

Draft Pending Adoption

VALUATION OF SECURITIES (E) TASK FORCE

Valuation of Securities (E) Task Force 2021 Spring National Meeting Minutes (Attachment One)

Valuation of Securities (E) Task Force May 24, 2021, interim minutes (Attachment Two)

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Draft: 7/28/2021

Valuation of Securities (E) Task Force
Virtual Meeting (*in lieu of meeting at the 2021 Summer National Meeting*)
July 15, 2021

The Valuation of Securities (E) Task Force met July 15, 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 (FL); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Chut Tee (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); Marlene Caride represented by John Sirovets (NJ); Linda A. Lacewell represented by Jim Everett (NY); Doug Slape represented by Amy Garcia (TX); Jonathan T. Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Tim Hays (WA); and Mark Afable represented by Randy Milquet (WI).

1. Adopted its May 24 and Spring National Meeting Minutes

Mr. Fry said the Task Force met May 24 and took the following action: 1) discussed comments received and adopted proposed amendments to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)* for the following: a) require the filing of private rating letter rationale reports; and b) permit filing exemption (FE) for credit tenant loan (CTL) and ground lease financing transactions; and 2) received and discussed the Securities Valuation Office (SVO) referral response to the Statutory Accounting Principles (E) Working Group on CTLs.

Mr. Thomas made a motion, seconded by Ms. Clements, to adopt the Task Force's May 24 (Attachment) and March 22 (*see NAIC Proceedings – Spring 2021, Valuation of Securities (E) Task Force*) minutes. The motion passed unanimously.

2. Adopted its 2022 Proposed Charges

Mr. Fry said the Task Force's 2022 proposed charges remain unchanged from 2021.

Ms. Doggett made a motion, seconded by Mr. Kozak, to adopt the Task Force's 2022 proposed charges (Attachment Three). The motion passed unanimously.

3. Adopted a P&P Manual Amendment to Add Additional Instructions to the Review of Funds

Mr. Fry said the next agenda item is to discuss and consider for adoption an amendment to the P&P Manual to add additional instructions to review of funds. The original amendment (Attachment Four-B) was received by the Task Force during the Spring National Meeting and exposed for a 45-day public comment period ending May 6. This updated amendment reflects technical comments and recommendations that were received from interested parties (Attachments Four-C, D and E). The revised amendment was received and approved for exposure through a Task Force e-vote on June 1 and exposed for a 30-day public comment period ending July 1. There was one supportive joint comment letter received on the updated amendment from the American Council of Life Insurers (ACLI), the North American Securities Valuation Association (NASVA), and the Private Placement Investors Association (PPiA).

Marc Perlman (NAIC) said the new proposal would adhere much more closely than the previous one to Rule 18f-4 under the U.S. Securities and Exchange Commission's (SEC) Investment Company Act of 1940 related to the use of derivatives by registered investment companies, including funds, which the SEC adopted in October 2020. Unlike the previous amendment, which had two separate tests for derivatives depending on the NAIC Fund List on which a fund is listed, this amendment would create a single test. Pursuant to the new proposal, a fund's exposure to: 1) derivatives under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payments or otherwise; 2) short sale borrowings; and 3) reverse repurchase agreements or similar financing would be limited to 10% of the fund's net assets in normal market conditions. Exposure would be calculated based on the gross notional amounts of derivatives, the value of assets sold short for short sale borrowings, and the proceeds received by the fund but not repaid for reverse repurchase agreements. Consistent with the SEC Rule, interest rate derivatives and option contracts exposure could be calculated with other defined methods consistent with market practice. Also consistent

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with the rule, certain currency and interest rate derivatives that hedge currency or interest rate risk associated with one or more specific equity or fixed-income investments of the fund would be excluded from the 10% exposure calculation.

