



NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

NAIC 2021 | **SPRING NATIONAL MEETING VIRTUAL**

Date: 3/5/2021

*Virtual Meeting
(in lieu of meeting at the 2021 Spring National Meeting)*

Valuation of Securities (E) Task Force

Monday, March 22, 2021

3:00 p.m. – 4:00 p.m. ET / 2:00 p.m. – 3:00 p.m. CT / 1:00 p.m. – 2:00 p.m. MT / 12:00 pm. – 1:00 p.m. PT

ROLL CALL

Dana Popish Severinghaus, Chair	Illinois	Gary Anderson	Massachusetts
Doug Ommen, Vice Chair	Iowa	Chlora Lindley-Myers	Missouri
Lori K. Wing-Heier	Alaska	Bruce R. Ramge	Nebraska
Ricardo Lara	California	Marlene Caride	New Jersey
Andrew N. Mais	Connecticut	Russell Toal	New Mexico
Trinidad Navarro	Delaware	Linda Lacewell	New York
David Altmaier	Florida	Doug Slape	Texas
Dean L. Cameron	Idaho	Jonathan T Pike	Utah
Vicki Schmidt	Kansas	Scott A. White	Virginia
James J. Donelon	Louisiana	Mike Kreidler	Washington
Kathleen A Birrane	Maryland	Mark Afable	Wisconsin

NAIC Support Staff: Charles A. Therriault, Marc Perlman

AGENDA

1. Consider Adoption of the meeting minutes for the Fall National meeting, and Dec. 18, 2020 and Feb. 18, 2021 interim meetings. *(Doc. ID 2020-030.01, 2021-031.01, 2021-032.01.)*
—Kevin Fry (IL), Eric Kolchinsky (NAIC), Charles Therriault (NAIC), Marc Perlman (NAIC) Attachment One
Attachment Two
Attachment Three
2. Discuss Comments and Consider for Adoption an Updated Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Update the Financial Modeling Instructions for RMBS/CMBS Securities and Direct IAO Staff to Produce NAIC Designation and NAIC Designations Categories for Non-Legacy Securities *(Doc. ID 2021-027.01, 2021-027.02)*
—Kevin Fry (IL), Eric Kolchinsky (NAIC), Charles Therriault (NAIC), Marc Perlman (NAIC) Attachment Four
Four - A & Four - B
3. Discuss Comments Received and Consider for Adoption an Updated Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Require the Filing of Private Rating Letter Rationale Report *(Doc. ID 2020-023.02, 2020-023.03)*
—Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC) Attachment Five
Five - A & Five - B



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| 4. Discuss Comments Received and Consider for Adoption a Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Update the List of NAIC Credit Rating Providers to Reflect NRSRO Changes
<i>(Doc. ID 2021-028.01)</i>
—Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC) | Attachment Six |
| 5. Receive a Request from the ACLI to Study the National Financial Presentation Standard for Spanish GAAP.
<i>(Doc. ID 2021-033.01)</i>
—Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC) | Attachment Seven |
| 6. Discuss and Receive a Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Clarify Guidance for Fund Leverage
<i>(Doc. ID 2021-034.01)</i>
—Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC) | Attachment Eight |
| 7. Hear a Staff Report on Projects Before the Statutory Accounting Principles (E) Working Group
—Julie Gann (NAIC) | |
| 8. Receive a Report from SVO on Year-end Carry-over Filings
—Charles Therriault (NAIC) | |
| 9. Receive a Report from SVO on Credit Tenant Loan Referral Response Update
—Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC) | |
| 10. Any other matters | |

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Draft Pending Adoption

Draft: 12/3/2020

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The SVO's recommendation is to retain all of these investment risk assessment-related functions within the WCFI section of the P&P Manual and recommend that the remaining changes be adopted as soon as possible to conform the P&P Manual to the AP&P Manual. Mr. Fry said this section takes the amendments authorized by the Statutory Accounting Principles (E) Working Group and puts them into SSAP No. 105R. This will make the guidance uniform while adding to the general analytical framework. The Task Force plans to expose this and have SSAP No. 105R and the P&P Manual in sync.

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

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

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

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

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

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

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

Marc Perlman (NAIC) said the SVO takes the position that it cannot rely on any implied parental support for a non-guaranteed subsidiary because without legally binding support, such as a guarantee, parental support of a subsidiary is entirely discretionary and ultimately reliant on the best interest of the parent. The SVO believes that no generally accepted analytical technique or methodology supports the assumption that a parent entity will necessarily support its subsidiary in times of financial distress and reached that conclusion based on its previous legal study of support obligations (which was done for the credit substitution

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guidance in the P&P Manual) and on its examination of rating agency methodologies, which include examples of parents not supporting subsidiaries.

The rating agencies are generally consistent in their approach to rating parents and subsidiaries. To give credit to one entity's relationship with another, it is necessary to first determine the stand-alone credit profile of both entities and then to notch up or down based on various factors explained in the various rating agency methodologies. These factors include: a parent's willingness and ability to support its subsidiary; strategic importance and core versus non-core businesses; and legal, operational and strategic ties between the parent and its subsidiary. While neither Standard & Poor's (S&P) nor Fitch Ratings (Fitch) directly addresses the question of whether an unrated, non-guaranteed subsidiary should or should not be assigned a rating based on implied support from its parent, they do make the determination of the stand-alone rating a key starting point for determining parent and subsidiary ratings. This means a subsidiary for which they cannot determine a stand-alone rating would receive no benefit from its parent. Moody's, however, provides a persuasive explanation of the problems with implying a parent's support for its subsidiary in the absence of a legally binding support agreement. Moody's writes:

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

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

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

The general rule among rating agencies that the strength of a parent can, at best, be used to notch up the subsidiary's stand-alone rating supports the similar approach found in the P&P Manual. This rule precludes the SVO from analytically deriving a designation for a subsidiary from its parent when the subsidiary has no stand-alone rating or NAIC designation. The SVO is aware that some in industry and some regulators have a different opinion on this topic. Therefore, if the Task Force deems it essential that the SVO be able to assign designations to WCFI transactions with unrated, non-guaranteed obligors, and based on the outcome of a referral to the Statutory Accounting Principles (E) Working Group, the SVO proposed an amendment to Part One of the P&P Manual by which the Task Force directs the SVO to rely upon the rating or designation of a WCFI obligor's parent entity.

Ms. Belfi said that for the Statutory Accounting Principles (E) Working Group, if a subsidiary is not a rated entity, it was one of the criteria for WCF notes. The Working Group talked about parental guarantees and concluded that the industry could not give a formal parental guarantee, which is a huge barrier for these notes. She asked if the SVO could provide some type of a

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rating to these subsidiaries that are not rated and if it is going to be based upon information from their parent. She also asked if this was being worked on in conjunction with Working Group to make sure that it is on board with this change.

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

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

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

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

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

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

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

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

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

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

5. Discussed Bespoke Securities and NAIC Reliance on CRP Ratings

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Mr. Fry said if the Task Force can just get the documentation, it can start to see the trends or even see individual examples and then couple that with data. The Task Force would find it useful to know how ratings are being used now in the context of a big bond portfolio with a lot of issuers, how many of them have multiple ratings and how many of them have a single rating that is private. If all of this is put together, then the Task Force can develop the policy part. It might be a case-by-case basis, or they might involve themes. It might be safer to quickly get the mandate to get this documentation and start studying the data and then set the policy as the Task Force moves forward in 2021. Ms. Belfi and Ms. Mears agreed. Mr. Fry said the quicker the Task Force gets that requirement, the quicker the Task Force can make that important policy decision.

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

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

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

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

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

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

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

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

Sasha Kamper (PPIA) said a lot of the things that Mr. Reese said about the concerns and the need for capital certainty in this marketplace. This is a marketplace that has historically not only offered additional yield to insurers above and beyond what can be obtained in the public corporate market, but also it has been found by multiple studies from the Society of Actuaries (SOA) that it has lower credit class experience as well. It outperforms the corporate public market in multiple ways. It is an important market for most insurers, and it is important to ensure that these deals stay part of the market. The concern is, as Mr. Reese said, that if by allowing the Task Force to override ratings, not because of some large thematic concern that poses a systemic risk to industries and insurers, it might encounter a difference of professional opinion, which does happen all the time, even among rating agencies. They sometimes can have a difference of opinion on a deal that causes capital uncertainty from insurers. If one bought it thinking one is going to have to be able to carry an NAIC 2.B type of capital and then find out it is an NAIC 2.C when moved to more granularity or worse yet, it is NAIC 3.A, that has really meaningful economic impact for insurers. It will cause insurers to want to steer away from this asset class. More importantly, it will probably cause bankers to start to advise their borrowers against this market's difficulty and steer them to the bank loan markets instead, which would deprive one of the opportunity to invest in good deals. Ms. Kamper said industry is very supportive of the idea of being

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transparent and is supportive of filing the private ratings letters and the rationales. She said it will take some time to work with the agencies to ensure that there are rationales for all the deals. Some of them right now just have a one-page letter with a rating and will require help in adjusting the confidentiality language to feel comfortable sharing it. She said as long as they are given time to do that, they will work towards that as they believe most of the rating agencies will accommodate. Ms Kamper said she does agree with some of the issues that Ms. Mears has raised. Ms. Kamper said she believes that maybe right now, the Task Force should focus on gathering the information and at a later time determine what the real risks are and what is the best way to fix.

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

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

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

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

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

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

8. Discussed Other Matters

Mr. Therriault said that to follow up on Ms. Gann's comments on CTLs, the SVO was requested to look at nonconforming CTL for year-end 2020. The SVO requests companies that have these securities to submit them to the SVO. He said he envisions a full filing package, including all the legal agreements, CTL forms, financial statements, property assessments and the rating agency rating analysis. As there is potential property risk associated with some of these CTLs, additional documentation may

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be necessary. Mr. Therriault said the SVO will be assigning a subscript “S” for these issues to indicate additional risks. The SVO is in the process of working to update the CTL forms and will have that published on the SVO web page underneath the tab labeled “Filing Info,” which is where the additional document guidance is located. The SVO will also start a project to review the 5% residual asset exposure and see if there are additional mitigants to identify that would make a CTL conform to the existing guidance. The SVO plans to report the results of that research to the Task Force and the Working Group.

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

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

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

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

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

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

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

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Valuation of Securities (E) Task Force
Virtual Meeting
December 18, 2020

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. Range 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.

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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.

2. Discussed Financially Modeled RMBS/CMBS Price Breakpoints and Other Issues Surrounding Securities That Have Zero-Loss in 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

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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.

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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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Valuation of Securities (E) Task Force
3/22/21

Draft: 3/10/21

Valuation of Securities (E) Task Force
Virtual Meeting
February 18, 2021

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 Sirovets (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 A. Fable 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 an amendment 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

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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.

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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 received 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. Ms. 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

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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.

Mr. Everett asked if the Statutory Accounting Principles (E) Working Group is setting the investment standards. Mr. Therriault said the Working Group sets the classification of assets and what schedules they are reported on. The Task Force sets the risk assessment of those assets. Mr. Everette said it looks like there is a shift from the P&P Manual of the residual risk to the AP&P Manual. Mr. Therriault said this referral is to guidance that is in the P&P Manual now that says there cannot be more than a 5% residual risk for a CTL to be conforming to the P&P Manual. SVO staff are aware that there are CTLs that are not conforming.

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

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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 ask 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.

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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.

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MEMORANDUM

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

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

CC: Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)* to Update the Financial Modeling Instructions for RMBS/CMBS Securities and Direct IAO Staff to Produce NAIC Designation and NAIC Designations Categories for Non-Legacy Securities

DATE: ~~February 03, 2021~~ March 5, 2021

1. Summary – On Oct. 11, 2018, the Valuation of Securities (E) Task Force adopted an amendment to delete the Modified Filing Exempt (MFE) provisions from the P&P Manual and directed a referral to the Statutory Accounting Principles (E) Working Group recommending the deletion of the MFE provisions from Statement of Statutory Accounting Principles (SSAP) No. 43R—Loan-Backed and Structured Securities. The effect of these changes resulted in these securities coming under the filing exempt instructions in the P&P Manual, if they have an Eligible NAIC CRP Credit Rating assigned to them. This change eliminated using the book adjusted carrying value to determine the NAIC designation for these securities.

The IAO staff reported to the Task Force at the 2019 Summer National Meeting that at some point the NAIC should align the RMBS/CMBS modeling to provide a single NAIC Designation for modeled RMBS/CMBS. This would have been a change from the current practice of providing a series of book adjusted carrying value price breakpoints to companies to determine the NAIC designation. The IAO staff submitted a proposal to the Task Force at the 2019 Fall National Meeting to eliminate the book adjusted carrying value price breakpoint process but the Task Force decided at the Feb. 4, 2020 meeting to defer such a change because industry expressed concerns there would be significant adverse risk-based capital (RBC) consequences from making such a change at that time.

In March 2020, the impact from the pandemic was just beginning to become apparent in the U.S. The pandemic's effect on RMBS and CMBS securities became more observable during the 2020 year-end financial modeling process. The 2020 year-end financial modeling identified several securities that no longer qualified as being zero-loss because more conservative scenarios, necessary to reflect the economic impact of the pandemic, were applied. Once these securities no longer qualified as being zero-loss, they became subject to the book adjusted carrying value price breakpoints process. Many of these securities are owned at a significant premium because of the low interest rate environment and, once the price break points were applied, securities that would otherwise be considered very high

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quality were required to be reported as an NAIC 2, 3, or 4 just because of their book adjusted carrying value and not because of any credit concern.

