles (E) Working Group requesting their approval of the proposed changes to these definitions.

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

Mr. Fry said the next agenda item is to hear a report on projects before the Statutory Accounting Principles (E) Working Group. Mr. Fry asked Julie Gann (NAIC) to provide that report.

Ms. Gann said a there were a few things to highlight from the Statutory Accounting Principles (E) Working Group’s March 15 meeting. She said that while the Working Group adopted several items and exposed several items, this update will only highlight four adoptions and two exposures. For the adoptions, the Working Group:

- Incorporated revisions to clarify that publicly traded preferred stock warrants should be treated as preferred stock. This is something similar to what was already in place for publicly traded common stock warrants to be treated as
commonly anticipated to occur within SSAP No. 26R and SSAP No. 43R; future discussions will determine the best approach.

She said it is also anticipated the investments that no longer qualify for D-1 will move to Schedule BA. It is anticipated that

securities. It establishes definitions and criteria of what should be captured within both classifications. Once the definition has

been publicly discussed, it is anticipated that SSAP revisions will occur to incorporate the definitional concepts. Those are

in accordance with the Working Group’s May 20 meeting.

By identifying what should be captured as a bond first, the project

will still be in scope of SSAP No. 43R, and those revisions align the financial model guidance to match the P&P Manual.

Clarified that perpetual bonds with an effective call option shall be amortized, using the yield to worst method with all other perpetual bonds that do not have an effective call option to be reported at fair value.

Incorporated guidance and new disclosures to ensure that all related parties, including those with over a 10% ownership that may have disclaimed affiliation, are still reported as related parties in the financial statements. There is also a new schedule Y Part 3 to detail age-related parties.

Regarding exposures, Ms. Gann said comments are due April 30. She reiterated that while the Working Group exposed a long list of items, she will highlight only two of them. The Working Group exposed:

- Exposed revisions to data capture and expanded disclosures in SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities to make it easier to identify when an insurer has transferred an asset and maintains continuing involvement, such as with a self-securitization. There are existing disclosures in SSAP No. 103R, but they are currently in the narrative. It is not possible to aggregate and assess those transactions or to see problems. That is one of the main goals of this new disclosure.

- Exposed a proposed interpretation to clarify that cryptocurrency such as Bitcoin does not meet the definition of cash and is a non-admitted asset under statutory accounting. With that exposure, the Working Group requested for industry to provide information regarding the extent that insurers hold cryptocurrency.

Ms. Gann said the Working Group plans to meet May 20 to hear comments on those exposed items and take action, particularly with regards to those that have blanks-related revisions.

Ms. Gann said the Working Group also discussed the SSAP No. 43R project. She said there has been a small group of industry that has been meeting with Iowa and NAIC staff weekly since Fall 2020. The initiative is to draft a definition of what should be captured as a bond on Schedule D-1. The project was undertaken as an initial first step in the 43R substantive project as it was identified that some investments that caused regulator concern are not necessarily limited to SSAP No. 43R, and they could have been either captured or reclassified to SSAP No. 26R. By identifying what should be captured as a bond first, the project removes the concern of potential reclassification for those investments. The small group has made significant progress in drafting this definition, and it is anticipated that this preliminary definition will be publicly exposed by the end of May, possibly in accordance with the Working Group’s May 20 meeting.

Ms. Gann added that the draft definition currently focuses on investments that reflect issuer credit obligations and asset backed securities. It establishes definitions and criteria of what should be captured within both classifications. Once the definition has been publicly discussed, it is anticipated that SSAP revisions will occur to incorporate the definitional concepts. Those are currently anticipated to occur within SSAP No. 26R and SSAP No. 43R; future discussions will determine the best approach. She said it is also anticipated the investments that no longer qualify for D-1 will move to Schedule BA. It is anticipated that the discussions will include accounting and reporting concepts for those investments and that referrals will be sent to the Capital Adequacy (E) Task Force to determine RBC.

Ms. Gann said the Working Group has received questions regarding CTLs and how the current project for D-1 assessment will affect that specific investment. These questions also asked about the purpose of the prior referral that the Working Group sent to the Task Force. To provide some clarity on this situation, there are two workstreams: 1) the Statutory Accounting Principles (E) Working Group project on the D-1 bond definition; and 2) the Valuation of Securities (E) Task Force project to revisit the structural requirements that are in the P&P Manual. It is anticipated that these will ultimately converge. However, with the specific discussion on CTLs last fall, specific focus is being given to these investments concurrently with the bond project. The determination of whether an investment qualifies within an SSAP and a particular reporting schedule is a decision of the Statutory Accounting Principles (E) Working Group. However, in certain cases, such as with CTLs, a structural analysis by the SVO under the requirements of the P&P Manual is necessary to satisfy this requirement. The original determination of residual risk allowing the reporting on Schedule D was made by the Invested Asset (E) Working Group, which has since been disbanded. Since that residual risk threshold is currently housed in the P&P Manual and information on the CTLs filed with the NAIC is reviewed by the Task Force, the prior referral intends to solicit the expertise of the Task Force and the NAIC SVO staff from their knowledge of those filed CTLs, which includes an assessment of whether that residual risk threshold should be revised.

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Both the structural parameters and the ultimate role of the structural analysis in relation to the principles developed through the Statutory Accounting Principles (E) Working Group bond project will require coordination between both groups as these projects progress. Statutory Accounting Principles (E) Working Group staff will continue to work closely with the Valuation of Securities (E) Task Force staff regarding those investments.