One difference between this proposal and the SEC Rule is that the P&P Manual's methodology requires a look-through assessment of all funds which, in turn, includes a requirement that a fund "predominantly hold" bonds or preferred stock, as applicable. As defined in the P&P Manual, "predominantly hold" means that a fund holds at least 80% of its assets in bonds or preferred stock, depending on the type of fund, in normal market conditions. This existing requirement, therefore, limits total derivatives, short sale borrowing, and reverse repurchase agreement exposure in any fund to 20%, exclusive of the excluded currency and interest rate derivatives. The amendment proposes calculating that exposure as previously explained, using gross notional amount for the derivatives. However, for derivatives under which a fund is not or a fund shall not be required to make any future payment or delivery of cash or other assets, exposure would be calculated based on the derivative's market value, a less conservative measure than gross notional, due to diminished risk of loss to the fund. These derivatives would include, for example, certain options pursuant to which the fund would have no possible future payment obligation following the initial premium payment. The Credit Risk Assessment portion of the existing methodology would also be updated to include a calculation of derivative exposure and, if analytically appropriate, the inclusion of derivatives in the weighted average rating factor (WARF) analysis. Derivative documentation can be complex and its review time-consuming. To expedite reviews of funds with derivatives while ensuring that the fund does not breach the proposed exposure thresholds, the proposal includes a new filing requirement to include certain derivatives information in the schedule of portfolio securities and assets, which is provided to the SVO for its review. Such additional information would include: 1) derivative type; 2) whether the derivative will require the fund to make a future payment or delivery of cash or other assets; 3) whether the derivative is an "excluded derivative transaction;" 4) the counterparty credit rating; and 5) the derivative exposure and how it is calculated. The expectation is that a complete and accurate summary of derivatives in the schedule will prevent the need for the SVO to review derivative legal documentation, but the SVO will reserve the right to request it if it deems it necessary.

Based on comments received from interested parties, the SVO removed the initially proposed management assessment from this amendment. Interested parties expressed concern that the management assessment could further weaken market clarity and predictability.

Mr. Fry said this will add a lot of transparency and understanding of the use of derivatives, and it will be a welcome addition to the P&P Manual.

Mike Reis, representing the ACLI, the NASVA, and the PPIA, said this provides clarity. He said industry appreciates the thought that went into the proposal and fully supports the exposure. It serves multiple purposes that are beneficial to everyone. One thing that was highlighted in the comment letter was that for some of the funds that get a designation, the risk-based capital (RBC) does not flow through from that designation, specifically, those funds in *Statement of Statutory Accounting Principles (SSAP) No. 30R—Unaffiliated Common Stock*. There has been talk in the past of potentially getting the RBC to be reflective of the NAIC designation on those funds. That change may have to go to the Capital Adequacy (E) Task Force and industry is certainly supportive of that change. There are certain things happening in the bond project at the Statutory Accounting Principles (E) Working Group, and there may be a population of other securities that would also benefit from some type of look through for RBC treatment as well.

Eric Hovey (Payden & Rygel) said Payden & Rygel had commented on the earlier version and appreciates that the input was taken, supports the new version, and appreciates the continued movement forward in looking at ways to treat bond mutual funds with look through assessment for capital treatment more aligned to the holdings of securities. Also, the SEC rule that is being mentioned here is not in force until August 2022 for the investment industry. There is a little bit of timing mismatch as far as the industry coming to terms exactly with what will be done for that rule versus this proposal being put forth today.

Ms. Mears made a motion, seconded by Mr. Milquet, to adopt the updated proposed amendment to the P&P Manual to add additional instructions to the review of funds. The motion passed unanimously.

4. Adopted an Amendment to the P&P Manual to Permit FE for CTLs and Ground Lease Financing Transactions.

Mr. Fry said the next item on the agenda is to discuss and consider for adoption an amendment to the P&P Manual to permit FE for CTLs and ground lease financing transactions. This is a change from the existing policy where these transactions had to be filed with the SVO for a legal, structure and credit assessment and only allow the residual asset exposure up to 5% of the original loan amount. This amendment was exposed on May 28 for a 30-day public comment period ending June 28. The Task Force has received two comment letters that were supportive of the amendment.

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Charles A. Therriault (NAIC) said the Statutory Accounting Principles (E) Working Group chairs proposed updating the definition of CTL and ground lease financing (GLF) transactions in the P&P Manual to limit them to only those investments that would meet the definition of a mortgage loan under *SSAP No. 37—Mortgage Loans*. Investments that are securities (which are expressly excluded from *SSAP No. 37*) that fall under the definition of *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities* would no longer meet the definition of a CTL and ground lease financing transactions in the P&P Manual and would, therefore, become eligible for FE, which includes private rating letters. The SVO can still review these transactions and refer to the CTL and GLF methodologies for any unrated security that is CTL-like or ground lease financing-like that requires filing with the SVO, as would any other unrated security. If this amendment is adopted by the Task Force, the SVO will look to see if there are any rated CTL or GLF transactions in the VISION application, remove the SVO assigned NAIC designation from them, and permit them to flow through FE.

Mr. Fry said that originally this was created for transactions that were mortgage loans that wanted to be on Schedule D, and over time, these types of structures made their way into being securities. The policy in the past has been that even if it was a security, it still had to be filed with the SVO and looked at for these characteristics. The Task Force recognizes that there are other securities that do not have to go through this type of criteria. There is also the *SSAP No. 43R—Loan-Backed and Structured Securities* project at the Statutory Accounting Principles (E) Working Group that will complement this in the future if it gets adopted.