At the Task Force's Dec. 18, 2020 meeting, industry, represented by the ACLI, agreed with the IAO staff that the mechanics of the price break points was causing insurer owned securities with otherwise strong credit to be reported as NAIC 2, NAIC 3 and NAIC 4 under the financial modeling price breakpoints process purely because they are owned at a premium and not because of their credit risk. It was also discussed that the use of financial modeling price breakpoints process was possibly disrupting the market for these otherwise high-quality investments. SSG staff at that meeting recommended getting rid of the price breakpoints process.

2. Recommendation – The IAO staff recommends that the NAIC move to a single NAIC designation and NAIC designation category for all non-Legacy Securities (those financially modelled RMBS/CMBS securities that closed on or after to Jan. 1, 2013). Moving away from financial modeling price breakpoints process for these non-Legacy Securities will avoid further and future market disruptions and permit a clearer assessment of the credit risk assessment for these securities that will not be impacted by the insurers book adjusted carrying value. Making this change for only non-Legacy Securities preserves their historical treatment. Given the potential impact to SSAP 43R - *Loan-Backed and Structured Securities*, staff recommends a referral to the Statutory Accounting Principles (E) Working Group.

3. Proposed Amendment – The following text shows the revisions in Part Four that would appear in the 2020 P&P Manual format.

PART FOUR
THE NAIC STRUCTURED SECURITIES GROUP

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DEFINITIONS

1. The following terms used in this Part Four have the meaning ascribed to them below.
 - **ABS** stands for asset-backed securities and means structured securities backed by consumer obligations originated in the United States.
 - **CMBS** stands for commercial mortgage-backed securities and means structured securities backed by commercial real estate mortgage loans originated in the United States. The definition of CMBS may refer to securitizations backed by commercial mortgages, respectively, originated outside of the United States if and to the extent that the vendor selected by the NAIC to conduct the financial modeling: (a) has the necessary information about the commercial mortgage and commercial mortgage loans originated outside of the United States to fully model the resulting securities; and (b) can adapt the modeling process to account for any structural peculiarities associated with the jurisdiction in which the mortgage was originated.
 - **Initial Information** means the documentation required to be filed with an Initial Filing of an RMBS or a CMBS CUSIP, pursuant to the section below and pertaining to Loan Information, Reps and Warranty Information and Structure and Formation Information for the transaction, where:
 - *Loan Information* means a review of the loan files by a third party to assess the sufficiency of legal title and other related issues.
 - *Reps and Warranty Information* means the actual representation and warranties in effect for the securitization given by the mortgage originator(s) to the Trust pertaining to loan origination processes and standards, compliance with applicable law, loan documentation and the process governing put backs of defective mortgages back to the originator(s).
 - *Structure and Formation Information* means the waterfall, as described in the definition of Ongoing Information, information and documentation in the form of legal opinions and documentation governing the formation of the securitization and its entities relative to issues such as bankruptcy remoteness, true sale characterization, the legal standards and procedures governing the securitization and other similar issues.
 - **Intrinsic Price** is an output of financial modeling, defined as ‘1 - weighted average of discounted principal loss’ expressed as a percentage, reflecting the credit risk of the security.

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- **Legacy Security**, for the purposes of this section shall mean any RMBS and any CMBS that closed prior to January 1, 2013.
- **Official Price Grids** means and refers to those generated by the SSG and provided to an insurance company or insurance companies that own the security for regulatory reporting purposes.
- **Ongoing Information** consists of: (a) tranche level data; such as principal balance, factors, principal and interest due and paid, interest shortfalls, allocated realized losses, appraisal reductions and other similar information for the specific tranche; (b) trust level data, such as aggregate interest and principal and other payments received, balances and payments to non-tranche accounts, aggregate pool performance data and other similar information; (c) loan level performance information; and (d) a computerized model of rules that govern the order and priority of the distribution of cash from the collateral pool (i.e., the “waterfall”) to the holders of the certificates/securities—provided in the format and modeling package used by the NAIC financial modeling vendor.
- **Original Source**, with respect to a specific set of data, means the Trustee, Servicer or similar entity that is contractually obligated under the agreement governing the RMBS or CMBS to generate and maintain the relevant data and information in accordance with standards specified in applicable agreements or an authorized re-distributor of the same.
- **NAIC Designation Intrinsic Price Mapping** is the mapping of the Intrinsic Price to a single NAIC Designation and Designation Category employing the midpoints between each adjoining AVR RBC charges (pre-tax). The midpoints are directly used as the minimum Intrinsic Prices (weighted average loss points) for corresponding NAIC Designations and Designation Categories.
- **Price Grids** means and refers to CUSIP-specific price matrices containing six price breakpoints; i.e., each price corresponding to a specific NAIC Designation category. Each breakpoint on a Price Grid is the price point that tips the NAIC Designation for the RMBS CUSIP into the next NAIC Designation (credit quality/credit risk) category. The plural is used because two Price Grids are generated for any CUSIP. This reflects the difference in RBC for those insurance companies that maintain an asset valuation reserve and for those insurance companies that do not.

- **Re-REMIC** is a securitization backed by: (a) otherwise eligible RMBS from one or two transactions; or (b) otherwise eligible CMBS from one or two transactions at closing. Re-REMICs cannot acquire any Underlying Securities after closing.
- **RMBS** stands for residential mortgage-backed securities and means structured securities backed by non-agency residential mortgages originated in the United States, where the collateral consists of loans pertaining to non-multi-family homes. That includes prime, subprime and Alt-A mortgages, as well as home-equity loans, home-equity lines of credit and Re-REMICs of the above. Excluded from this definition is agency RMBS, where the mortgages are guaranteed by federal and federally sponsored agencies such as the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC) and loans against manufactured or mobile homes or collateralized debt obligations backed by RMBS. The exclusion covers bonds issued and guaranteed by, or only guaranteed by, the respective agency. Also not included are loans guaranteed by the U.S. Department of Veteran Affairs or the U.S. Department of Agriculture's Rural Development Housing and Community Facilities Programs. The definition of RMBS may refer to securitizations backed by residential mortgages, respectively, originated outside of the United States if and to the extent that the vendor selected by the NAIC to conduct the financial modeling: (a) has the necessary information about the residential mortgage and residential mortgage loans originated outside of the United States to fully model the resulting securities; and (b) can adapt the modeling process to account for any structural peculiarities associated with the jurisdiction in which the mortgage was originated.
- **Underlying Security** means the RMBS or CMBS backing a Re-REMIC. A Re-REMIC cannot be an Underlying Security.

NOTE: The definitions of RMBS and CMBS reflect limitations associated with the financial modeling process, NAIC credit rating provider (CRP) internal naming conventions and SSG processes, as more fully discussed below and may, therefore, be subject to a narrower or a broader reading in any reporting period. Please call the SSG with any concerns or questions about the scope of the definitions for a given reporting period. Also note:

- It is possible that the scope of the RMBS and CMBS definitions may be broadened because the financial modeling vendors indicate other collateral or waterfall structures can be modeled.

- NAIC CRPs may adopt different internal conventions with respect to what market or asset segments are within their rated populations of RMBS, CMBS or ABS. This could affect the application of the adopted NAIC methodology or require the NAIC to select which naming process it wishes to adopt.
- It is possible that the SSG will acquire analytical assessment capabilities that permit the assessment of existing, additional or different structured securities that cannot now be modeled or that are not currently rated.

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ADMINISTRATIVE AND OPERATIONAL MATTERS

Certain Administrative Symbols

2. The following administrative symbols are used in the Valuation of Securities (VOS) Products to identify RMBS and CMBS that the NAIC vendor has confirmed will be subject to the financial modeling methodology described in this Part.
- **FMR** – Indicates that the specific CUSIP identifies a **Legacy Security** RMBS that is subject to the financial modeling methodology **and the application of Price Grids to determine a NAIC Designation and Designation Category.**
 - **FMC** – Indicates that the specific CUSIP identifies a **Legacy Security** CMBS that is subject to the financial modeling methodology **and the application of Price Grids to determine a NAIC Designation and Designation Category.**
 - **Non-Legacy RMBS and CMBS subject to the financial modeling methodology would be assigned an NAIC Designation and Designation Category by the SSG without an administrative symbol.**
 - ~~**FSR** – Indicates that the specific CUSIP identifies a non-Legacy Security RMBS that is subject to the financial modeling methodology and assignment of a NAIC Designation and Designation Category by the SSG.~~
 - ~~**FSC** – Indicates that the specific CUSIP identifies a non-Legacy Security CMBS that is subject to the financial modeling methodology and assignment of a NAIC Designation and Designation Category by the SSG.~~

NOTE: The administrative symbols **FMR** and, **FMC**, ~~**FSR** and **FSC**~~ are related to symbols that insurers are required to use in the financial statement reporting process. Under applicable financial statement reporting rules, an insurer uses the symbol **FM** as a suffix to identify **Legacy Security** modeled RMBS and CMBS CUSIPs **and ~~FS~~ as a suffix to identify non-Legacy Security modeled RMBS and CMBS CUSIPs.** The symbol **FM** ~~or **FS**~~ is inserted by the insurer in the financial statement as a suffix following the NAIC Designation **Category for **Legacy Security RMBS and CMBS;**** (e.g., **2.B FM**) ; **and for Non-Legacy RMBS and CMBS it would be left blank (e.g 3.C).**

The use of these administrative symbols in the VOS Product means the insurer should not use the filing exempt process for the security so identified.

Quarterly Reporting of RMBS and CMBS

3. To determine the NAIC Designation to be used for quarterly financial statement reporting for an RMBS or CMBS purchased subsequent to the annual surveillance described in this Part, the insurer uses the prior year-end modeling data for that CUSIP (which can be obtained from the NAIC) and follows the instructions in contained under the heading “Use of Net Present Value and Carrying Value for Financially Modelled Legacy Security RMBS and CMBS” ~~below~~ or ~~follows the instructions in~~ “~~Publication of Final Results Use of Intrinsic Price for Financially Modeled non-Legacy Security RMBS and CMBS~~” below, subject to, and in accordance with, *SSAP No. 43R—Loan-Backed and Structured Securities*.

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FILING EXEMPTIONS

Limited Filing Exemption for RMBS and CMBS

4. **RMBS and CMBS that Can be Financially Modeled** – RMBS and CMBS that can be financially modeled are exempt from filing with the SVO. NAIC Designations for RMBS and CMBS that can be financially modeled are determined by application of the methodology discussed in this Part, not by the use of credit ratings of CRPs.
5. **RMBS and CMBS securities that Cannot be Financially Modeled**
 - **But Are Rated by a CRP** – RMBS and CMBS that cannot be financially modeled but that are rated by a CRP are exempt from filing with the SSG. The NAIC Designations for these RMBS and CMBS are determined by application of the filing exemption procedures discussed in this Manual.
 - **But Are Not Rated by a CRP** – RMBS and CMBS that cannot be financially modeled and that are not rated by a CRP are not filing exempt and must be filed with the SSG or follow the procedures, as discussed below in this Part.

Filing Exemption for ABS

6. ABS rated by a CRP are exempt from filing with the SSG.

Review of Decisions of the SSG

7. Analytical decisions made through the application of financial modeling are not subject to the appeal process. In the absence of an appeal, the SSG shall provide whatever clarification as to the results of financial modeling is possible to any insurer who requests it and owns the security, provided that it is not unduly burdensome for the SSG to do so. Any decision made by the SSG that results in the assignment of an NAIC Designation and does not involve financial modeling methodology, whether developed by the SSG on its own or in collaboration with the SVO, is subject to the appeal process.

REQUIRED DATA AND DOCUMENTS FOR TRANSACTIONS SUBMITTED TO THE SSG

8. The policy statement set forth in this section shall be applicable generally to any transaction filed with the SSG for an analytical assessment, including, but not limited to, a Price Grid or for assignment of an NAIC **Designation**. Any filing with the SSG is deemed to be incomplete unless the insurer has provided the information, documentation, and data in quantity and quality sufficient to permit the SSG to conduct an analysis of the creditworthiness of the issuer and the terms of the security to determine the requested analytical value. It is the obligation of the reporting insurance company to provide the SSG with all necessary information. It is the responsibility of the SSG to determine whether the information provided is sufficient and reliable for its purposes and to communicate informational deficiencies to the reporting insurance company.

Documentation Standards

9. In order for an insurer-owned RMBS or CMBS to be eligible for the year-end modeling process, conducted pursuant to this section below, the analysis must be based on information, documentation and data of the utmost integrity. A Legacy Security must meet the Ongoing Information requirements. An RMBS, CMBS or Re-REMIC that is not a Legacy Security must meet the Initial Information and Ongoing Information requirements. For the purposes of determining a Re-REMIC's status as a Legacy Security, the closing date of the Re-REMIC (not the Underlying Security) shall be used. The SSG may, in its sole discretion, determine that the Initial Information and/or Ongoing Information is not sufficient and/or not reliable to permit the RMBS or CMBS CUSIP to be eligible for financial modeling. If the SSG determines that the Initial Information and/or Ongoing Information is not sufficient and/or not reliable to permit the RMBS or CMBS CUSIP to be eligible for financial modeling, it will communicate this decision to the insurer and invite a dialogue to ascertain whether alternative information is available that would be deemed sufficient and/or reliable by the SSG.