8. **Heard an Update on CTLs**

Mr. Fry said he would cover the CTL update next. The Statutory Accounting Principles (E) Working Group recently did an interpretation on CTLs that are called nonconforming CTLs and have a rating agency rating. These could be reported on Schedule D for year-end 2020 as long as they were filed with the SVO before Feb. 15, 2021. These securities were also required to be listed in the notes of the financial statement for year-end 2020. It was agreed that if the SVO assigns a designation to these securities, they would be allowed to be reported on Schedule D through the third quarter of 2021. The reason why the Working Group selected that date was that it was anticipated by then that the SSAP No. 43R project would provide a framework that would address these securities. If that framework has not been provided by that time, it might be possible for an extension of that policy until the SSAP No. 43R project matures. The SVO is committed to applying its methodology for CTLs or any other securities that have a residual risk up to 50%. If that residual risk is over 50%, on a case-by-case basis, the SVO would assess whether there are enough mitigating factors to designate these securities. The SVO is looking at the securities that were filed for last year-end. If there are any new securities in the market, the SVO will look at those it can designate. A designation does not mean that it goes on a specific schedule; that is the Statutory Accounting Principles (E) Working Group’s responsibility. If the SVO designates one of these and Statutory Accounting Principles (E) Working Group decides that it is not eligible for bond treatment on Schedule D, there may still be a Schedule BA home for these with fixed income like RBC, provided the Capital Adequacy (E) Task Force and everyone else signs off on this treatment.

Ms. Belfi said there was a lot of confusion on direction from some of the interested parties and Task Force members. Hopefully, there will be a resolution. Mr. Everett said if this unfreezes the market, then the Task Force is moving in the right direction.

Tom Sargent (Waterway Capital), representing the Lease-Backed Securities Industry Group, asked how Mr. Fry sees this moving forward. He asked, “If there is a CTL with a residual in the neighborhood of 20% to 50%, do we proceed in placing that in front of the SVO to get a designation?” Mr. Fry said it should be filed with the SVO as it has been looking at the ones that came in last at the end of last year, and the SVO will use that same methodology. This is a new area, looking at ones where there is a greater that 5% residual. The SVO is in a position where it is looking at them through 50%, verifying the structure and then looking through to the lessor. The SVO is going to look at those that will need mitigating factors. There is the project before the Statutory Accounting Principles (E) Working Group, and as that framework becomes more mature, everything will come together by the end of the year.

Mr. Sargent asked if they should be submitted as an RTAS. Mr. Therriault said insurers can be submit them to the SVO as a regular filing. The SVO did receive 21 filings that were identified as nonconforming by the Feb. 15 deadline. There were an additional 27 filings that have not been reviewed but were submitted by the deadline. Any direction the SVO receives from the Task Force, including accepting additional residual risk, will be taken into consideration during the SVO’s assessment, but the rest of the CTL criteria would still apply.

Mr. Sargent asked if the definition of “residual risk” was using the original loan balance or the appraised loan to value. Mr. Perlman said it would be the loan balance.

Mr. Bruggeman asked that since the Statutory Accounting Principles (E) Working Group sent over the letter to evaluate the old 5% threshold, is 50% the new standard or is that still ongoing, and is the SVO still evaluating it. Mr. Fry said the SVO can safely go to 50% in this interim period and can look at ones higher, but they will need other mitigating factors. The Task Force will formally change it in the P&P Manual up to the 50% mark once the interim solution becomes permanent. Mr. Bruggeman asked if the 50% is temporary just as the SVO is going through the process for the year-end files and then the Task Force will evaluate whether to make it permanent. Mr. Fry said that is right and probably any new securities so that the market is not frozen. They will still be at the mercy of the Statutory Accounting Principles (E) Working Group ruling and if they do not belong on the bond schedule, they will likely end up with a Schedule BA and will still need to go through the Capital Adequacy (E) Task Force to get RBC certainty.

Mr. KozakMD asked if there was a potential that some of this would go on Schedule B as opposed to Schedule BA. Mr. Fry said that is not definitive off the table. As the SSAP No. 43R project plays out, there will be some things that are in or out. If they are not in scope of SSAP No. 43R, it is possible one could consider those going on Schedule B. Some people may also see them on Schedule BA with a designation for fixed income, but that is only available to life insurers and fraternal insurers.
That would not be available to the property/casualty (P/C) insurers. Ms. Gann said it really depends on the structure of the investment. If it is not a security, then technically it would go on the mortgage loan schedule, which is Schedule B. The ones that are securities are where there may be a gray area, whether they should be SSAP No. 43R or Schedule BA. All of this is expected to be discussed further as part of the bond project.

Mr. Therriault said as the SVO receives filings with increasing amounts of residual exposure, the SVO will need additional documentation on the property because that additional component will now need to be assessed. This will be additional documentation beyond what is currently identified in the P&P Manual now.

9. Received a Report from SVO on Year-End Carry-Over Filings

Mr. Fry said once a year, the SVO gives the Task Force an update on its backlog and how that is looking. Mr. Fry asked Mr. Therriault for a quick update on that.

Mr. Therriault said for 2020, the SVO reviewed 12,696 filings comprised of: 3,092 initial filings; 7,866 annual updates; 1,209 additional issuances; and 529 other filing types. The total filing numbers included 2,027 manually processed private rating letters. For year-end 2020, there were 795 carry-over filings, 351 that received an “IF” for an accepted initial filing and 444 that received a “YE” for an accepted annual update. This was a carry-over rate of 6.3% for 2020, well below the rate of 10% or higher that the SVO considers concerning or reflective of a resource constraint.

As of March 16, there were only 70 remaining carry-over filings, 45 accepted initial filings and 25 accepted annual update filings. The remaining carry-over rate was 0.6% as of that date and has only gotten lower since then. This was an impressive performance by the SVO staff and managers given the significant disruptions introduced by working 100% remotely starting March 10, 2020, along with the team absorbing the new analytical work related to ground lease financing (GLF) transactions. At this time, Mr. Therriault said he is not seeing any SVO analyst resource constraint issues, but there are significant resource limitations with technology support for the office that have affected the SVO’s ability to improve the core systems, VISION, Automated Valuation Service+ (AVS+) and Structured Securities (STS), or fully use the SVO’s investment data. Also, if additional analytical tasks are assigned to the SVO, which the SVO is happy to take on for the Task Force, additional resources may be needed.