John Garrison (Lease-Backed Securities Working Group) said the Lease-Backed Securities Working Group appreciates the consideration and thought that went into this proposal.

Mike Reese (Northwestern Mutual), representing the ACLI, NASVA and PPIA, said this has had a lot of discussion over the past year. Industry is happy that these securities will receive similar treatment to other securities, and this change dovetails with the *SSAP No. 43R—Loan-Backed and Structured Securities* project at the Statutory Accounting Principles (E) Working Group.

Mr. Thomas made a motion, seconded by Mr. Fletcher, to adopt the proposed amendment to the P&P Manual permitting securities similar to CTL and GLF transactions to use NAIC credit rating provider (CRP) ratings through the FE policy. The motion passed unanimously.

5. Adopted Guidance for WCFIs Consistent with the Statutory Accounting Principles (E) Working Group's Adopted of Changes to SSAP No. 105R and Exposed an Amendment Permitting the SVO to Rely Upon the Unrated Subsidiaries of a CRP-Rated Parent Entity for Only WCFIs

Mr. Fry said the next item on the agenda deals with working capital finance investments (WCFIs). This was last exposed on Nov. 18, 2020, during the Fall National Meeting. There are two separate amendments. One amendment deals with the changes that the Statutory Accounting Principles (E) Working Group made to *SSAP No. 105R—Working Capital Finance Investments* and brings the P&P Manual into alignment with those changes. No comments were received on those changes. The second amendment deals with unrated subsidiaries, and it was exposed in November too but there were comments and updates made to that amendment. It is likely that the second amendment will be re-exposed and also referred to the Statutory Accounting Principles (E) Working Group.

Marc Perlman (NAIC) said the first WCFI amendment the SVO is proposing is unchanged since it was exposed in November 2020. It is intended to remove from the P&P Manual inconsistencies that arose when *SSAP No. 105R* was revised.

Under the second proposed WCFI amendment, when a WCFI obligor is unrated, cannot be designated by the SVO and is not guaranteed by its parent, the Task Force would direct the SVO to rely on the rating or NAIC designation of an obligor's parent based on its implied support. With this second iteration of the policy amendment, the SVO is recommending certain changes.

First, the initial test for whether the SVO should be able to rely on the parent's rating required that the obligor constitute a "substantial portion of its parent's operations representing at least 25% or greater of the parent entity's assets, revenue and net income." The SVO proposes removing this requirement since it was deemed too restrictive and could prevent, for example, a 5% subsidiary, which manufactures a crucial component for its parent's product, from benefiting from the policy. Additionally, interested parties explained that they did not think it would always be possible to determine the percentage of the parent's operations because it is not always clear from the parent's financial statements, and the subsidiary often lacks financial statements.

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Second, the initial proposal allowed the SVO to notch the designation down from that of the parent based on several subjective factors related to the parent/obligor relationship. The notching provisions were removed so that, according to the policy, the SVO will only imply the parent's rating on the obligor without notching. However, under the policy, the SVO expressly retains its right, in its sole analytic discretion, to notch the designation or choose not to assign a designation to a WCFI program for reasons unrelated to the relationship between the obligor and its parent.

Lastly, there is one clerical correction to the amendment. Where it currently references "eligible NAIC CRP rating" throughout, the word "eligible" was removed because an eligible NAIC CRP credit rating specifically refers in the P&P Manual to ratings assigned to securities eligible for Schedule D reporting. Since the rating on a parent could be an issuer rather than an issue rating, it might not meet the definition of "eligible NAIC CRP credit rating."

Mr. Fry said it would be easiest to consider the two amendments separately. The first amendment brings the P&P Manual into alignment with SSAP No. 105R. It has been previously exposed, and Mr. Fry asked if the ACLI, whose comment letter discussed both amendments, would like to specifically address this first amendment,

Mike Monahan (ACLI) said that the ACLI supports amending the language to agree with SSAP No. 105R and moving forward with the first amendment.

Mr. Fry ask Mr. Therriault for the SVO's recommendation. He recommended adoption of the first amendment to align the P&P Manual to the adopted changes with SSAP No. 105R. Mr. Monahan said the ACLI supports that recommendation.

Mr. Fry said that the second amendment deals with the unrated subsidiary piece and asked if there were any comments on it. Mr. Monahan said the ACLI is supportive of what the Task Force has done and will comment on the exposure. He said it is a safe asset class for large insurers.