Initial Information Requirements

10. An RMBS or CMBS meets the Initial Information Requirements if the security meets one of the following three conditions:
 - **RTAS** – The RMBS or CMBS was assigned a preliminary price grid or designation as described in this Part;
 - **Initial Sufficiency Filing** – The RMBS or CMBS was reviewed by SSG through an Initial Sufficiency Filing; or

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- **Safe Harbor** – The RMBS or CMBS meets the Safe Harbor requirements.

Initial Sufficiency Information Filing

11. An insurance company may file Initial Sufficiency Information with the SSG for the purpose of obtaining a determination that an RMBS or CMBS CUSIP is eligible for financial modeling under the annual surveillance process discussed below. Initial Sufficiency Information is only filed once for any given RMBS or CMBS. Reporting insurance companies are solely responsible for providing the SSG with Initial Information. A determination by the SSG that a given RMBS or CMBS CUSIP is eligible for financial modeling after an Initial Sufficiency Filing assessment is subject to the further and continuing obligation that the SSG obtain or the insurer provide the SSG with updated Ongoing Information close to the date of the annual surveillance.
12. **Required Documents for Initial Sufficiency Filing** – An insurer that owns an RMBS or a CMBS for which Initial Information is not publicly available shall provide the SSG with the following documentation.
13. **RMBS** – Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for an RMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:
 - Pooling and Servicing Agreement or similar
 - Prospectus, Offering Memorandum or similar; Accountant’s comfort letter
 - If applicable, ISDA Schedules and Confirmations or similar
 - Legal opinions given in connection with the transaction
 - Any other documents referenced by the above
 - Third-Party Due diligence scope document and raw results. If less than 100% due diligence, detailed description of the loan selection process
 - If applicable, loan purchase agreements or similar. Loan Tape
14. **CMBS** – Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for a CMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:
 - Pooling and Servicing Agreement or similar
 - Prospectus, Offering Memorandum or similar; Accountant’s comfort letter
 - If applicable, ISDA Schedules and Confirmations or similar

- Legal opinion given in connection with the transaction
- Any other documents referenced in the above
- Asset Summaries
- Loan Tape
- Loan documents, including reliable information about the terms of the transaction; including, but not limited to, financial covenants, events of default, legal remedies and other information about financial, contractual or legal aspects of the transaction in form and substance consistent with industry best practices for CMBS issuance.
- In certain cases, additional documents below will enable the SSG to verify and validate initial underwriting information of the property securing the CMBS. These documents may be required in form and substance consistent with best practices for typical CMBS issuance.
- Historical operating statements and borrower's budget
- Underwriter's analysis of stabilized cash flow with footnotes of assumptions used
- Property type specific, rent roll information
- Appraisals and other data from recognized industry market sources
- Independent engineering report (Property Condition Assessment)
- Environmental Site Assessment (ESA) – Phase I/Phase II
- Documentation related to seismic, flood and windstorm risks
- Franchise agreements and ground leases, if applicable
- Management agreements

SSG Modeling Alerts

15. The SSG shall at all times have discretion to determine that differences in the structure, governing law, waterfall structure or any other aspect of a securitization or a class of securitization requires that insurance companies provide Initial Information and/or Ongoing Information additional to or different from that identified in this Part. The SSG shall communicate such additional or different documentation requirements to insurers by publishing a Modeling Alert on the NAIC website and scheduling a meeting of the VOS/TF to ensure public dissemination of the decision.

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Safe Harbor

16. Safe Harbor options serve as proxies for the Initial Sufficiency filing. The options reflect publicly available information that a third party has analyzed the Initial Information. Because the structured securities market is quite dynamic, the list of Safe Harbor options may change frequently, with notice and opportunity for comment, as described in this section. An RMBS or CMBS meets the Initial Information requirement if:

- At least two Section 17(g)-7 reports issued by different CRPs are publicly available;
or
- A security that is publicly registered under the federal Securities Act of 1933.

Ongoing Information Requirements

17. An RMBS or CMBS meets the Ongoing Information Requirements if Ongoing Information is available to the SSG and the relevant third-party vendor from an Original Source. The SSG, in its sole discretion and in consultation with the relevant third-party vendor, may determine that the Ongoing Information is not sufficient or reliable to permit a given RMBS or CMBS CUSIP to be financially modeled. However, in making such a determination, the SSG shall take into account reasonable market practices and standards.

Special Rules for Certain Re-REMICs

18. Re-REMICs are generally simple restructurings of RMBS or CMBS. An Initial Sufficiency Filing for a Re-REMIC (a) which is not a Legacy Security itself but (b) where each Underlying Security is a Legacy Security shall not require submission of information regarding the Underlying Securities. In most cases, a prospectus for the Re-REMIC will be sufficient. If the SSG determines that additional information about the Re-REMIC structure or formation is required, it will communicate this decision to the insurer and invite a dialogue to ascertain whether additional information is available that would be deemed sufficient by the SSG.

ANALYTICAL ASSIGNMENTS

ANNUAL SURVEILLANCE OF RMBS AND CMBS – MODELED AND NON-MODELED SECURITIES

Scope

19. This section explains the financial modeling methodology applicable to **all** RMBS and CMBS (defined above) securitizations, ~~and~~ the book/adjusted carrying value methodology applicable to **a modeled Legacy Security, the NAIC Designation Intrinsic Price Mapping applicable to a modeled non-Legacy Security,** and non-modeled securities subject to *SSAP No. 43R—Loan-Backed and Structured Securities*. Please refer to SSAP No. 43R for a description of securities subject to its provisions. The VOS/TF does not formulate policy or administrative procedures for statutory accounting guidance. Reporting insurance companies are responsible for determining whether a security is subject to SSAP No. 43R and applying the appropriate guidance.

Important Limitation on the Definitions of RMBS and CMBS

20. The definitions of RMBS and CMBS above are intended solely to permit the SSG to communicate with financial modeling vendors, insurance company investors who own RMBS and CMBS subject to financial modeling and/or the book/adjusted carrying value methodology and their investment advisors to facilitate the performance by the SSG of the financial modeling methodology described below. The definitions contained in this section are not intended for use and should not be used as accounting or statutory statement reporting instructions or guidance.

NOTE: Please refer to *SSAP No. 43R—Loan-Backed and Structured Securities* for applicable accounting guidance and reporting instructions.

ANALYTICAL PROCEDURES APPLICABLE TO RMBS AND CMBS SECURITIZATIONS SUBJECT TO FINANCIAL MODELING METHODOLOGY

Filing Exemption Status of RMBS and CMBS

21. RMBS and CMBS are not eligible for ~~the~~ filing exemption because credit ratings of CRPs are no longer used to set risk-based capital (RBC) for RMBS or CMBS. However, RMBS and CMBS are not submitted to the SSG.

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Use of Financial Modeling for Year-End Reporting for RMBS and CMBS

22. Beginning with year-end 2009 for RMBS and 2010 for CMBS, probability weighted net present values will be produced under NAIC staff supervision by an NAIC-selected vendor using its financial model with defined analytical inputs selected by the SSG. The vendor will provide the SSG with a **Intrinsic Price and/or a range of net present values** for each RMBS or CMBS corresponding to each NAIC Designation category. The NAIC Designation for a specific **Legacy Security** RMBS or CMBS is determined by the insurance company, based on book/adjusted carrying value ranges, **and the NAIC Designation for a specific non-Legacy Security RMBS or CMBS is determined by the NAIC Designation Intrinsic Price Mapping by SSG.**

NOTE: Please refer to *SSAP No. 43R—Loan-Backed and Structured Securities* for guidance on all accounting and related reporting issues.

Analytical Procedures for RMBS and CMBS

23. The SSG shall develop and implement all necessary processes to coordinate the engagement by the NAIC of a vendor who will perform loan-level analysis of insurer-owned RMBS and CMBS using the vendor's proprietary models.

RMBS AND CMBS SUBJECT TO FINANCIAL MODELING
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Setting Microeconomic Assumptions and Stress Scenarios

24. Not later than September of each year, the SSG shall begin working with the vendor to identify the assumptions, stress scenarios and probabilities (hereafter model criteria) the SSG intends to use at year-end to run the vendor's financial model.

The Financial Modeling Process

25. Information about the financial modeling process can be found at www.naic.org/structured_securities/index_structured_securities.htm.

Use of Net Present Value and Carrying Value for Financially Modeled Legacy Security RMBS and CMBS

26. For each modeled Legacy Security RMBS and CMBS, the financial model determines the net present value at which the expected loss equals the midpoint between the RBC charges for each NAIC Designation; i.e., each price point, if exceeded, changes the NAIC Designation. Net present value is the net present value of principal losses, discounted using the security’s coupon rate (adjusted in case of original issue discount securities to book yield at original issue and in case of floating rate securities, discounted using LIBOR curve + Origination spread). Because of the difference in RBC charge, the deliverable is five values for each RMBS and CMBS security for companies required to maintain an asset valuation reserve (AVR) and five values for companies not required to maintain an AVR. This is illustrated in the chart below.

RBC charge / NAIC designation (pre-tax)

P&C	RBC	Midpoint
1	0.3%	0.65%
2	1.0%	1.50%
3	2.0%	3.25%
4	4.5%	7.25%
5	10.0%	20.00%
6	30.0%	
Life	RBC	Midpoint
1	0.4%	0.85%
2	1.3%	2.95%
3	4.6%	7.30%
4	10.0%	16.50%
5	23.0%	26.50%
6	30.0%	

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

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

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

Use of Intrinsic Price for Financially Modeled non-Legacy Security RMBS and CMBS

28. The NAIC Designation and NAIC Designation Category for a given modeled non-Legacy Security RMBS or CMBS CUSIP owned by a given insurance is assigned by SSG and **does not** depend on the insurer’s book/adjusted carrying value of each RMBS or CMBS. The NAIC Designation and Designation Category assigned will be determined by applying the Intrinsic Price to the NAIC Designation Intrinsic Price Mapping, as defined in this Part.

**SECURITIES NOT MODELED BY THE SSG AND NOT RATED BY AN NAIC CRP
OR DESIGNATED BY THE SVO**

29. Securities subject to *SSAP No. 43R—Loan-Backed and Structured Securities* that cannot be modeled by the SSG and are not rated by an NAIC CRP or designated by the SVO are either: (a) assigned the NAIC administrative symbol **ND** (not designated), requiring subsequent filing with the SVO; or (b) assigned the NAIC Designation for Special Reporting Instruction [i.e., an **NAIC 5GI**, NAIC Designation Category **NAIC 5.B GI** or **NAIC 6*** (six-star)].

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MORTGAGE REFERENCED SECURITIES

Definition

30. A Mortgage Referenced Security has the following characteristics: A Mortgage Referenced Security's coupon and/or principal payments are linked, in whole or in part, to prices of, or payment streams from, real estate, index or indices related to real estate, or assets deriving their value from instruments related to real estate, including, but not limited to, mortgage loans.

Not Filing Exempt

31. A Mortgage Referenced Security is not eligible for filing exemption but is subject to the filing requirement.

NAIC Risk Assessment

32. In determining the NAIC Designation of a Mortgage Referenced Security, the SSG may use the financial modeling methodology discussed in this Part, adjusted (if and as necessary) to the specific reporting and accounting requirements applicable to Mortgage Referenced Securities.

Quarterly Reporting for Mortgage Reference Securities

33. To determine the NAIC Designation to be used for quarterly financial statement reporting for a Mortgage Reference Security purchased subsequent to the annual surveillance described in this Part, the insurer uses the prior year-end modeling data for that CUSIP (which can be obtained from the NAIC) until the annual surveillance data is published for the current year. For a Mortgage Reference Security that is not in the prior year-end modeling data for that CUSIP, the insurer may follow the instructions in Part Two of this manual for the assignment of the SVO Administrative Symbol "Z" provided the insurer owned security meets the criteria for a security that is in transition in reporting or filing status.

NOTE: Please refer to SSAP No. 26R and SSAP No. 43R for the definition of and guidance on Structured Notes and Mortgage Referenced Securities. Please also refer to Part Three of this Manual for guidance about the filing exempt status of Structured Notes.

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GROUND LEASE FINANCING TRANSACTIONS

Definition

34. Ground Lease Financing (GLF) transactions are defined and explained in “Ground Lease Financing Transactions” in Part Three of this Manual.

SSG Role and Process

1. On occasion, the SVO may refer a GLF transaction to the SVO for financial modeling of the GLF space leases or business operation, as applicable, in accordance with the process set forth in “Ground Lease Financing Transactions” in Part Three of this Manual. Following an SVO referral the SSG and SVO will maintain open communication related to requests for additional data, analytical questions and analytical conclusions. Any GLF transaction NAIC Designation will be assigned by the SVO.

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THE RTAS – EMERGING INVESTMENT VEHICLE

Purpose

2. Price grids **and/or Designations and Designation Categories** are generated for the exclusive use of insurance companies and the NAIC regulatory community. Insurance companies use official Price Grids **and/or Designations and Designation Categories** by following the instructions in *SSAP No. 43R—Loan-Backed and Structured Securities* to derive a final NAIC Designation for the RMBS or CMBS, which they use to derive the RBC applicable for the RMBS or CMBS.