Mr. Monahan said a suggestion for the future is to add the report as an attachment, and he thanked and congratulated the SVO for their hard work.

Having no further business, the Valuation of Securities (E) Task Force adjourned.
The Valuation of Securities (E) Task Force met Feb. 18, 2021. The following Task Force members participated: Dana Popish Severinghaus, 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 (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Carolyn Morgan and Ray Spudeck (FL); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary D. Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak (MD); 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); Jonathan T. Pike represented by Jake Garn (UT); Scott A. White represented by Edward Buyalos (VA); Mike Kreidler represented by John Jacobson (WA); and Mark Afable represented by Randy Milquet (WI).

1. Received a Proposed Amendment to the P&P Manual to Update the Financial Modeling Instructions for RMBS/CMBS and Direct IAO Staff to Produce NAIC Designation and NAIC Designation Categories for Non-Legacy Securities

Mr. Fry said the first item on the agenda is to update the Financial Modeling Instructions of the Purpose and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to move away from using price break points for securities issued after Jan. 1, 2013. The Task Force, through the Structured Securities Group (SSG), will still model everything and use break points up to the cutoff date. Any security issued after that cutoff date would use modeling to produce a single NAIC designation that all insurers would use regardless of their carrying value. This amendment was driven by problems experienced last year with the price break point methodology. During the year-end modeling process, there were more non-zero loss securities because of the modeling scenarios, which then subjected those securities to the price break point process. Given the very low interest rate environment, many of these securities trade at a premium. The combination of all these factors caused some illogical results in securities that were more highly rated than the final results going through the break point methodology. The SSG was able to fix this for year-end by changing its criteria for a non-zero loss security. This was a temporary fix; by year-end, there were still some securities with illogical results, but there were less of them than there would have been. The Task Force agreed at that time that it needed to relook at this process, and the Investment Analysis Office (IAO) staff came back with this amendment. Ideally, it would be good to have this for year-end 2021. The proposed amendment may produce a couple of new symbols that would need to work through with Blanks (E) Working Group.

Eric Kolchinsky (NAIC) said the first thing is that the proposal is separating securities into legacy and non-legacy. The legacy date was chosen just to conform what was already used in the past for securities in Part Four of the P&P Manual. The thinking behind it was the same, and it is better not to have multiple dates for this. Legacy securities will continue to receive the price break points. Those are the securities that were affected by the global financial crisis, and they are far more affected by this process. For newer securities, the proposal would map from the intrinsic price, similar to what is done to the Structured Agency Credit Risk (STACR)/Connecticut Avenue Securities (CAS) type securities, which are issuer obligations. What is being proposed is mapping the non-legacy intrinsic price to the five break point levels currently used for the mortgage reference securities, CAS, and STACR, and providing the NAIC designation for those mapped securities. The proposal is attached, and as things develop in terms of broader risk-based capital (RBC) factors, there will be adjustments. A short comment period is recommended for this proposal so that it can be implemented for year-end 2021 and referred to the Blanks (E) Working Group, if need be. NAIC staff have been working with industry participants on the proposal, as this was a fairly known issue.

Michael M. Monahan (American Council of Life Insurers—ACLI) said the ACLI is very supportive of the 30-day exposure, and it committed to getting this done as efficiently and effectively as possible. There was an ACLI call on Feb. 11 to see where ACLI members were, and the ACLI members are solidly in the camp of Mr. Kolchinsky and the Task Force. Another call is scheduled for tomorrow.

Mr. Fry directed IAO staff to expose this amendment to update the financial modeling instructions for residential mortgage-backed securities (RMBS)/commercial mortgage-backed securities (CMBS) to produce NAIC designation and NAIC
designation categories for non-legacy securities for a 30-day public comment period.

2. Discussed Comments Received and Considered for Adoption of a Proposed Amendment to the P&P Manual to Require the Filing of Private Rating Letter Rationale Report

Mr. Fry said the next item is a proposed amendment to require the filing of private rating letter rationale reports along with the private letter ratings. Given industry feedback on this item, it may best to update the amendment and consider it again at the Spring National Meeting. This amendment goes along with the bespoke effort started last year to gain transparency. Getting the rating rationale reports would be a big part of that transparency. Comments were received from industry, and the Securities Valuation Office (SVO) staff has reviewed them.

Charles A. Therriault (NAIC) said this proposal would require the rating rationale report to be filed with the SVO for privately rated securities. The rating rationale report should include a more in-depth analysis of the transaction structure; the methodology used to arrive at the private rating; and, as appropriate, the transaction’s credit, legal and operational risks. With both the private rating letter and the private rating letter rationale report, the SVO will be able to determine whether the private credit rating is an Eligible NAIC Credit Rating Provider (CRP) Rating, meaning the security type is eligible to be reported on Schedule D, and it is appropriate for a nationally recognized statistical rating organization (NRSRO) credit rating to determine the NAIC designation.

A joint comment letter was received from the ACLI, the North American Securities Valuation Association (NASVA), and the Private Placement Investors Association (PPiA). There were several constructive suggestions. The first suggestion relates to the creation of a transition period between when private rating letters were first required for securities issued after Jan. 1, 2018, and the effective date for this new provision, Jan. 1, 2022. SVO staff agree with the recommendations, and the text they proposed to paragraph 11 and 22 (Attachment B-1) in the comment letter, highlighted in blue, provides for a transition period or for a situation where the rating rationale is not submitted.

The joint comment letter also asked for clarification on providing the rating rationale reports for only the initial issuance by the CRP and whether it is required annually. The amendment was structured as an ongoing filing requirement, including any material changes. Many things can happen to an investment after issuance, and the SVO still recommends that this be an ongoing requirement, but that is a decision for the Task Force.