Mr. Everett asked if industry might be able to address in their comments some questions he had, and that is that SSAP No. 105R now requires an obligor rating, and the parent will not be the obligor. The SVO indicated that a methodology for these kinds of things is lacking and, in light of the Greensill supply chain financing situation, it has become clear that not even generally accepted accounting principles (GAAP) has any standards for supplier finance programs. Standard & Poor's (S&P) just had a seminar and released a research paper on supply chain finance disruptions. Mr. Everett said if possible, if industry could distinguish the situation from Greensill and address the standards issue in their comment letter, it would be appreciated.

Mr. Monahan said they are on top of what happened with Greensill and have been working with the Financial Standards Accounting Board (FASB) on disclosures so that it is more transparent to users of financial statements.

Mr. Thomas made a motion, seconded by Ms. Doggett, to adopt proposed amendments to the P&P Manual to conform the WCFI guidance to reflect the changes adopted by the Statutory Accounting Principles (E) Working Group to SSAP No. 105R. The motion passed unanimously.

The Task Force also directed the SVO to expose the amendment to direct the SVO to rely upon the unrated subsidiaries of a CRP rated parent entity for only WCFI for a 30-day public comment period and refer it to the Statutory Accounting Principles (E) Working Group for comment.

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

Julie Gann (NAIC) said the Statutory Accounting Principles (E) Working Group has three meetings scheduled for the near future. The Working Group plans to meet July 29 in regulator-to-regulator session, pursuant to paragraph 6 (consultations with NAIC staff members) of the NAIC Policy Statement on Open Meetings, to hear state insurance regulator reports regarding financial statement information from the 2020 financial filings. The Statutory Accounting Principles (E) Working Group usually does that in conjunction with the national meetings, but since those have been hybrid sessions, there has not been the opportunity to do so. Any state insurance regulator who would like to have information on any disclosure can contact NAIC staff. There are a handful of items planned for presentation with regard to information that the Working Group has gathered from the financial statements. Some examples are the Federal Home Loan Bank (FHLB) disclosure, the SVO-identified exchange-traded funds (ETFs), the new cash pooling, and permitted practices. Ms. Gann said if anyone wants anything specific, let NAIC staff know.

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Additionally, the Working Group plans to meet Aug. 10 in regulator-to-regulator session, pursuant to paragraph 6 (consultations with NAIC staff members) of the NAIC Policy Statement on Open Meetings, to discuss comments received on the Schedule - D project and on the *SSAP No. 97—Investments in Subsidiaries, Controlled and Affiliated Entities* exposure. It also plans to meet Aug. 26 to hear comments on proposed items.

Ms. Gann said with the action taken today on CTLs, Interpretation (INT) 2010 will be reviewed. It formally expires Oct. 1, but with the action that occurred today, that interpretation may no longer be needed. She said the Statutory Accounting Principles (E) Working Group will look at that and hopes to have an update for its Aug. 26 meeting.

7. Discussed Other Matters

Mr. Fry said there is an update from Eric Kolchinsky (NAIC) on updating the structured securities reporting for the legacy and non-legacy changes adopted this spring along with planning for the recently adopted updated RBC factors.

Mr. Kolchinsky said there are two broad categories of updates. The first is the announcement of the selection for the financial modelling request for proposal (RFP). It was a long and tough RFP, and the Structured Securities Group (SSG) selected BlackRock Solutions. There were some excellent bidders, and it was an interesting RFP. Mr. Kolchinsky said the SSG looks forward to working with BlackRock Solutions on many of the issues that are going to be discussed next.

Mr. Kolchinsky said the second issue is that the SSG has a number of overlapping changes that are happening with modeled securities: 1) there is BlackRock Solutions, a vendor that has worked with the SSG before; 2) there is the change from breakpoints to designations for non-legacy securities that requires a technical change; 3) there is through-the-cycle modeling; and 4) there are the changes to the RBC factors from Capital Adequacy (E) Task Force. The SSG and the SVO received a letter from the ACLI discussing many of these issues on financially modeled securities that the SSG will look at with the SVO. The SSG staff are in general agreement with the ACLI letter as to how to prioritize the rollout of all these changes and appreciates the letter in general. The letter has not been exposed yet. There are some issues that are short on details that the SSG needs to work out such as implementation of the zero-loss framework. Mr. Kolchinsky said the SSG may come back to the Task Force to discuss these issues, and there may be a need for some minor changes to the P&P Manual. The biggest issues is moving the implementation of both the breakpoints and on the new 20 designation categories using the new RBC factors into 2022. The rationale for moving this into 2022 is that it will give the SSG the opportunity to think through these changes and bring it to Valuation of Securities (E) Task Force for approval instead of rushing it in for year-end 2021, given all these other changes.