NOTE: Please refer to SSAP No. 43R for a full explanation of the applicable procedure.

Extension of Authority

3. The Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure is extended to the SSG, and the SSG is authorized to determine probable regulatory treatment for RMBS and CMBS pursuant to this Part or for other securities, where, in the opinion of the SSG, financial modeling methodology would yield the necessary analytical insight to determine probable regulatory treatment or otherwise enable the SSG to make recommendations to the VOS/TF as to regulatory treatment for a security.

Interpretation

4. To facilitate this purpose, wherever in the Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure reference is made to the SVO, it shall be read to also refer to and apply to the SSG, adjusting for differences in the operational or methodological context. The Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure shall also be read as authority for collaboration between SVO and SSG staff functions so as to encompass RTAS assignments that require the use of SVO financial, corporate, municipal, legal, and structural analysis and related methodologies, as well as of financial modeling methodologies.

Translation of Preliminary into Official Price Grids and/or NAIC Designations and Designation Categories

5. Price Grids and/or Designations and Designation Categories (“PGD”) generated by the SSG pursuant to an RTAS are preliminary within the meaning of that term as used in the Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure and accordingly cannot be used for official NAIC regulatory purposes. Preliminary NAIC Designations are translated into official NAIC Designations by the SVO when an insurance company purchases and files the security and the SVO conducts an official assessment. However, this Manual does not require the filing of RMBS and CMBS subject to financial modeling methodology with the SSG. It is, therefore, necessary to specify a procedure for the translation of preliminary Price Grids and/or Designations and Designation Categories (“Preliminary PGD”) into official ~~Price Grids~~-PGD that can be used for NAIC regulatory purposes. Preliminary ~~Price Grids~~-PGDs generated by the SSG become an official ~~Price Grid~~ PGD within the meaning of this section when an insurance company has purchased the security for which the ~~Price Grid~~ PGD was generated and reported that security for quarterly reporting purposes using the SSG generated ~~Price Grid~~ PGD. A ~~Price Grid~~ PGD for a security reported by an insurance company for quarterly reporting is effective until the SSG conducts the next annual surveillance pursuant to this Part at which the time the ~~Price Grid~~ PGDs generated by the SSG at year-end shall be the official ~~Price Grid~~ PGDs for that security.

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MEMORANDUM

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

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

CC: Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO)

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)* to Update the Financial Modeling Instructions for RMBS/CMBS Securities and Direct IAO Staff to Produce NAIC Designation and NAIC Designations Categories for Non-Legacy Securities

DATE: February 03, 2021

1. Summary – On Oct. 11, 2018, the Valuation of Securities (E) Task Force adopted an amendment to delete the Modified Filing Exempt (MFE) provisions from the P&P Manual and directed a referral to the Statutory Accounting Principles (E) Working Group recommending the deletion of the MFE provisions from Statement of Statutory Accounting Principles (SSAP) No. 43R—Loan-Backed and Structured Securities. The effect of these changes resulted in these securities coming under the filing exempt instructions in the P&P Manual, if they have an Eligible NAIC CRP Credit Rating assigned to them. This change eliminated using the book adjusted carrying value to determine the NAIC designation for these securities.

The IAO staff reported to the Task Force at the 2019 Summer National Meeting that at some point the NAIC should align the RMBS/CMBS modeling to provide a single NAIC Designation for modeled RMBS/CMBS. This would have been a change from the current practice of providing a series of book adjusted carrying value price breakpoints to companies to determine the NAIC designation. The IAO staff submitted a proposal to the Task Force at the 2019 Fall National Meeting to eliminate the book adjusted carrying value price breakpoint process but the Task Force decided at the Feb. 4, 2020 meeting to defer such a change because industry expressed concerns there would be significant adverse risk-based capital (RBC) consequences from making such a change at that time.

In March 2020, the impact from the pandemic was just beginning to become apparent in the U.S. The pandemic's effect on RMBS and CMBS securities became more observable during the 2020 year-end financial modeling process. The 2020 year-end financial modeling identified several securities that no longer qualified as being zero-loss because more conservative scenarios, necessary to reflect the economic impact of the pandemic, were applied. Once these securities no longer qualified as being zero-loss, they became subject to the book adjusted carrying value price breakpoints process. Many of these securities are owned at a significant premium because of the low interest rate environment and, once the price break points were applied, securities that would otherwise be considered very high

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quality were required to be reported as an NAIC 2, 3, or 4 just because of their book adjusted carrying value and not because of any credit concern.

At the Task Force's Dec. 18, 2020 meeting, industry, represented by the ACLI, agreed with the IAO staff that the mechanics of the price break points was causing insurer owned securities with otherwise strong credit to be reported as NAIC 2, NAIC 3 and NAIC 4 under the financial modeling price breakpoints process purely because they are owned at a premium and not because of their credit risk. It was also discussed that the use of financial modeling price breakpoints process was possibly disrupting the market for these otherwise high-quality investments. SSG staff at that meeting recommended getting rid of the price breakpoints process.

2. Recommendation – The IAO staff recommends that the NAIC move to a single NAIC designation and NAIC designation category for all non-Legacy Securities (those financially modelled RMBS/CMBS securities that closed on or after to Jan. 1, 2013). Moving away from financial modeling price breakpoints process for these non-Legacy Securities will avoid further and future market disruptions and permit a clearer assessment of the credit risk assessment for these securities that will not be impacted by the insurers book adjusted carrying value. Making this change for only non-Legacy Securities preserves their historical treatment. Given the potential impact to SSAP 43R - *Loan-Backed and Structured Securities*, staff recommends a referral to the Statutory Accounting Principles (E) Working Group.

3. Proposed Amendment – The following text shows the revisions in Part Four that would appear in the 2020 P&P Manual format.

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PART FOUR
THE NAIC STRUCTURED SECURITIES GROUP

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DEFINITIONS

1. The following terms used in this Part Four have the meaning ascribed to them below.
 - **ABS** stands for asset-backed securities and means structured securities backed by consumer obligations originated in the United States.
 - **CMBS** stands for commercial mortgage-backed securities and means structured securities backed by commercial real estate mortgage loans originated in the United States. The definition of CMBS may refer to securitizations backed by commercial mortgages, respectively, originated outside of the United States if and to the extent that the vendor selected by the NAIC to conduct the financial modeling: (a) has the necessary information about the commercial mortgage and commercial mortgage loans originated outside of the United States to fully model the resulting securities; and (b) can adapt the modeling process to account for any structural peculiarities associated with the jurisdiction in which the mortgage was originated.
 - **Initial Information** means the documentation required to be filed with an Initial Filing of an RMBS or a CMBS CUSIP, pursuant to the section below and pertaining to Loan Information, Reps and Warranty Information and Structure and Formation Information for the transaction, where:
 - *Loan Information* means a review of the loan files by a third party to assess the sufficiency of legal title and other related issues.
 - *Reps and Warranty Information* means the actual representation and warranties in effect for the securitization given by the mortgage originator(s) to the Trust pertaining to loan origination processes and standards, compliance with applicable law, loan documentation and the process governing put backs of defective mortgages back to the originator(s).
 - *Structure and Formation Information* means the waterfall, as described in the definition of Ongoing Information, information and documentation in the form of legal opinions and documentation governing the formation of the securitization and its entities relative to issues such as bankruptcy remoteness, true sale characterization, the legal standards and procedures governing the securitization and other similar issues.
 - **Intrinsic Price** is an output of financial modeling, defined as ‘1 - weighted average of discounted principal loss’ expressed as a percentage, reflecting the credit risk of the security.

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- **Legacy Security**, for the purposes of this section shall mean any RMBS and any CMBS that closed prior to January 1, 2013.
- **Official Price Grids** means and refers to those generated by the SSG and provided to an insurance company or insurance companies that own the security for regulatory reporting purposes.
- **Ongoing Information** consists of: (a) tranche level data; such as principal balance, factors, principal and interest due and paid, interest shortfalls, allocated realized losses, appraisal reductions and other similar information for the specific tranche; (b) trust level data, such as aggregate interest and principal and other payments received, balances and payments to non-tranche accounts, aggregate pool performance data and other similar information; (c) loan level performance information; and (d) a computerized model of rules that govern the order and priority of the distribution of cash from the collateral pool (i.e., the “waterfall”) to the holders of the certificates/securities—provided in the format and modeling package used by the NAIC financial modeling vendor.
- **Original Source**, with respect to a specific set of data, means the Trustee, Servicer or similar entity that is contractually obligated under the agreement governing the RMBS or CMBS to generate and maintain the relevant data and information in accordance with standards specified in applicable agreements or an authorized re-distributor of the same.
- **NAIC Designation Intrinsic Price Mapping** is the mapping of the Intrinsic Price to a single NAIC Designation and Designation Category employing the midpoints between each adjoining AVR RBC charges (pre-tax). The midpoints are directly used as the minimum Intrinsic Prices (weighted average loss points) for corresponding NAIC Designations and Designation Categories.
- **Price Grids** means and refers to CUSIP-specific price matrices containing six price breakpoints; i.e., each price corresponding to a specific NAIC Designation category. Each breakpoint on a Price Grid is the price point that tips the NAIC Designation for the RMBS CUSIP into the next NAIC Designation (credit quality/credit risk) category. The plural is used because two Price Grids are generated for any CUSIP. This reflects the difference in RBC for those insurance companies that maintain an asset valuation reserve and for those insurance companies that do not.

- **Re-REMIC** is a securitization backed by: (a) otherwise eligible RMBS from one or two transactions; or (b) otherwise eligible CMBS from one or two transactions at closing. Re-REMICs cannot acquire any Underlying Securities after closing.
- **RMBS** stands for residential mortgage-backed securities and means structured securities backed by non-agency residential mortgages originated in the United States, where the collateral consists of loans pertaining to non-multi-family homes. That includes prime, subprime and Alt-A mortgages, as well as home-equity loans, home-equity lines of credit and Re-REMICs of the above. Excluded from this definition is agency RMBS, where the mortgages are guaranteed by federal and federally sponsored agencies such as the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC) and loans against manufactured or mobile homes or collateralized debt obligations backed by RMBS. The exclusion covers bonds issued and guaranteed by, or only guaranteed by, the respective agency. Also not included are loans guaranteed by the U.S. Department of Veteran Affairs or the U.S. Department of Agriculture's Rural Development Housing and Community Facilities Programs. The definition of RMBS may refer to securitizations backed by residential mortgages, respectively, originated outside of the United States if and to the extent that the vendor selected by the NAIC to conduct the financial modeling: (a) has the necessary information about the residential mortgage and residential mortgage loans originated outside of the United States to fully model the resulting securities; and (b) can adapt the modeling process to account for any structural peculiarities associated with the jurisdiction in which the mortgage was originated.
- **Underlying Security** means the RMBS or CMBS backing a Re-REMIC. A Re-REMIC cannot be an Underlying Security.

NOTE: The definitions of RMBS and CMBS reflect limitations associated with the financial modeling process, NAIC credit rating provider (CRP) internal naming conventions and SSG processes, as more fully discussed below and may, therefore, be subject to a narrower or a broader reading in any reporting period. Please call the SSG with any concerns or questions about the scope of the definitions for a given reporting period. Also note:

- It is possible that the scope of the RMBS and CMBS definitions may be broadened because the financial modeling vendors indicate other collateral or waterfall structures can be modeled.

- NAIC CRPs may adopt different internal conventions with respect to what market or asset segments are within their rated populations of RMBS, CMBS or ABS. This could affect the application of the adopted NAIC methodology or require the NAIC to select which naming process it wishes to adopt.
- It is possible that the SSG will acquire analytical assessment capabilities that permit the assessment of existing, additional or different structured securities that cannot now be modeled or that are not currently rated.

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ADMINISTRATIVE AND OPERATIONAL MATTERS

Certain Administrative Symbols

2. The following administrative symbols are used in the Valuation of Securities (VOS) Products to identify RMBS and CMBS that the NAIC vendor has confirmed will be subject to the financial modeling methodology described in this Part.
 - **FMR** – Indicates that the specific CUSIP identifies a **Legacy Security** RMBS that is subject to the financial modeling methodology **and the application of Price Grids to determine a NAIC Designation and Designation Category**.
 - **FMC** – Indicates that the specific CUSIP identifies a **Legacy Security** CMBS that is subject to the financial modeling methodology **and the application of Price Grids to determine a NAIC Designation and Designation Category**.
 - **FSR** – Indicates that the specific CUSIP identifies a **non-Legacy Security** RMBS that is subject to the financial modeling methodology and assignment of a NAIC Designation and Designation Category by the SSG.
 - **FSC** – Indicates that the specific CUSIP identifies a **non-Legacy Security** CMBS that is subject to the financial modeling methodology and assignment of a NAIC Designation and Designation Category by the SSG.

NOTE: The administrative symbols **FMR**~~and~~, **FMC**, **FSR** and **FSC** are related to symbols that insurers are required to use in the financial statement reporting process. Under applicable financial statement reporting rules, an insurer uses the symbol **FM** as a suffix to identify **Legacy Security** modeled RMBS and CMBS CUSIPs and **FS** as a suffix to identify **non-Legacy Security** modeled RMBS and CMBS CUSIPs. The symbol **FM** or **FS** is inserted by the insurer in the financial statement as a suffix following the NAIC Designation **C**category; e.g., **2.B FM**, **3.C FS**.