The next recommendation in the comment letter, highlighted in green, introduces a new definition of a security that is ineligible for an NAIC designation. There are extensive definitions already in the P&P Manual devoted to Filing Exemption (FE) eligibility and NAIC designation eligibility. Adding an additional section for only privately rated securities is unnecessary, and it will potentially create confusion and inconsistency in our guidance. The SVO does not recommend including that suggested change. There was also a request for a new appeal process specific to private rating securities. The existing instructions in the P&P Manual already provide for an insurer to request clarifications from an SVO analyst, appeal an SVO opinion, and escalate to the Task Force chair. Given the robust existing instructions to address this issue, the SVO believes there is no reason to create an alternate process. Likewise, the only entities that should be permitted to appeal an SVO opinion are insurers, as NAIC designations are only intended for NAIC members and are not for the issuers of securities. This recommendation had an option for issuers of securities to also appeal SVO decisions, which is not consistent with the rest of the P&P Manual. The SVO recommends that the suggested changes in green not be adopted by the Task Force.

Michael Reis (Northwestern Mutual Life Insurance Company) said he was unable to follow all of what Mr. Therriault said, but he understood that he did not recommend the changes in green. Mr. Reis said industry was not looking for a new appeals process, but they would like to know why a security is being rejected. If it is being rejected because it is not FE per the P&P Manual or because NAIC staff does not believe it is a bond for the Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds or SSAP No. 43R—Loan-Backed and Structured Securities, industry is asking that they be told why a security is rejected.

Mr. Therriault said there are extensive instructions in Part One of the P&P Manual, so if any insurer has a question about a filing, they can ask and the SVO analyst will respond. He encouraged companies to take advantage of that process if there is a question about anything the SVO is doing.
Mr. Reis said if a security is rejected, there should automatically be a disclosure without having to request that information. Mr. Therriault said if there is a concern about our opinion, a filer can submit a quick email to the SVO analyst. Requiring a formal detailed response on every filing would create an extra burden on SVO staff. Linda Phelps (NAIC) said the analysts include a very brief rejection reason, and if anybody wants additional information beyond that, they should reach out to the analyst.

Mr. Reis suggested that the topic be taken offline because there are a number of companies requesting this update, and he would like the opportunity to discuss it further. Tracey Lindsey (NASVA) said filers are looking for transparency. If someone else files a security, it gets rejected for the rest of the holders who do not know what the reason is for the rejection. This could be a dropdown option in VISION to indicate why something was not accepted by the NAIC. Mr. Therriault said it might be worth taking this offline because it does not sound like the procedure in the amendment or an appeal process but more of an enhancement to the VISION system.

Sasha Kamper (PPiA) said Mr. Therriault recommended that the ratings rationale be an ongoing filing requirement as opposed to a one-time filing requirement. The reason industry asked for the one-time requirement is because the output received from the rating agencies is very deal dependent, even by the same rating agency. Some deals may have ongoing rationales that are updated annually. Others may have an in-depth rationale report that is done at time of issue; thereafter, they only get a private rating letter. An update to the rating letter and any comments related to the why might be somewhat cursory from the rating agency and particularly for those deals, especially again issued before 2022. The work product that the borrower gets is a result of a commercial negotiation and a legal agreement between the rating agency and the borrower. Industry may have difficulty getting those borrowers that only paid for a one-time rationale to go back and amend their agreements with the rating agencies to produce rationales every year. If you have the rationale that describes the deal in full, then you can at least understand the nature of the deal and what the rating agency was looking at when they first rated it, then you get updates and the ratings thereafter. Unless there has been a major amendment or structural change to the transaction, that should at least provide the analysts at the NAIC with enough clarity to understand the deal. Industry would not have any problem with the extent that rationales are available. It is really an issue of the fact that sometimes it will not be available and all that was receives was the letter.

Mr. Fry said that can be discussed a little bit more before Mr. Therriault puts out his final version, and if we have two versions to consider, the Task Force can decide on its next call.

Mr. Reis said there is broad agreement for the proposal and moving forward with it. Industry had a call with Mr. Therriault and narrowed the gap to around the edges for some items. Some of the rating agencies have reached out to us and expressed their confusion as to what should be included in our meeting rationale report; they could be 500 pages or five sentences. One thought that they could use the rating rationale that the SVO provides in the Regulatory Treatment Analysis Service (RTAS) Letter, but that probably does not have the level of data that Mr. Therriault is looking for. Industry stands ready to work to make that process as efficient and beneficial as possible.

Ms. Mears said the question for Ms. Camper, just as a follow up to her comments, especially when you are talking about the potential that some of those updates may not include the rationale, is whether that is the main concern or whether it is feasible that some of these private letters are not updated, there is only the initial rating provided and then nothing subsequent to that Mr. Kamper said it is not clear whether the rationales are updated or not. The rules in the P&P Manual make it very clear that for a private ratings letter to be valid and for security to be FE, it has to be reviewed no less than annually. If there is no updated ratings letter to prove that it was at least reviewed, then it cannot be FE and would need to be filed.

Mr. Fry advised that anyone who has any concerns around these issues reach out to Mr. Therriault. Mr. Therriault will rework a new version and expose it.

3. **Received a Referral from the Statutory Accounting Principles (E) Working Group on Non-Conforming CTLs**

Mr. Fry said the next item on the agenda is informational for now. The Task Force has received a referral from the Statutory Accounting Principles (E) Working Group about credit tenant loan (CTL) investments and more specifically about the residual risk threshold. SVO staff are going to put together a memorandum that will address whether, in their opinion, it is appropriate to revisit the 5% residual risk threshold that we are currently operating under for CTLs. Then if applicable, the memorandum will address what would be an appropriate residual risk threshold, if there is one. The Task Force will also be considering
whether other mechanisms or compensating controls could be incorporated as a mitigating factor. SVO staff will be putting together this response, and they will let the Task Force look at that response.