Francisco Paez (MetLife) said, there are a number of changes that are happening on the RBC front, not only on the bond side, but also in other parts of the business, and structured securities is part of that equation. It was important to keep that in consideration. There are changes that industry hoped would get done on the modelled security side to address the issues encountered last year. There is also an operational component, and one thing that industry wanted to make sure of is that things are managed in a way that do not lend themselves to any kind of last-minute operational complexities or risks that are not necessary. The letter recommends prioritizing the orderly adoption of these changes and makes suggestions in terms of which changes are most meaningful to industry to achieve some balance.

Mr. Fry asked if when mentioning year-end 2021 and the 20 designations, is this considering only the six designations for this year-end and then going with 20 designations for next year, 2022.

Eric Kolchinsky said that is correct. He said what would occur is that the reporting would still be as currently defined in the P&P Manual. There is already a provision for reporting the NAIC designation categories. In terms of calculating the breakpoints between the layers, as well as for the designations, that is a process the SSG would like to do on a more interactive basis with the Valuation of Securities (E) Task Force and not do it hastily, considering everything else that needs to be done for this year-end. He said the SSG would also like to run a few more scenarios, given the extra granularity that will be seen now in the 20 versus the six designations. SSG staff are concerned that having just four scenarios will force the results to bunch up in just a few categories, which understates or overstates the risk to the securities. SSG staff would like to take the year of 2022 to discuss these issues with Task Force and report for the current year with the existing designation categories.

Mr. Paez said what was done last year in terms of mapping of securities is a little bit of a road map that could be used again this year. That way, there can be six categories but still mapping on to the new designation categories where they map to the middle of the designation category. The only point that is going to be important for industry is that those bonds that meet the highest quality definition can make it to the 1.A category. There may be a need for enhancements to the scenarios in order to capture all the granularity. Thinking specifically about this year-end and the path that was used last year could be replicable

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this year. Mr. Paez said all that would be needed to do is figure out a way to address that 1A category, which, in the absence of more detail, the methodology for the zero loss could be that indicator that allows the mapping to the 1.A category. It should capture really what it is supposed to capture because most of those securities are going to be AAA securities.

Eric Kolchinsky said, in general, SSG staff agreed, but they need to work through it and the operational concerns. The new breakpoint file will need 19 columns instead of five. Vendors on the industry side will need to figure out how to take in the new files, and not having to rush is a huge benefit. Mr. Therriault said the SVO will expose the ACLI comment letter on the Task Force web page.

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

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Draft: 3/31/2021

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); Chlora 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. Laceywell 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); Dec. 18, 2020 (Attachment); 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.

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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

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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 publicly 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

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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

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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 said states have defined their bond treatment by NAIC treatment. "Speculative" was mentioned regarding certain funds. Does the SVO know what funds those are? And if states permit these to be used for surplus, that would seem to be a departure. What is being defined as "speculative"? Mr. Perlman said "speculative" is anything with leverage where a fund can have outsized gains or losses. What the SVO is proposing—except for the exempt derivatives discussed, which are derivatives hedging certain risks on assets within the fund portfolio, but other than those preventing risks—where there is potential loss or future payment obligations, capping those with the potentially unlimited upside gain because the P&P Manual has the predictable and periodic standard to be bond-like.

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.

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Mr. Everett asked if it would 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 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 common stock. The reason it is required to be specified is all other warrants are captured as derivatives in the scope of *SSAP No. 86—Derivatives*. The Working Group had not seen those preferred stock publicly traded warrants before, but they are out there, so the guidance was clarified accordingly.
- Adopted revisions to indicate that the changes to the Freddie Mac Structured Agency Credit Risk (STACR) and Fannie Mae Connecticut Avenue Securities (CAS) programs, which will be issued through REMIC, which is a REMIC trust, 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

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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. 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. Mr. Fry asked Ms. Gann if she had anything to add or if he had mis-characterized anything. She responded that Mr. Fry had summarized the issues correctly and that she had nothing to add. Ms. Mears and Mr. Theriault both also responded that Mr. Fry's summary was accurate.

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 that 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

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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 than 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 lessee. 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, just that the residual component would widen up to 50%.

Mr. Sargent asked if the definition of “residual risk” was using the original loan balance or the appraised loan to value. Mr. Therriault referred the question to Mr. Perlman who said it would be the loan balance. Mr. Therriault suggested they take this up “off-line”.

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. Kozak 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 completely 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

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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.

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Valuation of Securities (E) Task Force
Virtual Meeting
May 24, 2021

The Valuation of Securities (E) Task Force met May 24, 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); Chlora Lindley-Myers represented by Debbie Doggett (MO); Eric Dunning 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); Scott A. White represented by David Smith (VA); Mike Kreidler represented by John Jacobson (WA); and Mark A. fable represented by Randy Milquet (WI). Also participating was: Dale Bruggeman (OH).