The use of these administrative symbols in the VOS Product means the insurer should not use the filing exempt process for the security so identified.

Quarterly Reporting of RMBS and CMBS

3. To determine the NAIC Designation to be used for quarterly financial statement reporting for an RMBS or CMBS purchased subsequent to the annual surveillance described in this Part, the insurer uses the prior year-end modeling data for that CUSIP (which can be obtained from the NAIC) and follows the instructions in contained under the heading “Use of Net Present Value and Carrying Value for Financially Modelled Legacy Security RMBS and CMBS” ~~below~~ or ~~follows the instructions in~~ “~~Publication of Final Results Use of Intrinsic Price for Financially Modeled non-Legacy Security RMBS and CMBS~~” below, subject to, and in accordance with, *SSAP No. 43R—Loan-Backed and Structured Securities*.

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FILING EXEMPTIONS

Limited Filing Exemption for RMBS and CMBS

4. **RMBS and CMBS that Can be Financially Modeled** – RMBS and CMBS that can be financially modeled are exempt from filing with the SVO. NAIC Designations for RMBS and CMBS that can be financially modeled are determined by application of the methodology discussed in this Part, not by the use of credit ratings of CRPs.
5. **RMBS and CMBS securities that Cannot be Financially Modeled**
 - **But Are Rated by a CRP** – RMBS and CMBS that cannot be financially modeled but that are rated by a CRP are exempt from filing with the SSG. The NAIC Designations for these RMBS and CMBS are determined by application of the filing exemption procedures discussed in this Manual.
 - **But Are Not Rated by a CRP** – RMBS and CMBS that cannot be financially modeled and that are not rated by a CRP are not filing exempt and must be filed with the SSG or follow the procedures, as discussed below in this Part.

Filing Exemption for ABS

6. ABS rated by a CRP are exempt from filing with the SSG.

Review of Decisions of the SSG

7. Analytical decisions made through the application of financial modeling are not subject to the appeal process. In the absence of an appeal, the SSG shall provide whatever clarification as to the results of financial modeling is possible to any insurer who requests it and owns the security, provided that it is not unduly burdensome for the SSG to do so. Any decision made by the SSG that results in the assignment of an NAIC Designation and does not involve financial modeling methodology, whether developed by the SSG on its own or in collaboration with the SVO, is subject to the appeal process.

REQUIRED DATA AND DOCUMENTS FOR TRANSACTIONS SUBMITTED TO THE SSG

8. The policy statement set forth in this section shall be applicable generally to any transaction filed with the SSG for an analytical assessment, including, but not limited to, a Price Grid or for assignment of an NAIC **Designation**. Any filing with the SSG is deemed to be incomplete unless the insurer has provided the information, documentation, and data in quantity and quality sufficient to permit the SSG to conduct an analysis of the creditworthiness of the issuer and the terms of the security to determine the requested analytical value. It is the obligation of the reporting insurance company to provide the SSG with all necessary information. It is the responsibility of the SSG to determine whether the information provided is sufficient and reliable for its purposes and to communicate informational deficiencies to the reporting insurance company.

Documentation Standards

9. In order for an insurer-owned RMBS or CMBS to be eligible for the year-end modeling process, conducted pursuant to this section below, the analysis must be based on information, documentation and data of the utmost integrity. A Legacy Security must meet the Ongoing Information requirements. An RMBS, CMBS or Re-REMIC that is not a Legacy Security must meet the Initial Information and Ongoing Information requirements. For the purposes of determining a Re-REMIC's status as a Legacy Security, the closing date of the Re-REMIC (not the Underlying Security) shall be used. The SSG may, in its sole discretion, determine that the Initial Information and/or Ongoing Information is not sufficient and/or not reliable to permit the RMBS or CMBS CUSIP to be eligible for financial modeling. If the SSG determines that the Initial Information and/or Ongoing Information is not sufficient and/or not reliable to permit the RMBS or CMBS CUSIP to be eligible for financial modeling, it will communicate this decision to the insurer and invite a dialogue to ascertain whether alternative information is available that would be deemed sufficient and/or reliable by the SSG.

Initial Information Requirements

10. An RMBS or CMBS meets the Initial Information Requirements if the security meets one of the following three conditions:
 - **RTAS** – The RMBS or CMBS was assigned a preliminary price grid or designation as described in this Part;
 - **Initial Sufficiency Filing** – The RMBS or CMBS was reviewed by SSG through an Initial Sufficiency Filing; or

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- **Safe Harbor** – The RMBS or CMBS meets the Safe Harbor requirements.

Initial Sufficiency Information Filing

11. An insurance company may file Initial Sufficiency Information with the SSG for the purpose of obtaining a determination that an RMBS or CMBS CUSIP is eligible for financial modeling under the annual surveillance process discussed below. Initial Sufficiency Information is only filed once for any given RMBS or CMBS. Reporting insurance companies are solely responsible for providing the SSG with Initial Information. A determination by the SSG that a given RMBS or CMBS CUSIP is eligible for financial modeling after an Initial Sufficiency Filing assessment is subject to the further and continuing obligation that the SSG obtain or the insurer provide the SSG with updated Ongoing Information close to the date of the annual surveillance.
12. **Required Documents for Initial Sufficiency Filing** – An insurer that owns an RMBS or a CMBS for which Initial Information is not publicly available shall provide the SSG with the following documentation.
13. **RMBS** – Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for an RMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:
 - Pooling and Servicing Agreement or similar
 - Prospectus, Offering Memorandum or similar; Accountant’s comfort letter
 - If applicable, ISDA Schedules and Confirmations or similar
 - Legal opinions given in connection with the transaction
 - Any other documents referenced by the above
 - Third-Party Due diligence scope document and raw results. If less than 100% due diligence, detailed description of the loan selection process
 - If applicable, loan purchase agreements or similar. Loan Tape
14. **CMBS** – Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for a CMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:
 - Pooling and Servicing Agreement or similar
 - Prospectus, Offering Memorandum or similar; Accountant’s comfort letter
 - If applicable, ISDA Schedules and Confirmations or similar

- Legal opinion given in connection with the transaction
- Any other documents referenced in the above
- Asset Summaries
- Loan Tape
- Loan documents, including reliable information about the terms of the transaction; including, but not limited to, financial covenants, events of default, legal remedies and other information about financial, contractual or legal aspects of the transaction in form and substance consistent with industry best practices for CMBS issuance.
- In certain cases, additional documents below will enable the SSG to verify and validate initial underwriting information of the property securing the CMBS. These documents may be required in form and substance consistent with best practices for typical CMBS issuance.
- Historical operating statements and borrower's budget
- Underwriter's analysis of stabilized cash flow with footnotes of assumptions used
- Property type specific, rent roll information
- Appraisals and other data from recognized industry market sources
- Independent engineering report (Property Condition Assessment)
- Environmental Site Assessment (ESA) – Phase I/Phase II
- Documentation related to seismic, flood and windstorm risks
- Franchise agreements and ground leases, if applicable
- Management agreements

SSG Modeling Alerts

15. The SSG shall at all times have discretion to determine that differences in the structure, governing law, waterfall structure or any other aspect of a securitization or a class of securitization requires that insurance companies provide Initial Information and/or Ongoing Information additional to or different from that identified in this Part. The SSG shall communicate such additional or different documentation requirements to insurers by publishing a Modeling Alert on the NAIC website and scheduling a meeting of the VOS/TF to ensure public dissemination of the decision.

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Safe Harbor

16. Safe Harbor options serve as proxies for the Initial Sufficiency filing. The options reflect publicly available information that a third party has analyzed the Initial Information. Because the structured securities market is quite dynamic, the list of Safe Harbor options may change frequently, with notice and opportunity for comment, as described in this section. An RMBS or CMBS meets the Initial Information requirement if:

- At least two Section 17(g)-7 reports issued by different CRPs are publicly available; or
- A security that is publicly registered under the federal Securities Act of 1933.

Ongoing Information Requirements

17. An RMBS or CMBS meets the Ongoing Information Requirements if Ongoing Information is available to the SSG and the relevant third-party vendor from an Original Source. The SSG, in its sole discretion and in consultation with the relevant third-party vendor, may determine that the Ongoing Information is not sufficient or reliable to permit a given RMBS or CMBS CUSIP to be financially modeled. However, in making such a determination, the SSG shall take into account reasonable market practices and standards.

Special Rules for Certain Re-REMICs

18. Re-REMICs are generally simple restructurings of RMBS or CMBS. An Initial Sufficiency Filing for a Re-REMIC (a) which is not a Legacy Security itself but (b) where each Underlying Security is a Legacy Security shall not require submission of information regarding the Underlying Securities. In most cases, a prospectus for the Re-REMIC will be sufficient. If the SSG determines that additional information about the Re-REMIC structure or formation is required, it will communicate this decision to the insurer and invite a dialogue to ascertain whether additional information is available that would be deemed sufficient by the SSG.

ANALYTICAL ASSIGNMENTS

ANNUAL SURVEILLANCE OF RMBS AND CMBS – MODELED AND NON-MODELED SECURITIES

Scope

19. This section explains the financial modeling methodology applicable to **all** RMBS and CMBS (defined above) securitizations, ~~and~~ the book/adjusted carrying value methodology applicable to **a modeled Legacy Security, the NAIC Designation Intrinsic Price Mapping applicable to a modeled non-Legacy Security,** and non-modeled securities subject to *SSAP No. 43R—Loan-Backed and Structured Securities*. Please refer to SSAP No. 43R for a description of securities subject to its provisions. The VOS/TF does not formulate policy or administrative procedures for statutory accounting guidance. Reporting insurance companies are responsible for determining whether a security is subject to SSAP No. 43R and applying the appropriate guidance.

Important Limitation on the Definitions of RMBS and CMBS

20. The definitions of RMBS and CMBS above are intended solely to permit the SSG to communicate with financial modeling vendors, insurance company investors who own RMBS and CMBS subject to financial modeling and/or the book/adjusted carrying value methodology and their investment advisors to facilitate the performance by the SSG of the financial modeling methodology described below. The definitions contained in this section are not intended for use and should not be used as accounting or statutory statement reporting instructions or guidance.

NOTE: Please refer to *SSAP No. 43R—Loan-Backed and Structured Securities* for applicable accounting guidance and reporting instructions.

ANALYTICAL PROCEDURES APPLICABLE TO RMBS AND CMBS SECURITIZATIONS SUBJECT TO FINANCIAL MODELING METHODOLOGY

Filing Exemption Status of RMBS and CMBS

21. RMBS and CMBS are not eligible for ~~the~~ filing exemption because credit ratings of CRPs are no longer used to set risk-based capital (RBC) for RMBS or CMBS. However, RMBS and CMBS are not submitted to the SSG.

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Use of Financial Modeling for Year-End Reporting for RMBS and CMBS

22. Beginning with year-end 2009 for RMBS and 2010 for CMBS, probability weighted net present values will be produced under NAIC staff supervision by an NAIC-selected vendor using its financial model with defined analytical inputs selected by the SSG. The vendor will provide the SSG with a **Intrinsic Price and/or a range of net present values** for each RMBS or CMBS corresponding to each NAIC Designation category. The NAIC Designation for a specific **Legacy Security** RMBS or CMBS is determined by the insurance company, based on book/adjusted carrying value ranges, **and the NAIC Designation for a specific non-Legacy Security RMBS or CMBS is determined by the NAIC Designation Intrinsic Price Mapping by SSG.**

NOTE: Please refer to *SSAP No. 43R—Loan-Backed and Structured Securities* for guidance on all accounting and related reporting issues.

Analytical Procedures for RMBS and CMBS

23. The SSG shall develop and implement all necessary processes to coordinate the engagement by the NAIC of a vendor who will perform loan-level analysis of insurer-owned RMBS and CMBS using the vendor's proprietary models.

RMBS AND CMBS SUBJECT TO FINANCIAL MODELING
--

Setting Microeconomic Assumptions and Stress Scenarios

24. Not later than September of each year, the SSG shall begin working with the vendor to identify the assumptions, stress scenarios and probabilities (hereafter model criteria) the SSG intends to use at year-end to run the vendor's financial model.

The Financial Modeling Process

25. Information about the financial modeling process can be found at www.naic.org/structured_securities/index_structured_securities.htm.

Use of Net Present Value and Carrying Value for Financially Modeled Legacy Security RMBS and CMBS

26. For each modeled Legacy Security RMBS and CMBS, the financial model determines the net present value at which the expected loss equals the midpoint between the RBC charges for each NAIC Designation; i.e., each price point, if exceeded, changes the NAIC Designation. Net present value is the net present value of principal losses, discounted using the security’s coupon rate (adjusted in case of original issue discount securities to book yield at original issue and in case of floating rate securities, discounted using LIBOR curve + Origination spread). Because of the difference in RBC charge, the deliverable is five values for each RMBS and CMBS security for companies required to maintain an asset valuation reserve (AVR) and five values for companies not required to maintain an AVR. This is illustrated in the chart below.