Mr. Everett stated that he is a little confused looking at the memorandum where it says that we are looking at these like their mortgage loans; they are basically securities. If it were a mortgage loan, then the lender would end up with the property at the end of the day; that does not happen here. Mr. Everett asked what the considerations are, because generally when looking at tenant credit quality, the lease obligation, the structure of the transaction, and real estate considerations really come in only when the property goes dark. He also asked what the broader picture is here.

Mr. Therriault said the purpose of the CTL structure, which evolved sometime in the 90s, is that the credit risk should be to a corporate obligor. Some of these transactions have a residual risk, which means the bond continues beyond the lease term so there is a residual threshold, which then has exposure to the property without a lease payment associated with it. When that original decision was made to permit these on Schedule D reporting, that was a requirement both in the P&P Manual and the Accounting Practices & Procedures Manual (AP&P Manual) for guidance to be allowed and recorded on Schedule D. This is a long-standing instruction that the Statutory Accounting Principles (E) Working Group is looking at as part of its project to consider whether the classification of this asset should still be allowed to be reported as a Schedule D bond. The referral is a question coming from the Working Group to SVO staff that reviews these transactions asking if, in its opinion, this threshold is still appropriate and whether there might be anything out there to prevent that kind of residual exposure underlying the asset.

John Garrison (Lease-Backed Securities Working Group) said the Working Group welcomes the referral from the Statutory Accounting Principles (E) Working Group to this Task Force to reconsider the appropriate residual percentages for CTLs; it is a reconsideration that is long overdue. The 5% current threshold that is in the P&P Manual was put in place 27 years ago when CTLs were first introduced. It was originally intended by all parties to be a sort of provisional number that would be reconsidered in several years, as more information on the performance of these securities became available. The number has not changed over the 27 years since it was first introduced, even as the markets continued to evolve and the strong performance of these securities was well documented. Repeated studies have shown that CTLs have the best performance of any insurance company investment asset. As the Task Force considers this referral, there are a couple of factors to consider. First, under the code of federal regulations, a 50% residual balance is the percentage that is already set forth as the allowable standard by the U.S. Securities and Exchange Commission (SEC) for asset-backed and lease-backed securities. This regulation specifically states that securities backed by leases, and that is clearly the case with CTLs, may rely on up to 50% “on the cash proceeds from the disposition of the physical property underlying such leases.” Second, in other asset classes, a residual balance of 50% is generally consistent with an asset quality of AA. Third, the 50% standard that is set forth in the federal regulations is an across-the-board standard, and it includes many leased assets which are depreciating: equipment, rail, cars, airplanes, etc. Leased automobiles are subject to a higher standard, which is 65% for residual. Real estate is widely accepted to be a non-depreciating asset, so it seems nonsensical to us to submit it to a lower standard than it is currently allowed for other lease depreciating assets. Especially in the light of this 50% federal rule, a 5% threshold seems unreasonable and unnecessarily restrictive for insurance companies.

Mr. Garrison continued that, a change, as the Task Force considers this, from the 5% threshold to a standard of 50%, which we recommend, could be accomplished with a simple revision to the P&P Manual. It would resolve once and for all the whole issue of nonconforming CTL deals that were historically filed with rating letters from CRPs, all CTLs would be filed with the SVO, as they currently are. The CTLs are under the manual for an SVO-determined designation, which would create total transparency for the state insurance regulators. Second, it would bring outdated regulations in line with current industry practice. The referenced studies by the American Academy of Actuaries (Academy) document that CTLs are the best performing of any insurance company investment. So far, no evidence has been provided, and our Lease-Backed Securities Working Group is not aware of any deals with larger residual percentages that were submitted with filing letters; and FE have not performed any worse than CTLs with the 5% threshold or resulted in any significant losses, credit issues, or solvency issues for insurance company investors. A revision such as this would unfreeze these markets. Mr. Garrison said he has heard from
many insurance company investors who have shied away from this market and have stated they are reluctantly accepting lower yielding investments rather than dealing with the cloud that is hanging over this market due to the regulatory uncertainty.

Mr. Fry said one interesting feature is the transparency part of that effort. If the threshold was raised these securities would require an SVO designation and would not be eligible for FE. The Task Force would have better control over the policy of these securities than it would with private letter ratings.

4. Received a Proposed Amendment to the P&P Manual to Update the List of NAIC CRPs to Reflect NRSRO Changes

Mr. Fry said agenda item four is to receive a proposed amendment to update the list of any CRPs to reflect recent NRSRO changes. The CRPs, Morningstar, and Dominion Bond Rating Service (DBRS) merged in 2019 to become a single NRSRO. Mr. Fry asked Mr. Therriault to provide an overview of the amendment.

Mr. Therriault said the catalyst for this amendment was the merger of Morningstar and DBRS. Because of that merger, there is now a single set of rating agency symbols. The P&P Manual currently has symbols for both Morningstar and DBRS. With the alignment under the DBRS symbol set, the proposal removes the Morningstar symbol set. In the process of going through the SEC's Office of Credit Ratings (OCR) website, several other minor name changes were identified. It made sense to make all these updates to the P&P Manual to reflect these minor changes. There is a minor inconsistency on the OCR website related to the Kroll Bond Rating Agency (KBRA). It is referred to as the “Kroll Bond Rating Agency Inc.” but its Form NRSRO has “Kroll Bond Rating Agency LLC”; the LLC is the correct title. With the Task Force’s permission, the amendment would be modified for that correction. This is a non-substantive amendment to make some corrections and updates to this section of the P&P Manual.

Mr. Fry directed SVO staff to expose this amendment to update the list of NAIC CRPs to reflect NRSRO changes for a 30-day public comment period.

5. Discussed SEC Rule 18f-4 Under the Investment Company Act of 1940 Related to the Use of Derivatives by Registered Investment Companies

Mr. Fry said there is an update on the regulation of derivatives used by funds. When the Task Force met last July, Marc Perlman (NAIC) provided an update on the SEC’s proposed Rule 18f-4. Last October, the SEC adopted the final rule, a new framework for derivatives used by registered funds. Mr. Fry asked Mr. Perlman to provide an update to the Task Force on the new rule, specifically the parts that the SVO thinks might be pertinent to potential updates to the P&P Manual.