1. Adopted an Amendment to the P&P Manual to Require the Filing of a Private Rating Letter Rationale Report

Mr. Fry said the first item on the agenda is to discuss comments and updates to a proposed amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to require the filing of a private rating analysis report. The Task Force has discussed this amendment several times, most recently at the Spring National Meeting. The Securities Valuation Office (SVO) staff has been working closely with the American Council of Life Insurers (ACLI), the North American Securities Valuation Association (NASVA), and the Private Placement Investors Association (PPIA) to address concerns regarding confidentiality restrictions and potential operational issues since this amendment was first exposed at the 2020 Fall National Meeting on Nov. 18, 2020. As reflected in their supportive joint comment letter, this collaboration has resulted in the amendment before the Task Force today that addresses those outstanding issues. The amendment requires the filing of private rating letter rationale reports beginning Jan. 1, 2022. There is a provision for deferring the submission for private letter rating securities in certain situations. The Task Force was informed of a typo in the last section of paragraph 22; the word "Filing Exception" should be changed to "Filing Exemption." Mr. Fry thanked industry and staff on their close collaboration on developing this amendment.

Sasha Kamper, representing the ACLI, the PPIA and the NASVA, said industry's concerns with the Bespoke Securities proposal was always twofold. Industry wanted to provide the transparency that state insurance regulators are asking for so they can understand what insurers are investing in and minimize the amount of disruption that any sort of change could potentially cause in capital markets. The private placement market not only is an opportunity to provide incremental yield to insurers at a time when interest rates are quite low, but it also provides incremental downside protection through financial covenants and collateral packages in many of these deals. The U.S. private placement market is a very important market for several insurers and something to preserve. Industry believes that this exposure really strikes that right balance. There was extensive work over the last several months to get through some of the operational details and get the timing right in this proposal. The proposal is somewhat retroactive, and the first stage takes place for securities issued beginning Jan. 1, 2018. It was important not to expect rating agencies to go back and reopen commercial contracts with borrowers and need to amend the terms of those contracts. The SVO staff were very understanding of that and worked to accommodate these concerns; if there was a ratings rationale and it was allowed to be shared, if required to do so, they would not expect insurers and borrowers to renegotiate deals that were done a few years ago. Industry also worked with the SVO staff to explain that certain rating agencies, even some of the larger more established rating agencies, do less surveillance work on certain types of structured securities. There will be an initial study and publication put forth that describes the transactions and the ratings rationale in great detail. If nothing changes with the structure and things are performing about as expected, the annual surveillance reports are light. This is true, both on the public and private side. The SVO staff understood that and were only looking for similar work product to what is produced in the public sector. Industry believes this is something that all the rating agencies should be able to comply with, and they are being given enough time to put things in place. There are still some operational details to work out with the SVO, and the rating agencies specifically, about the delivery mechanism, but these ratings rationales will be provided to the SVO.

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Ms. Doggett made a motion, seconded by Mr. Thomas, to adopt the amendment to the P&P Manual to require the filing of private rating letter rationale reports. The motion passed unanimously.

2. Discuss and Receive an Amendment to the P&P Manual to Permit FE for CTLs and GLF Transactions

Mr. Fry said the next item on the agenda is to discuss and receive an amendment to the P&P Manual to permit filing exemption (FE) for credit tenant loans (CTLs) and ground lease financing (GLF) transactions that exceed a 5% residual exposure. This amendment would give insurers the option to submit either CTLs or GLF transactions to the SVO for their review, or they could use the NAIC FE process. After exposing this amendment, the Task Force received a referral from the Statutory Accounting Principles (E) Working Group chairs with an alternative P&P Manual amendment recommendation to achieve the same outcome, but without what the chairs saw as a possible overstep of the Task Force and possible conflict in guidance.