RBC charge / NAIC designation (pre-tax)

P&C	RBC	Midpoint
1	0.3%	0.65%
2	1.0%	1.50%
3	2.0%	3.25%
4	4.5%	7.25%
5	10.0%	20.00%
6	30.0%	
Life	RBC	Midpoint
1	0.4%	0.85%
2	1.3%	2.95%
3	4.6%	7.30%
4	10.0%	16.50%
5	23.0%	26.50%
6	30.0%	

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

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

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

Use of Intrinsic Price for Financially Modeled non-Legacy Security RMBS and CMBS

28. The NAIC Designation and NAIC Designation Category for a given modeled non-Legacy Security RMBS or CMBS CUSIP owned by a given insurance is assigned by SSG and **does not** depend on the insurer’s book/adjusted carrying value of each RMBS or CMBS. The NAIC Designation and Designation Category assigned will be determined by applying the Intrinsic Price to the NAIC Designation Intrinsic Price Mapping, as defined in this Part.

**SECURITIES NOT MODELED BY THE SSG AND NOT RATED BY AN NAIC CRP
OR DESIGNATED BY THE SVO**

29. Securities subject to *SSAP No. 43R—Loan-Backed and Structured Securities* that cannot be modeled by the SSG and are not rated by an NAIC CRP or designated by the SVO are either: (a) assigned the NAIC administrative symbol **ND** (not designated), requiring subsequent filing with the SVO; or (b) assigned the NAIC Designation for Special Reporting Instruction [i.e., an **NAIC 5GI**, NAIC Designation Category **NAIC 5.B GI** or **NAIC 6*** (six-star)].

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MORTGAGE REFERENCED SECURITIES

Definition

30. A Mortgage Referenced Security has the following characteristics: A Mortgage Referenced Security's coupon and/or principal payments are linked, in whole or in part, to prices of, or payment streams from, real estate, index or indices related to real estate, or assets deriving their value from instruments related to real estate, including, but not limited to, mortgage loans.

Not Filing Exempt

31. A Mortgage Referenced Security is not eligible for filing exemption but is subject to the filing requirement.

NAIC Risk Assessment

32. In determining the NAIC Designation of a Mortgage Referenced Security, the SSG may use the financial modeling methodology discussed in this Part, adjusted (if and as necessary) to the specific reporting and accounting requirements applicable to Mortgage Referenced Securities.

Quarterly Reporting for Mortgage Reference Securities

33. To determine the NAIC Designation to be used for quarterly financial statement reporting for a Mortgage Reference Security purchased subsequent to the annual surveillance described in this Part, the insurer uses the prior year-end modeling data for that CUSIP (which can be obtained from the NAIC) until the annual surveillance data is published for the current year. For a Mortgage Reference Security that is not in the prior year-end modeling data for that CUSIP, the insurer may follow the instructions in Part Two of this manual for the assignment of the SVO Administrative Symbol "Z" provided the insurer owned security meets the criteria for a security that is in transition in reporting or filing status.

NOTE: Please refer to SSAP No. 26R and SSAP No. 43R for the definition of and guidance on Structured Notes and Mortgage Referenced Securities. Please also refer to Part Three of this Manual for guidance about the filing exempt status of Structured Notes.

GROUND LEASE FINANCING TRANSACTIONS

Definition

34. Ground Lease Financing (GLF) transactions are defined and explained in “Ground Lease Financing Transactions” in Part Three of this Manual.

SSG Role and Process

1. On occasion, the SVO may refer a GLF transaction to the SVO for financial modeling of the GLF space leases or business operation, as applicable, in accordance with the process set forth in “Ground Lease Financing Transactions” in Part Three of this Manual. Following an SVO referral the SSG and SVO will maintain open communication related to requests for additional data, analytical questions and analytical conclusions. Any GLF transaction NAIC Designation will be assigned by the SVO.

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THE RTAS – EMERGING INVESTMENT VEHICLE

Purpose

2. Price grids **and/or Designations and Designation Categories** are generated for the exclusive use of insurance companies and the NAIC regulatory community. Insurance companies use official Price Grids **and/or Designations and Designation Categories** by following the instructions in *SSAP No. 43R—Loan-Backed and Structured Securities* to derive a final NAIC Designation for the RMBS or CMBS, which they use to derive the RBC applicable for the RMBS or CMBS.

NOTE: Please refer to SSAP No. 43R for a full explanation of the applicable procedure.

Extension of Authority

3. The Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure is extended to the SSG, and the SSG is authorized to determine probable regulatory treatment for RMBS and CMBS pursuant to this Part or for other securities, where, in the opinion of the SSG, financial modeling methodology would yield the necessary analytical insight to determine probable regulatory treatment or otherwise enable the SSG to make recommendations to the VOS/TF as to regulatory treatment for a security.

Interpretation

4. To facilitate this purpose, wherever in the Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure reference is made to the SVO, it shall be read to also refer to and apply to the SSG, adjusting for differences in the operational or methodological context. The Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure shall also be read as authority for collaboration between SVO and SSG staff functions so as to encompass RTAS assignments that require the use of SVO financial, corporate, municipal, legal, and structural analysis and related methodologies, as well as of financial modeling methodologies.

Translation of Preliminary into Official Price Grids and/or NAIC Designations and Designation Categories

5. Price Grids and/or Designations and Designation Categories (“PGD”) generated by the SSG pursuant to an RTAS are preliminary within the meaning of that term as used in the Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure and accordingly cannot be used for official NAIC regulatory purposes. Preliminary NAIC Designations are translated into official NAIC Designations by the SVO when an insurance company purchases and files the security and the SVO conducts an official assessment. However, this Manual does not require the filing of RMBS and CMBS subject to financial modeling methodology with the SSG. It is, therefore, necessary to specify a procedure for the translation of preliminary Price Grids and/or Designations and Designation Categories (“Preliminary PGD”) into official ~~Price Grids~~-PGD that can be used for NAIC regulatory purposes. Preliminary ~~Price Grids~~-PGDs generated by the SSG become an official ~~Price Grid~~ PGD within the meaning of this section when an insurance company has purchased the security for which the ~~Price Grid~~ PGD was generated and reported that security for quarterly reporting purposes using the SSG generated ~~Price Grid~~ PGD. A ~~Price Grid~~ PGD for a security reported by an insurance company for quarterly reporting is effective until the SSG conducts the next annual surveillance pursuant to this Part at which the time the ~~Price Grid~~ PGDs generated by the SSG at year-end shall be the official ~~Price Grid~~ PGDs for that security.

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Mike Monahan
Senior Director, Accounting

Tracey Lindsey
President

March 20, 2021

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

Ms. Carrie Mears, Vice Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
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Kansas City, MO 64016-2197

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Update the Financial Modeling Instructions for RMBS/CMBS Securities and Direct IAO Staff to Produce NAIC Designation and NAIC Designations Categories for Non-Legacy Securities

Dear Mr. Fry and Ms. Mears:

The American Council of Life Insurers (ACLI)¹ and the North American Securities Valuation Association (NASVA)² (“the undersigned”) appreciate the opportunity to comment on the February 3, 2021 proposed amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office.

The ACLI and NASVA (and their respective members) recognize that the proposed change to a single NAIC designation and NAIC designation category for all non-Legacy Securities, in conjunction with the anticipated change to a through-the-cycle modeling approach for CMBS, will help reduce the disproportionate adverse risk-based capital (RBC) impact that we saw in 2020 for these securities. As such, we support the proposed and anticipated changes and view them as a positive step towards refining the RBC framework for modeled securities so that it truly captures the economic cost of holding the credit risk of these securities.

¹ The *American Council of Life Insurers* (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI’s member companies are dedicated to protecting consumers’ financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI’s 280 member companies represent 94 percent of industry assets in the United States. Learn more at www.acli.com.

² The *North American Securities Valuation Association* (NASVA) is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC’s ISIS electronic security filing system, and commenting on year-end processes.

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North American Securities Valuation Association
contact: Tracey Lindsey, President
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We are confident that the NAIC will ensure that the application of these proposed and anticipated changes produces RBC results for modeled securities that are commensurate with the credit risk that they carry as measured by various market metrics, including reasonable NRSRO ratings. We are also confident that the implementation of the new reporting process associated with the proposed changes will be handled with the necessary expedience to ensure an orderly adoption by insurers and their vendors.

After the adoption of this proposal, and as the NAIC continues to evaluate ways to enhance the RBC framework for modeled securities in future years, we respectfully recommend focusing on two key aspects: 1) benefits of an enhanced price breakpoint approach, and 2) opportunities to continue to expand the transparency of the modeling process.

Benefits of an enhanced price breakpoint approach

The concept of considering the basis at which a security is held to determine the appropriate RBC treatment for that holding is a sound one – the economic loss that an insurer incurs in the event of a bond default will vary depending on the price paid for that security. In the aftermath of the Great Financial Crisis (GFC), the price breakpoint framework for modeled securities, which takes into account their carrying value, had two key impacts for insurance companies: it did not create unnecessary RBC pressure for securities carried at appropriate book values, and it allowed insurers to add securities with strong price-adjusted credit and income profiles to their portfolios.

In the downturn of 2020, the price breakpoint methodology -- combined with a pro-cyclical modeling approach for CMBS, led to a disproportionately punitive RBC treatment of highly rated securities carried at a premium and that were modeled to suffer small losses. The reason for these skewed results is fairly simple: price breakpoints as currently implemented implicitly assume that the maximum price at which a security may be purchased is par without consideration for the impact that significant changes in interest rates could have for the value of these securities.

There are different ways that could be studied to fix the rigidity of the current breakpoint mechanism in a sound and prudent manner. For example, price breakpoints could be determined by considering all bond cashflows in the context of the prevailing rate environment. Alternatively, a hybrid approach could be analyzed so that price breakpoints are applied only in instances where they are not materially distorted by changes in the interest rate environment.

Given the superior effectiveness of a framework that considers carrying value to determine appropriate levels of RBC, we would strongly recommend that a workable implementation of such an approach be studied for future years. The implementation of such an approach would likely prove to be prudent policy for the insurance industry in the event of another severe market dislocation like the one we had in the aftermath of the GFC.

Opportunities to continue to expand the transparency of the modeling process

We truly appreciate the efforts that the Structured Securities Group has undertaken to provide transparency to the industry around the modeling process. At the same time, we would welcome additional details that could allow insurance companies to better understand the drivers of the modeled results and reduce the uncertainty around the RBC treatment of modeled securities that we face every year.

For example, disclosing key modeling assumptions and providing collateral loss detail under each modeled scenario could go a long way in helping insurance companies understand the proportionality

of NAIC designations. Additionally, increasing the frequency of these disclosures could help insurers better develop expectations of RBC requirements ahead of year-end.

We are grateful for having had the opportunity to provide these comments, and for all the time that regulators and staff devoted to industry participants as we studied this proposal.

Please do not hesitate to contact us should you have any questions. Thank you.

Sincerely,


Senior Director, Accounting Policy
American Council of Life Insurers

Tracey Lindsey
President
North American Securities Valuation Associationcc:

Mr. Charles Therriault, Director, SVO



MEMORANDUM

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

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

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

RE: **Updated** - Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Private Rating Letter Rationale Report Only

DATE: February 28, 2021 ~~December 7, 2020~~ ~~October 30, 2020~~

1. Summary –The IAO staff discussed with the Task Force at its May 14th meeting the IAO’s concerns with bespoke securities and the NAIC’s excessive reliance on credit rating provider (CRP) ratings to assess investment risk and for regulatory purposes. At that meeting the Task Force exposed the IAO’s memorandum, dated February 27, 2020, summarizing these concerns. The Task Force requested the SVO make incremental recommendations to address these issues.

On October 23rd of this year the Financial Condition (E) Committee directed the Task Force to include a new charge for 2021; specifically, to, “implement policies to oversee the NAIC’s staff administration of rating agency ratings used in NAIC processes, including, staff’s discretion over the applicability of their use in its administration of Filing Exemption.” In furtherance of the proposed new Task Force charge and the Task Force’s request for incremental recommendations, the SVO proposes taking a first step towards implementation of some of its recommendations in its memo by increasing SVO scrutiny of PL securities, many of which are bespoke securities.

At the Task Force meeting on November 14th, the Task Force directed the SVO to update its proposed amendment to have the Private Rating Letter Rationale Reports filed with the SVO but without the SVO’s discretion over evaluating the appropriateness of the rating or methodology utilized, at least at this time. The SVO still recommends that it be granted this oversight authority and will be scheduling a regulator-only call in 2021 to review with the Task Force PLR transactions which appear to be either ineligible for filing exemption, ineligible for Schedule D reporting and/or where there is a material difference in opinion as to the risk.

2. Recommendation for oversight of PL Securities – In its bespoke securities memo the SVO described its concern that its lack of authority to use its judgment in determining whether a CRP rating is useful for NAIC purposes (meaning its rating methodology may not be appropriate for, or consistent with, the assessment of investment risk for statutory purposes) has fed an increase in the use of bespoke securities, many of which are assigned NAIC designations through the Filing Exempt (FE) process, which includes the private letter rating process. To begin to address this lack of meaningful oversight of CRP ratings, the SVO proposes, as it did in its memo, that securities assigned private letter ratings be submitted to it for review. Understanding the many CRP private rating letters include little or no analysis

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beyond the assigned private rating, the SVO recommends that for a PL security to receive an NAIC Designation the SVO must receive, along with the private rating letter, a related private rating letter rationale report providing more in-depth analysis of the transaction, the methodology used to arrive at the private rating, and, as appropriate, discussion of the transaction's credit, legal and operational risks and mitigants. With both the private rating letter and the private rating letter rationale report the SVO would be able to determine (i) whether the private credit rating is an Eligible NAIC CRP Rating, meaning the security type is eligible to be reported on Schedule D and that it is appropriate for and NRSRO credit rating to be used to determine the regulatory treatment of the security, and (ii) whether the SVO agrees with the private credit rating. The SVO would have full discretion, based on its reasonable review of the private rating letter and the supporting rationale report, to assign an NAIC designation equivalent to the CRP PLR, to require the security to be filed for review or, to decline to assign any NAIC designation.