Mr. Perlman said the SEC adopted a final version of Rule 18f-4 in October 2020. The rule will allow funds to enter into derivative transactions, notwithstanding the Investment Company Act of 1940’s restrictions on derivatives, so long as funds meet certain conditions. Much of the final rule is substantially the same as the proposed rule described in July 2020. Funds will need to institute a derivatives risk management program, which would include stress testing, back testing and internal reporting. Funds would need to abide by a limit on fund leverage risk by instituting an outer limit on leverage, which would be based on a value at risk (VaR) calculation. Fund boards will need to approve of a derivative risk manager who will oversee the derivatives risk management program and report to the board. The SVO is focusing most closely on the exception to these requirements for limited users of derivatives, meaning funds that limit their derivative exposure to 10% or less of net assets. The final limited user exception differs from that in the proposal, and for the purposes of calculating the 10% exposure, funds can exclude certain derivative use to hedge currency and interest rate risks.

Pursuant to the P&P Manual, the SVO is required to determine if a fund is fixed income-like, meaning the SVO must determine whether a fund will generate predictable and periodic cash flows in a manner broadly similar to a situation where the holding of bonds or preferred stock of unknown credit quality were held individually. Under this test, the SVO is by extension granted discretion when determining whether funds’ use of derivatives is consistent with a fixed income-like security and is therefore eligible for an NAIC designation. The SVO recognizes that this discretion regarding the use of derivatives by funds can lead to a possible lack of predictability when a fund is submitted to us for potential inclusion on one of the SVO fund lists; therefore, the Task Force may want to consider a possible amendment to the P&P Manual to create a more predictable bright line test. One possible solution for the Task Force to consider would be to use Rule 18f-4 as a kind of guidepost for updated P&P Manual guidance on the use of derivatives by funds by adapting the rules and limited user standards to guide the SVO determination of what is an acceptable use of derivatives by a fund so that the fund payments can be considered fixed income.
For example, a more definitive limitation on the use of derivatives in funds consistent with the limited user exception and the rule could be established whereby the gross notional amount of derivatives cannot exceed 10% of the net asset value of the fund except for currency and interest rate swaps matched to securities in the fund portfolios and reverse repurchase agreements. The SVO believes that such a change would benefit the market by providing greater clarity to fund sponsors and investors while maintaining the limit on the use of leverage by funds. Additionally, the SVO recognizes that based on a 10% test, certain funds may not qualify as fixed income-like and would not be eligible for reporting as bonds on Schedule D, Part One. If the Task Force members believe there is interest by the Capital Adequacy (E) Task Force and RBC working groups, a separate risk assessment process for funds can be proposed, which would not qualify as fixed income-like, but it could be permitted to receive NAIC designations, or modified version thereof, for reporting as common stock and Schedule D, Part 2 Section 2 but with an NAIC designation adjusted to reflect market risk in addition to credit risk, and a separate RBC factor might be necessary for such funds.

Mr. Fry said the SVO will soon produce some sort of an amendment that will be exposed through the Task Force’s normal process. If anyone has any ideas during this drafting phase, their comments will be taken into consideration.

Mr. Fry directed the SVO to prepare a P&P Manual amendment on the use of derivatives by funds for the Task Force to consider.

6. Discussed Other Matters

Mr. Fry said the Task Force is scheduling a call for the Spring National Meeting on March 22, 2021. A number of these items will be discussed on that call.

Mr. Kolchinsky said the NAIC has a policy of periodically re-submitting the vendor contracts. In 2015, the NAIC signed Blackrock to a three-year plus two one-year extension contract that was set to run out in 2020. Given the COVID-19 pandemic, this was pushed out one year, but now the Executive (EX) Committee of the NAIC has asked this request for proposal (RFP) as our usual business practice. The press release for the RFP was just released during this meeting, and it can be found on the front page of the NAIC website for anyone who is interested or curious to see.

Mr. Monahan asked if there is enough time to work through the comments assuming that the comment deadline is March 15, and the Spring National Meeting is the week of March 22. Mr. Kolchinsky said yes, and if there are any technical things, information should keep flowing. While we typically publish two weeks before a meeting, Mr. Therriault asked if the Task Force is fine with some of the materials being posted after that deadline. No concerns were expressed by the Task Force members.

Having no further business, the Valuation of Securities (E) Task Force adjourned.
The Valuation of Securities (E) Task Force met Dec. 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 (CT); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Kathleen A. Birrane represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Shannon Schomoeger (MO); Bruce R. Ramge represented by Lindsay Crawford (NE); Marlene Caride represented by John Sirovetz (NJ); Linda A. Lacewell represented by Jim Everett (NY); Texas represented by Amy Garcia (TX); Tanji J. Northrup represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); and Mark Afable represented by Randy Milquet (WI).

1. Exposed an Updated Amendment to the P&P Manual to Include Instructions for the Financially Modeled RMBS/CMBS Securities to Map NAIC Designations Categories

Mr. Fry said there are two issues to address for the financially modeled NAIC designation for year-end 2020. He said the issues were not the fault of NAIC staff and were largely attributable to the use of price breakpoints. Sometimes there are shortcomings in that approach, and it produces results that do not seem logical. If a security is financially modeled and shows no losses in any of the modeling scenarios that the Securities Valuation Office runs and under the filing exempt (FE) process, it would be an NAIC 1 designation. If it had both of those characteristics, the security is automatically considered an NAIC 1 and does not need to go through the price breakpoint process. In May 2019, because the NAIC is moving towards 20 NAIC designations, at least for informational purposes, the Task Force had to map to the NAIC designations categories. These financially modeled no loss securities were originally going to be mapped to a NAIC 1.D for this year-end but ended up instead being mapping to an NAIC 1.A. As companies got ready to apply the new process, they realized that you would need to be both a zero loss security and be rated “AAA” and, if not, the security would need to go through the breakpoints. This was not the intent of the mapping change, and even though it has been exposed for some time, it should be fixed. In the materials in Attachment A, there is updated language that would fix this unintended consequence and clarify that if an insurer has a financially modeled zero loss security that would also be an NAIC 1 under FE, it would now be mapped to an NAIC 1.D—the middle of the NAIC 1 scale. The Task Force could expose this for a very short time, maybe three days. If positive comments are received, then the Task Force could conduct an e-vote on the amendment to adopt it before year-end.