Mr. Bruggeman said that part of this challenge has always been the term “CTL.” It has been used in a lot of different ways than what was originally introduced back in the ‘90s. A CTL, by statutory accounting definition, is a direct mortgage to someone that is backed by whoever is leasing the property and backed by those lease payments. It is a mortgage that is following *Statement of Statutory Accounting Principles (SSAP) No. 37—Mortgage Loans*, and if those credit tenant financings are being provided at least 95% (one minus the 5% the Task Force has been talking about), that can move from Schedule B (the mortgage schedule) to Schedule D-1 (the bond schedule). All of those had to be reviewed by the SVO. Over the years, these CTLs have been put inside securities. Those securities are also called CTLs. Therein lies part of this confusion; i.e., when that CTL ends up inside of a security and that security issues debt, now that debt is a security, and it is now covered under *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities*. If there are multiples of these inside a structure, that goes to SSAP No. 43R; otherwise, it will stay in SSAP No. 26R. Those are the statutory accounting definitions. The challenge is that when statutory accounting staff see CTLs, they immediately assume the mortgage SSAP No. 37 definition, but it has been utilized more than that. The memo that was sent out to the Task Force from the Working Group chairs tries to go through that process. The memo tried to highlight the terms “security” and “mortgage.” The memo proposes changes in the P&P Manual in Part Three, paragraph 4, in the “FE Securities” section, changing the sentence from, “[a] CTL is a mortgage loan ...” to, “[a] CTL is a mortgage loan, in scope of SSAP No. 37...,” because by definition, SSAP No. 37 excludes securities that would be covered under SSAP No. 26R or SSAP No. 43R. There is a similar change in Part One, paragraph 100; any change to the residual percentage on the securities side does not affect the SSAP No. 37 CTLs. CTLs really fit into three different buckets— a mortgage bucket under SSAP No. 37, a bond bucket under SSAP No. 26R, and a structured bucket SSAP No. 43R.

Julie Gann (NAIC) said the Working Group chairs are recommending exposing the very limited proposed changes to the P&P Manual to clarify that the references of the CTL are mortgage loans in scope of SSAP No. 37. That separates the conversation between what is a direct mortgage loan and what is a security. This guidance would then refer to the *Accounting Practices and Procedures Manual (AP&P Manual)* to SSAP No. 26R and SSAP No. 43R on defining what should be in scope and reported on Schedule D. It was anticipated that this would eliminate the inconsistency and the confusion that currently exists regarding the different named structures that could perhaps have underlying real estate risk. From information that the SVO has provided, some companies have called those CTLs, some have called them lease-backed securities, and some companies call them other names. Anything that meets the current definition of a bond would continue to be in scope of SSAP No. 26R or SSAP No. 43R, as applicable. As the bond proposal continues, if there is concern about some of these investments and the ultimate residual risk, they would also be captured within that bond proposal and perhaps need be relocated to a different schedule once that project is done; but it would eliminate the inconsistency that currently exists and clarify that the current reference to mortgage loans is specific to those non-security structures that are in scope of SSAP No. 37. This came about Thursday evening after the Working Group call. The Working Group took action to expose modifications to *Interpretation (INT) 20-10: Reporting Nonconforming Credit Tenant Loans*. Contingently, in response to the original proposal that was suggested to the Task Force, if the Task Force moves forward with the limited edits that are reflected in the chair memo that was submitted, that exposure would be pulled back, and the Working Group would be informed of this change and work on the next way forward with regards to INT 20-10. If these proposed revisions to clarify the scope of the CTLs go through, INT 20-10 may no longer be applicable.

Mr. Fry said operationally, if there is a security that has a lot of CTL characteristics and under 5%, as defined in the P&P Manual, the SVO can still designate those; even though they are a security, they would not lose their standing in that regard. Mr. Everett questioned how the proposal interacts with the proposal that was sent out for the P&P Manual on Friday. Mr. Fry said the exposure in the materials has an amendment that would have created a similar effect. The Task Force will expose a new version, the simplified version that Mr. Bruggeman and Ms. Gann explained, and take comments on it. If the Task Force adopts that exposure, it would be the smoother, or at least disruptive path, and complement the SSAP No. 43R project. It would

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put a natural guard rail around those investments as everyone begins understanding those principles. If there are a lot of residual risks and securities start looking and acting like something else, there is a risk of possibly not falling into the new principles-based SSAP No. 43R. The Task Force has got some work to do regarding looking at how it is using ratings and private letter rating. The Task Force can always look at ways to accomplish accounting for these risks through its processes.

John Garrison (Leased-Backed Securities Working Group) said this is an elegant and simple solution to the confusion that has been existing in the market. CTLs would stay in the P&P Manual, as they always have with all their guidelines and so forth. They would be preserved as an asset class with just a clarification that they would be deals that would normally be in the scope of SSAP No. 37. The clarification would be that any deal that is done in the form of a security would be FE, just like any bond. Investors would have the option, depending on the characteristics of the deal, to either do them under FE or submit them to the SVO for an NAIC Designation. This also applies to GLF transactions that are a security, and they would be FE. Mr. Fry confirmed that interpretation.

Ms. Mears said insurers should be thoughtful about those types of security characteristics that currently have large residual values in relation to the bond project and the bond proposal. As the residual values get higher and higher, more of an analysis needs to occur to show that those still produce bond like cash flows under the proposal. Should that proposal move forward the detail, securities with CTL like characteristics, along with any other investments that have those high residual values, would fall under that definition and its requirements.