The SVO understands there are potential obstacles to attaining private rating letter rationale reports such as CRP confidentiality policies. However, the SVO thinks such analysis is crucial to its ability to best determine whether a rating is a satisfactory assessment of investment risk for statutory purposes due to the typical private rating letter's lack of analysis and transparency. As such the SVO is committed to working with industry and CRPs to find solutions to possible obstacles.

3. Proposed Amendment – The SVO proposes the following amendments to Parts One and Three of the Purposes and Procedures Manual of the Investment Analysis Office to permit the SVO to review all PL securities whether processed through a feed or submitted directly to the SVO and would require insurance company filers to provide private rating letter rationale reports for each security. The following text in red shows the proposed Purposes and Procedures Manual revisions. Updates are highlighted in yellow.

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

FILING EXEMPTIONS

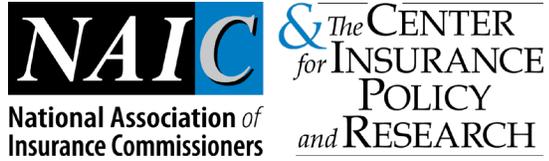
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<p>POLICIES APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL) RATING SECURITIES</p>
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Policy Considerations

83. In connection with the implementation of the verification procedure for PL securities, the VOS/TF acknowledges that the practices adopted by NAIC CRPs in relation to the distribution of private rating letters for what the NAIC refers to as PL securities, including their confidentiality procedures and agreements, are integral to the business models of private for-profit entities that the NAIC does not regulate and which the NAIC stands in the relation of a customer of rating services. Accordingly, the SVO, as NAIC staff, shall not be responsible for negotiating with NAIC CRPs to modify their confidentiality practices or provide data-feeds to the SVO. However, if an NAIC CRP shall determine that it is willing to modify its confidentiality provisions or provide such data-feed or an alternative process so that the SVO can obtain electronically, copies of private rating letters **and private rating letter rationale reports** for PL securities issued by that NAIC CRP instead of by requiring insurers to provide PDF files, then the SVO is authorized to work with the NAIC CRP to obtain and integrate the private rating letters and **private rating letter rationale reports** or the data-feeds into NAIC systems to create electronic processes that will permit electronic verification that the insurer-owned PL security have been assigned an NAIC CRP Eligible Credit Rating. Individual insurers and/or representatives of the insurance industry are encouraged to find ways to resolve confidentiality restrictions imposed by NAIC CRPs on the private rating letter **and private rating letter rationale report** or to influence the process as investors to encourage NAIC CRPs to provide the data-feeds to the SVO or alternative methods to permit the SVO to obtain NAIC CRP credit ratings **and private rating letter rationale report** for PL securities to be used to administer the PL securities verification procedure specified in this section.



PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS

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**PROCEDURE APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL)
RATING SECURITIES**

...

PL SECURITIES

Effective Date of Verification Procedure for PL Securities

9. Effective January 1, 2022, for each PL security received by the SVO either through a copy of a private rating letter or in a CRP credit rating feed, insurance companies shall be responsible for providing the SVO a copy of the related private rating letter rationale report from the applicable NAIC CRP, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs.
10. Effective July 1, 2018, insurance companies shall be responsible for providing the SVO copies of private rating letters for PL securities, where applicable, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs.
11. For (i) PL Securities issued prior to January 1, 2018, ~~if for which~~ an insurance company cannot provide a copy of the rating letter to the SVO due to confidentiality concerns and the rating is not included in a CRP credit rating feed (or other form of direct delivery from the NAIC CRP), ~~or~~ and (ii) ~~for~~ PL Securities issued from January 1, 2018 to January 1, 2022 for which an insurance company cannot provide a copy of a “rating rationale report” to the SVO due to confidentiality or contractual reasons, the insurer shall report such securities on such securities’ General Interrogatory to be developed for this purpose (i.e., a PL GI security).

Definitions

12. For purposes of this section:
 - The phrase “private rating letter” means a letter or report issued by an NAIC CRP on its letterhead or its controlled website to an issuer or investor, obtained by an insurer in its capacity as an investor in the issuance or by following the confidentiality process established by the NAIC CRP.

- The phrase “privately rated security” means a security issued by an issuer wherein the issuer has solicited a credit rating for the issuance from an NAIC CRP and the NAIC CRP has agreed to issue a credit rating for the issuance to be communicated to the issuer and a specified group of investors only and not publicly released via the NAIC CRP’s public data feed or website. The privately rated security is the subject of the private rating letter and is referred to herein as a private letter (PL) security.
- The phrase “private rating letter rationale report” means an analytical review of the privately rated security explaining the transaction structure, methodology relied upon, and, as appropriate, analysis of the credit, legal and operational risks and mitigants supporting the assigned NAIC CRP rating, in a report issued by an NAIC CRP on its letterhead or its controlled website to an issuer or investor, obtained by an insurer in its capacity as an investor in the issuance or by following the confidentiality process established by the NAIC CRP.

Conditions to Filing Exemption for PL Securities Issued on or After January 1, 2018

13. **PL** securities are exempt from filing with the SVO for assignment of an analytically determined NAIC Designation if the security has been assigned an Eligible NAIC CRP Credit Rating, ~~and~~ the insurer verifies the rated status of the **PL** security to the SVO, ~~the insurer or NAIC CRP provides the SVO with the private rating letter rationale report, and the SVO concurs with the assigned Eligible NAIC CRP Credit Rating and the SVO~~ deems the privately rated security eligible to receive an NAIC Designation with an NAIC CRP Credit Rating.
14. If the **PL** security is not rated by an NAIC CRP; or a credit rating is assigned that is not an Eligible NAIC CRP Credit Rating; or if the insurer cannot provide the SVO a private rating letter verifying that the assigned credit rating is an Eligible NAIC CRP Credit Rating; or the NAIC CRP cannot provide the Eligible NAIC CRP Credit Rating on the **PL** security to the NAIC through an electronic data feed approved by the SVO and that specifically identifies the **PL** securities rated by that NAIC CRP; ~~or the insurer or NAIC CRP cannot provide the private rating letter rationale report; or the SVO does not concur with the assigned Eligible NAIC CRP Credit Rating based on its review of the private letter rating rationale report;~~ or the SVO deems the privately rated security ineligible to receive an NAIC Designation with a NAIC CRP Credit Rating, the **PL** security is not filing exempt.
15. An insurer that owns a **PL** security that is not filing exempt shall either: (a) file the security with the necessary documentation with the SVO for an analytically determined NAIC Designation; or (b) self-assign an **NAIC 5GI** to the security and report using the Interrogatory procedure; in either case within 120 days of purchase.

Conditions to Filing Exemption for PL Securities Issued Prior to January 1, 2018

16. **PL** securities issued prior to January 1, 2018 are exempt from filing with the SVO for assignment of an analytically determined NAIC Designation if the security has been assigned an Eligible NAIC CRP Credit Rating. If the **PL** security CRP rating is not included in the applicable CRP credit rating feed (or other form of direct delivery from the CRP) or the insurer cannot submit the private letter rating to the SVO because of confidentiality provisions, the security shall be designated **PLGI**. Insurers shall report on all such securities in a General Interrogatory with an attestation that all such securities have an Eligible CRP Credit and are reflected in the financial statements and risk-based capital calculation commensurate with that rating.

Procedure

17. The NAIC shall create systems and develop and staff administrative and operational procedures to be administered by the SVO to identify insurer-owned **PL** securities; verify whether or not the assigned credit rating is an Eligible NAIC CRP Credit Rating, review the private rating letter rationale report, and either translate that credit rating into its equivalent NAIC Designation and input the NAIC Designation for the security into the appropriate NAIC systems or notify the insurer that the security is not eligible for filing exemption.

SVO to Administer Verification Procedures

18. It shall be the responsibility of the NAIC to create and maintain for the SVO, electronic facilities to accept: (a) electronic data-feeds provided by NAIC CRPs containing and specifically identifying the **PL** securities rated by that NAIC CRP, ~~and~~ the credit rating assigned to the **PL** securities and the supporting private rating letter rationale report; or (b) PDF files of private rating letters provided by insurers to the SVO containing the NAIC CRP credit rating for the **PL** security and a copy of the supporting private rating letter rationale report.

The PL Process

19. It shall be the responsibility of the SVO to identify **PL** securities in the AVS+ system for insurance companies to use when reporting **PL** securities to the NAIC as part of the NAIC's Financial Statement Blank reporting process. The SVO identifies **PL** securities when it conducts the quarterly compilation of the SVO List of Securities.

Producing NAIC Designations for PL Securities

20. The SVO shall produce NAIC Designations for securities subject to private letter ratings as follows:

- The insurance company shall file a copy of the private rating letter with the SVO if not included in the applicable NAIC CRP Rating feed(s) (or other form of direct delivery from the CRP) noted above in Conditions to Filing Exemption for PL Securities and **the supporting private rating letter rationale report, if the SVO has not received it directly from the CRP, within the initial filing deadline for newly acquired securities or securities in transition (as explained in “SVO Analytical Department Symbols” in Part Two of this Manual) and each calendar year thereafter along with any changes in PL Securities rating.** In instances where the **PL** security is included in the applicable NAIC CRP Rating feed(s), the SVO shall follow the procedure for Filing Exempt (FE) securities **only after the SVO receives both the private rating letter and private rating letter rationale report either directly or through a NAIC CRP Rating feed(s), and if, in its sole discretion, it concurs with the assigned Eligible NAIC CRP Credit Rating after reviewing the private rating letter rationale report and the SVO** deems the privately rated security eligible to receive an NAIC Designation with an NAIC CRP Credit Rating.
- In instances where a private letter **and private rating letter rationale report** is filed, the SVO shall evaluate the private letter **and private rating letter rationale report** to determine whether the security has been assigned an Eligible NAIC CRP Rating **and if the privately rated security is eligible to receive an NAIC Designation with a NAIC CRP Credit Rating.** Similar to public securities where a rating is received directly from the CRP via electronic feeds, **there is a similar assumption for the PL security,** that the **rating** meets the definition of an Eligible NAIC CRP Rating as a normal part of the CRP rating process, absent evidence to the contrary in the rating letter **or private rating letter rationale report** (e.g., evidence that the rating applies only to principal or interest, in a deviation from the normal CRP rating process).
- If the SVO verifies that the security has been assigned an Eligible NAIC CRP Rating and **if the SVO, upon review of the private rating letter rationale report and in its sole discretion, concurs with the assigned Eligible NAIC CRP Credit Rating** deems the privately rated security eligible to receive an NAIC Designation with a **NAIC CRP Credit Rating,** it assigns an NAIC Designation in accordance with the policy and procedure specified in this Manual. The assumption in the application of this step of the procedure is that **PL** securities are typically assigned a credit rating by only one NAIC CRP. However, if this assumption is inaccurate for any **PL** security, the SVO applies the same procedure specified for FE securities.

21. If the SVO verifies that the security:

- Has been assigned a credit rating but that the credit rating is not an Eligible NAIC CRP Credit Rating; or
- Has not been rated by an NAIC CRP; or

- Is no longer subject to a private letter rating; or
- ~~Has an assigned Eligible NAIC CRP Credit Rating that the SVO, in its sole discretion, does not concur with; or~~
- Is a type of security that is ineligible to receive an NAIC Designation with a NAIC CRP Credit Rating.

If the SVO deems a security ineligible to receive an NAIC Designation per the instructions in this Manual because (a) the security is ineligible for Filing Exemption according to “Specific Populations of Securities Not Eligible for Filing Exemption” in this Part or (b) the security is of a type outside the scope of *SSAP No. 26R - Bonds, SSAP No. 32- Preferred Stock, or SSAP No. 43R – Loan Backed and Structured Securities* then, for such a security, the SVO will provide a brief explanation in VISION, accessible to all VISION account holders, of why the security will not be provided an NAIC Designation.

The SVO shall notify the insurer that the security is not eligible for filing exemption. The insurance company shall then either file that security and necessary documentation with the SVO for an independent credit assessment or assign an **NAIC 5GI** Regulatory Designation to the security in the related Interrogatory.

22. An **NAIC 5GI** Designation may also be used in connection with the designation of **PL** securities rated by an NAIC CRP (i.e., for private letter ratings issued on or after January 1, 2018) when the documentation is not available for the SVO to assign an NAIC Designation, ~~or for private letter ratings issued from January 1, 2018 to January 1, 2022, if an insurance company does not provide a copy of a “rating rationale report” to the SVO and there are no confidentiality or contractual limitations reasons, or for any private letter ratings issued after January 1, 2022 for which a rating rationale report is not submitted to the SVO.~~ For purposes of this section, the documentation is not available for the SVO to assign an NAIC Designation if the NAIC CRP credit rating is not included in the applicable CRP credit rating feed (or other form of direct delivery from the NAIC CRP) and the insurer is unable to provide a copy of the private letter rating documentation, ~~including the private rating letter rationale report,~~ necessary for the SVO to assign an NAIC Designation.