Mike Monahan (American Council of Life Insurers—ACLI) said the ACLI supports the expedited time frame and appreciates the Task Force’s and NAIC staff’s efforts to fix this issue. He said if the blame lies anywhere, it is on the mechanics of the price break points. He said the ACLI will be fully committed to working with NAIC staff and state insurance regulators in 2021 to solve that problem.

Francisco Paez (MetLife) said the solution that the NAIC staff are proposing here really addresses the issue. It basically leaves things in the same place that they had been in the past and the way that zero loss securities have been treated from a risk-based capital (RBC) standpoint. From that perspective, it resolves what was going to be a potential issue where there would have been a significant drift in NAIC designations in securities that are otherwise some of the top-quality securities insurance companies own.

Tracey Lindsey (North American Securities Valuation Association—NASVA) asked if perhaps the Task Force, as it considers the mapping to NAIC 1.D., could permit the mapping to NAIC 1.A for just this year-end because that is how insurer systems have been built with the existing mapping instruction in place today. There would be no impact to RBC for this year-end. Mr. Fry said there should not be an RBC effect for this yearend; the 20 NAIC designation categories are just informational, and he said he does not see a problem with that request. Charles A. Therriault (NAIC) said he is sympathetic to insurers’ system concerns. There is a fairly broad rating distribution for no loss securities that goes from AAA into the non-investment grade ratings. The thinking behind the original recommendation was to try to find a midpoint to give the overall estimation of risk. Mr. Therriault said the NAIC 1.A mapping could be an option for insurers that cannot change their systems to accommodate the NAIC 1.D correction.
Mr. Fry said the Task Force will need to look at this whole process and the price breakpoints next year. He said that permitting insurers that cannot make the change in mapping from an NAIC 1.A to NAIC 1.D will be captured in the minutes as an instruction if it is not operationally possible to make this update. Ms. Mears said she supports the plan to keep it as NAIC 1.D in the exposure with the allowance in the minutes of an NAIC 1.A, to at least ensure that companies that are able to use the NAIC 1.D in their systems can do so. There was no objection from the Task Force members to this instruction for year-end 2020.

Mr. Fry directed SVO staff to expose the updated *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) instructions for the financial modeled residential mortgage-backed securities (RMBS)/commercial mortgage-backed securities (CMBS) mapping to NAIC designations categories for a three-day public comment period ending Dec. 22, 2020. He also directed SVO staff to conduct an e-vote immediately after the exposure period ends and include in the minutes permitting insurers that cannot make the system change in mapping from an NAIC 1.A to NAIC 1.D to report the NAIC 1.A for 2020.


Mr. Fry said in 2019, there were around 3,900 no loss securities. For 2020, the modeling has 500–600 fewer no loss securities. This means that if the security is no longer no loss, it must now go through the price breakpoints. A lot of these securities trade based on the interest rate environment. Because the security is now no longer no loss, the security must use the price breakpoints which could take a security, for example, that has a very small loss in the most draconian of the five scenarios, to now be an NAIC 3, NAIC 4 or NAIC 5. It might be rated AA by the rating agencies, but the price breakpoints would turn it into a below investment grade. That is the problem with the rules as they are now.

Mr. Paez said there are two things happening. On the one hand, there is the modeling results that this year are more conservative than they had been in the past, and rightly so, given the economic environment. Combined with the low interest rate environment that has existed for some time now, the fixed rate and long duration nature of CMBS implies, from a pricing standpoint, that a lot of companies have been purchasing premium price CMBS securities that, up to last year, would have been a zero loss security. Because these securities had been zero loss, they did not need to go through the price breakpoints. But now, with the more conservative scenarios, that are appropriate given the market, those securities need to go through the price breakpoints because they no longer qualify as zero loss. Because they are owned at a significant premium, once put through the price breakpoints, there is a cliff effect that is very dramatic with securities that are otherwise very high-quality securities.

He said, to give a little bit of context, an analysis that was put out by Bank of America estimated that approximately half of securities that are AA-rated today that were zero loss last year are no longer a zero loss this year. Similarly, 75% of securities that were A-rated this year and were zero loss last year are no longer zero loss. That is a pretty substantial percentage of those two classes of CMBS securities that, when combined with premium pricing, is causing them to drift down significantly in terms NAIC designations. From the rating agency standpoint, the rating agencies are doing a fine job in terms of determining the risks. These continue to be some of the highest quality securities out there. From a pricing standpoint, the market generally perceives those securities as being of very high quality as well. From an NAIC designation standpoint, and by extension from an RBC standpoint, those securities are starting to drift down to NAIC 2, NAIC 3 and NAIC 4 under these new modeling results in 2020.

This is starting to cause some significant issues in the market. On the one hand, insurance companies looked at what that was going to mean in terms of impact to their RBC and started thinking that it may be preferable to sell those securities. There was a significant amount of activity a couple of weeks after the modeling interim results came out where insurance companies were the sellers of these types of securities. The buyers were other type of institutions, generally, that would not be subject to the same rules. Insurance companies were selling very high-quality securities that have a very attractive cash-flow profile for prudent asset-liability management, and they were getting picked up by other types of entities that were taking advantage of this opportunity. For that same reason, the appetite from insurance companies for these types of securities started to come down. The likely implication was that the number of potential providers of liquidity for those securities that continue to be owned by insurance companies, in many cases, was coming down and, therefore, had the potential of reducing the liquidity of these holdings. There was a real impact to the market. And again, the issue here is not really with the quality of these securities. These securities continue to be rated today in a very high rating category by the rating agencies. They continue from a pricing
standpoint to be priced by the market as very high-quality securities. But from an NAIC designation perspective, they were going to suffer and have a potential meaningful impact on companies’ RBC.