Ms. Mears made a motion, seconded by Mr. Everett, directing the SVO staff to expose a new amendment to the P&P Manual following the suggestions proposed by the Working Group chairs permitting CTLs and GLF transactions that are securities to be FE for a 30-day public comment period. The motion passed unanimously.

3. Discussed the SVO Referral Response to the Statutory Accounting Principles (E) Working Group on CTLs

Mr. Fry said the next item on the agenda is to hear a summary from the SVO on the referral it received from the Statutory Accounting Principles (E) Working Group on CTLs. The referral asked the SVO some basic questions about CTLs.

Mr. Therriault said a lot has changed, given the new direction just discussed, but the Working Group asked the SVO a number of questions related to CTLs centered around the appropriateness of the 5% residual exposure and whether it is appropriate to revisit the 5% risk threshold restrictions for conforming CTLs. The SVO agreed that it makes sense to revisit that threshold. It sounds like the bond definition project will be covering that issue, so it is not necessary to do that here. Also, with the change in definition just discussed, it seems like it will no longer be necessary for the P&P Manual instructions.

Another question was for a recommendation of an appropriate residual risk threshold. That is where the SVO response went into some detail on the various risks that it has observed. The SVO staff did not think it was appropriate for the SVO to weigh in on the residual risk threshold, as that was more of a regulatory policy decision. The SVO staff assumed that the Task Force would come back and make a recommendation to the Working Group in that regard as to what it believes is the appropriate residual risk for the bond project.

Mr. Therriault said there was a question regarding other mechanisms for compensating controls beyond a residual risk insurance policy that could be incorporated to mitigate those factors for CTLs. The residual risk insurance is the most common mitigant that the SVO is seeing, but other mitigants that would be acceptable include non-cancelable guarantees, cash escrows and reserves, excess rent set asides, and recourse to the lessee. The SVO did not have an all-encompassing list, because it was anticipated that there could be other mitigants, and it did not want to exclude them.

The other question from the Working Group was for a listing of the nonconforming CTLs that had been filed with the SVO and some characteristics about them. The SVO received 61 CTLs since the time INT 20-10 was issued through April 21. There were 16 conforming CTLs, 27 nonconforming CTLs, and 18 transactions where documentation was still pending. Typical outstanding documentation include the primary legal agreement, the CTL evaluation form, the mortgage, residual value insurance, lease agreement, condemnation insurance, appraisal, and assignment of lease and rents. For the nonconforming CTLs, 20 had balloon payments in excess of 5%, six involved a lack of casualty or condemnation gap insurance, and one involved a keep-well agreement that would not be adequate for credit substitution purposes. The Working Group was sent a regulator-only list of those nonconforming CTLs, as it had requested.

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Mr. Fry said the Task Force would likely preserve the 5% residual risk for the things that otherwise would be on the mortgage loan schedule that want to go over to Schedule D. It may no longer be relevant how much over the 5% limitation the Task Force would suggest to the Working Group because there is no limit now for any other asset class. The new SSAP No. 43R principles will probably end up setting that benchmark.

Mr. Bruggeman asked Mr. Therriault if all the CTLs listed were structured as securities. Mr. Therriault said that is correct; CTLs structured as securities is what the SVO has traditionally received. The SVO has not received a mortgage type CTL in a long time. Mr. Therriault said the comments in the SVO's response to the Working Group highlighted risks that were generic to any lease-backed securities. The SVO wanted to make the Working Group and Task Force aware of those risks without making any policy recommendations. Mr. Bruggeman said he appreciated the SVO memo sent to the Working Group, as it broke out CTLs from the old definition and how they are being used now in securities.

Ms. Belfi asked for clarification regarding whether the Task Force should take up the policy questions from the Working Group, such as whether the residual exposure percentage should increase from 5% to something else now that it would not apply anymore, because the Working Group is going to be looking at the risk factors within SSAP No. 43R. Mr. Fry said a lot of these CTLs were not mortgage loans. They were a security, and like any other security, such as collateralized fund obligations (CFOs), they have different characteristics; and the Task Force does not really highlight those and create a special process for them, but they are just part of the FE universe. Everything is being put into that basket, then someday the new SSAP No. 43R principles will serve a useful purpose to keep that in check.

Mr. Bruggeman said for the bond definition project, most of these are already there, but there might be a few that fall outside of that principle in the bond definition. Those that are outside of the principles would have to move off Schedule D as securities, not as mortgages that are on Schedule D, but the second two buckets described earlier.

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

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