Eric Kolchinsky (NAIC) said the breakpoint approach greatly penalizes fixed rate securities without any real reason. Using a real bond example from a spreadsheet from the midyear file or the interim file, it has a book adjusted carrying value (BACV) price of 102.7 but has an intrinsic price of 99.25. That is not a huge loss, at 75 basis points (bps), but it still would be in the range of NAIC 1 or NAIC 2 in terms of risk. However, it would be held at NAIC 3 because of the breakpoint analysis and only because of the BACV price of 102.7. That price reflects that interest rates have been steadily moving down, and these are fixed rate bonds. As interest rates move down and you get a wider coupon in the bond, the price goes up and has no aspect of quality. Unlike RMBS, where they are floaters, and if there is a credit issue, they will move down as a result of price. Here you had bond move up in price because of rates and nothing to do with credit. It is not a bad bond, but it would be held at NAIC 3 under the breakpoint analysis.

Mr. Kolchinsky said one of the things that was put in place was what is called the “no loss exception.” This was done around 2010 because of this very issue with CMBS bonds. Basically, an insurer could hold something at NAIC 1 under one of two conditions. First, there was no loss or zero losses in any of the scenarios that were run by the NAIC. Second, if it had gone through the NAIC FE rules, it would still be NAIC 1. This covers the first part of the discussion today, which is the change in the language.

Mr. Kolchinsky said he took a look at the effect of the new framework and about $8 billion of bonds for 2019 that have a rating between AA or A, and they have zero loss. In this case, one of the things that was discovered was that in the past, the flag sent in the Structured Securities Group (SSG) files only addressed the scenarios and did not take into account any ratings. These securities have zero loss in our scenarios, they have original ratings of AA or A, and they are held at a premium because that is what happens in a low rate environment. As rates go down, these bonds would be penalized. In the example bond, which is held by a number of insurers with BACV pricing from 101.1 to 101.6, there were no losses in any scenario, it had an original rating of AA, and it seems to be doing fine. However, it would still have to be held at NAIC 2, which makes no sense.

SSG staff recommend the Task Force accept the proposed editorial changes to the mapping framework and for 2021 look at getting rid of the price breakpoints. The ACLI proposal came in late, and SSG staff have been trying to figure out what can be done, as staff are sympathetic to the effects of the price breakpoints. The proposal from the ACLI would be very difficult to implement operationally. However, it is possible to lower the threshold as to where the flag for something to be considered zero loss is set. SSG staff propose lowering that threshold to 99.5, so that means it would take about 50 bps of discounted loss before it is flagged as having some losses. These are bonds that are still held as NAIC 1 and will still have capital held against them, just 40 bps for asset valuation reserve (AVR) companies and 60 bps for non-AVR companies. SSG staff thought that giving them some leeway in the allowance to be held at NAIC 1 through this framework makes sense. SSG staff provided a quick analysis of securities that were modeled in 2020 and 2019. For the ones that had no losses, the basis of their analysis in 2019 was that there were 3,923 of those securities, and for 2020, it was 3,357 securities that had no losses in the interim report. So, there were 566 fewer securities that were zero loss and would now be subject to breakpoints. What is being proposed is to change where to set the zero loss flag in the data files. If the flag for the zero loss final was set at 99.5, there would only be a drop of just 51 securities.

This is the serial effect of the nonlinearities. If the nonlinearities that are built into the capital level already, as into this nonlinearity of the breakpoint approach and the nonlinearity of the no loss, when you line them up, you can have these really convex results. And that is what we are seeing here, and SSG staff do not think those results are the correct result. This would only be a temporary solution until further changes can be made next year, as Mr. Kolchinsky discussed, to get rid of the breakpoints.

Mr. Fry said the Task Force is exposing some language changes to fix one issue. With this issue, he said that SSG has the discretion to use these parameters and change them without the Task Force necessarily being required to approve them. Mr. Kolchinsky said that is correct, but he does not want to do it without letting the Task Force know. He said he wants to make sure that people understand what is being done and that there are no issues with the approach.

Mr Fry said normally the SSG would have run the results, but it has held off to discuss this change and will be a few days late. Mr. Kolchinsky said they can make the change quickly and may only be a day or two late.
Mr. Monahan thanked Mr. Kolchinsky for the presentation, the quick response, the simplified solution to this issue for year-end, and fully engaging with state insurance regulators and NAIC staff in 2021 to develop a long-term solution.

Rakesh Kansara (New England Asset Management) said the last slide states that this is for year-end 2020 CMBS only. He asked if this applies also to the post-crisis fixed rate RMBS. Mr. Kolchinsky said they did not analyze RMBS and just focused on CMBS. He said that it would generally apply to post-crisis security, theoretically, but in terms of procedurally trying to find that with this time left might be difficult. Mr. Kansara agreed that the pre-financial crisis RMBS years were all floater and that it is a different deal, but just to draw some distinctions on the post-financial crises RMBS securities, they are fixed-rate securities. In most cases, but not all, because of their duration, they will trade at premium prices in the current low-rate environment. And it may have a similar impact on the NAIC designation change from last year to this year because of purely interest rates. Mr. Kolchinsky said he does not have an issue making this threshold change; the same thing applies for RMBS as well, but he asked if the Task Force members had a concern. Mr. Fry said the SSG can study it and see that it does the same and make the change without compromising the rest of the process. Ms. Mears agreed.

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

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