MEMORANDUM

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

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

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

RE: **Updated** - Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Private Rating Letter Rationale Report Only

DATE: **December 7, 2020** ~~October 30, 2020~~

1. Summary –The IAO staff discussed with the Task Force at its May 14th meeting the IAO’s concerns with bespoke securities and the NAIC’s excessive reliance on credit rating provider (CRP) ratings to assess investment risk and for regulatory purposes. At that meeting the Task Force exposed the IAO’s memorandum, dated February 27, 2020, summarizing these concerns. The Task Force requested the SVO make incremental recommendations to address these issues.

On October 23rd of this year the Financial Condition (E) Committee directed the Task Force to include a new charge for 2021; specifically, to, “implement policies to oversee the NAIC’s staff administration of rating agency ratings used in NAIC processes, including, staff’s discretion over the applicability of their use in its administration of Filing Exemption.” In furtherance of the proposed new Task Force charge and the Task Force’s request for incremental recommendations, the SVO proposes taking a first step towards implementation of some of its recommendations in its memo by increasing SVO scrutiny of PL securities, many of which are bespoke securities.

At the Task Force meeting on November 14th, the Task Force directed the SVO to update its proposed amendment to have the Private Rating Letter Rationale Reports filed with the SVO but without the SVO’s discretion over evaluating the appropriateness of the rating or methodology utilized, at least at this time. The SVO still recommends that it be granted this oversight authority and will be scheduling a regulator-only call in 2021 to review with the Task Force PLR transactions which appear to be either ineligible for filing exemption, ineligible for Schedule D reporting and/or where there is a material difference in opinion as to the risk

2. Recommendation for oversight of PL Securities – In its bespoke securities memo the SVO described its concern that its lack of authority to use its judgment in determining whether a CRP rating is useful for NAIC purposes (meaning its rating methodology may not be appropriate for, or consistent with, the assessment of investment risk for statutory purposes) has fed an increase in the use of bespoke securities, many of which are assigned NAIC designations through the Filing Exempt (FE) process, which includes the private letter rating process. To begin to address this lack of meaningful oversight of CRP ratings, the SVO proposes, as it did in its memo, that securities assigned private letter ratings be submitted to it for review. Understanding the many CRP private rating letters include little or no analysis

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beyond the assigned private rating, the SVO recommends that for a PL security to receive an NAIC Designation the SVO must receive, along with the private rating letter, a related private rating letter rationale report providing more in-depth analysis of the transaction, the methodology used to arrive at the private rating, and, as appropriate, discussion of the transaction's credit, legal and operational risks and mitigants. With both the private rating letter and the private rating letter rationale report the SVO would be able to determine (i) whether the private credit rating is an Eligible NAIC CRP Rating, meaning the security type is eligible to be reported on Schedule D and that it is appropriate for and NRSRO credit rating to be used to determine the regulatory treatment of the security, and (ii) whether the SVO agrees with the private credit rating. The SVO would have full discretion, based on its reasonable review of the private rating letter and the supporting rationale report, to assign an NAIC designation equivalent to the CRP PLR, to require the security to be filed for review or, to decline to assign any NAIC designation.

The SVO understands there are potential obstacles to attaining private rating letter rationale reports such as CRP confidentiality policies. However, the SVO thinks such analysis is crucial to its ability to best determine whether a rating is a satisfactory assessment of investment risk for statutory purposes due to the typical private rating letter's lack of analysis and transparency. As such the SVO is committed to working with industry and CRPs to find solutions to possible obstacles.

3. Proposed Amendment – The SVO proposes the following amendments to Parts One and Three of the Purposes and Procedures Manual of the Investment Analysis Office to permit the SVO to review all PL securities whether processed through a feed or submitted directly to the SVO and would require insurance company filers to provide private rating letter rationale reports for each security. The following text in red shows the proposed Purposes and Procedures Manual revisions. Updates are highlighted in yellow.

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

FILING EXEMPTIONS

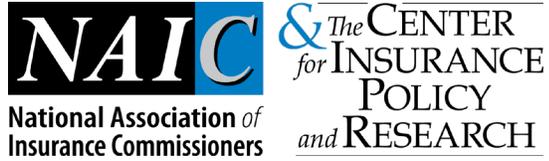
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<p>POLICIES APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL) RATING SECURITIES</p>
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Policy Considerations

83. In connection with the implementation of the verification procedure for PL securities, the VOS/TF acknowledges that the practices adopted by NAIC CRPs in relation to the distribution of private rating letters for what the NAIC refers to as PL securities, including their confidentiality procedures and agreements, are integral to the business models of private for-profit entities that the NAIC does not regulate and which the NAIC stands in the relation of a customer of rating services. Accordingly, the SVO, as NAIC staff, shall not be responsible for negotiating with NAIC CRPs to modify their confidentiality practices or provide data-feeds to the SVO. However, if an NAIC CRP shall determine that it is willing to modify its confidentiality provisions or provide such data-feed or an alternative process so that the SVO can obtain electronically, copies of private rating letters and private rating letter rationale reports for PL securities issued by that NAIC CRP instead of by requiring insurers to provide PDF files, then the SVO is authorized to work with the NAIC CRP to obtain and integrate the private rating letters and private rating letter rationale reports or the data-feeds into NAIC systems to create electronic processes that will permit electronic verification that the insurer-owned PL security have been assigned an NAIC CRP Eligible Credit Rating. Individual insurers and/or representatives of the insurance industry are encouraged to find ways to resolve confidentiality restrictions imposed by NAIC CRPs on the private rating letter and private rating letter rationale report or to influence the process as investors to encourage NAIC CRPs to provide the data-feeds to the SVO or alternative methods to permit the SVO to obtain NAIC CRP credit ratings and private rating letter rationale report for PL securities to be used to administer the PL securities verification procedure specified in this section.



PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS

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**PROCEDURE APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL)
RATING SECURITIES**

...

PL SECURITIES

Effective Date of Verification Procedure for PL Securities

9. Effective January 1, 2022, for each PL security received by the SVO either through a copy of a private rating letter or in a CRP credit rating feed, insurance companies shall be responsible for providing the SVO a copy of the related private rating letter rationale report from the applicable NAIC CRP, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs.
10. Effective July 1, 2018, insurance companies shall be responsible for providing the SVO copies of private rating letters for PL securities, where applicable, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs.
11. For **PL** Securities issued prior to January 1, 2018, if an insurance company cannot provide a copy of the rating letter to the SVO due to confidentiality concerns and the rating is not included in a CRP credit rating feed (or other form of direct delivery from the NAIC CRP), the insurer shall report such securities on such securities' General Interrogatory to be developed for this purpose (i.e., a **PL GI** security).

Definitions

12. For purposes of this section:
 - The phrase “private rating letter” means a letter or report issued by an NAIC CRP on its letterhead or its controlled website to an issuer or investor, obtained by an insurer in its capacity as an investor in the issuance or by following the confidentiality process established by the NAIC CRP.
 - The phrase “privately rated security” means a security issued by an issuer wherein the issuer has solicited a credit rating for the issuance from an NAIC CRP and the NAIC CRP has agreed to issue a credit rating for the issuance to be communicated to the issuer and a specified group of investors only and not publicly released via the NAIC CRP’s public data feed or website. The privately rated security is the subject of the private rating letter and is referred to herein as a private letter (PL) security.

- The phrase “private rating letter rationale report” means an analytical review of the privately rated security explaining the transaction structure, methodology relied upon, and, as appropriate, analysis of the credit, legal and operational risks and mitigants supporting the assigned NAIC CRP rating, in a report issued by an NAIC CRP on its letterhead or its controlled website to an issuer or investor, obtained by an insurer in its capacity as an investor in the issuance or by following the confidentiality process established by the NAIC CRP.

Conditions to Filing Exemption for PL Securities Issued on or After January 1, 2018

13. **PL** securities are exempt from filing with the SVO for assignment of an analytically determined NAIC Designation if the security has been assigned an Eligible NAIC CRP Credit Rating, ~~and~~ the insurer verifies the rated status of the **PL** security to the SVO, ~~the insurer or NAIC CRP provides the SVO with the private rating letter rationale report, and the SVO concurs with the assigned Eligible NAIC CRP Credit Rating and the SVO deems the privately rated security eligible to receive an NAIC Designation with an NAIC CRP Credit Rating.~~
14. If the **PL** security is not rated by an NAIC CRP; or a credit rating is assigned that is not an Eligible NAIC CRP Credit Rating; or if the insurer cannot provide the SVO a private rating letter verifying that the assigned credit rating is an Eligible NAIC CRP Credit Rating; or the NAIC CRP cannot provide the Eligible NAIC CRP Credit Rating on the **PL** security to the NAIC through an electronic data feed approved by the SVO and that specifically identifies the **PL** securities rated by that NAIC CRP; ~~or the insurer or NAIC CRP cannot provide the private rating letter rationale report; or the SVO does not concur with the assigned Eligible NAIC CRP Credit Rating based on its review of the private rating rationale report;~~ or the SVO deems the privately rated security ineligible to receive an NAIC Designation with a NAIC CRP Credit Rating, the **PL** security is not filing exempt.
15. An insurer that owns a **PL** security that is not filing exempt shall either: (a) file the security with the necessary documentation with the SVO for an analytically determined NAIC Designation; or (b) self-assign an **NAIC 5GI** to the security and report using the Interrogatory procedure; in either case within 120 days of purchase.

Conditions to Filing Exemption for PL Securities Issued Prior to January 1, 2018

16. **PL** securities issued prior to January 1, 2018 are exempt from filing with the SVO for assignment of an analytically determined NAIC Designation if the security has been assigned an Eligible NAIC CRP Credit Rating. If the **PL** security CRP rating is not included in the applicable CRP credit rating feed (or other form of direct delivery from the CRP) or the insurer cannot submit the private letter rating to the SVO because of confidentiality provisions, the security shall be designated **PLGI**. Insurers shall report on all such securities in a General Interrogatory with an attestation that all such securities have an Eligible CRP Credit and are reflected in the financial statements and risk-based capital calculation commensurate with that rating

Procedure

17. The NAIC shall create systems and develop and staff administrative and operational procedures to be administered by the SVO to identify insurer-owned **PL** securities; verify whether or not the assigned credit rating is an Eligible NAIC CRP Credit Rating, review the private rating letter rationale report, and either translate that credit rating into its equivalent NAIC Designation and input the NAIC Designation for the security into the appropriate NAIC systems or notify the insurer that the security is not eligible for filing exemption.

SVO to Administer Verification Procedures

18. It shall be the responsibility of the NAIC to create and maintain for the SVO, electronic facilities to accept: (a) electronic data-feeds provided by NAIC CRPs containing and specifically identifying the **PL** securities rated by that NAIC CRP, ~~and~~ the credit rating assigned to the **PL** securities and the supporting private rating letter rationale report; or (b) PDF files of private rating letters provided by insurers to the SVO containing the NAIC CRP credit rating for the **PL** security and a copy of the supporting private rating letter rationale report.

The PL Process

19. It shall be the responsibility of the SVO to identify **PL** securities in the AVS+ system for insurance companies to use when reporting **PL** securities to the NAIC as part of the NAIC's Financial Statement Blank reporting process. The SVO identifies **PL** securities when it conducts the quarterly compilation of the SVO List of Securities.

Producing NAIC Designations for PL Securities

20. The SVO shall produce NAIC Designations for securities subject to private letter ratings as follows:

- The insurance company shall file a copy of the private rating letter with the SVO if not included in the applicable NAIC CRP Rating feed(s) (or other form of direct delivery from the CRP) noted above in Conditions to Filing Exemption for PL Securities and **the supporting private rating letter rationale report, if the SVO has not received it directly from the CRP, within the initial filing deadline for newly acquired securities or securities in transition (as explained in “SVO Analytical Department Symbols” in Part Two of this Manual) and each calendar year thereafter along with any changes in PL Securities rating.** In instances where the **PL** security is included in the applicable NAIC CRP Rating feed(s), the SVO shall follow the procedure for Filing Exempt (FE) securities **only after the SVO receives both the private rating letter and private rating letter rationale report either directly or through a NAIC CRP Rating feed(s), and if, in its sole discretion, it concurs with the assigned Eligible NAIC CRP Credit Rating after reviewing the private rating letter rationale report and the SVO** deems the privately rated security eligible to receive an NAIC Designation with an NAIC CRP Credit Rating.
- In instances where a private letter **and private rating letter rationale report** is filed, the SVO shall evaluate the private letter **and private rating letter rationale report** to determine whether the security has been assigned an Eligible NAIC CRP Rating **and if the privately rated security is eligible to receive an NAIC Designation with a NAIC CRP Credit Rating.** Similar to public securities where a rating is received directly from the CRP via electronic feeds, **there is a similar assumption for the PL security,** that the **rating** meets the definition of an Eligible NAIC CRP Rating as a normal part of the CRP rating process, absent evidence to the contrary in the rating letter **or private rating letter rationale report** (e.g., evidence that the rating applies only to principal or interest, in a deviation from the normal CRP rating process).
- If the SVO verifies that the security has been assigned an Eligible NAIC CRP Rating and **if the SVO, upon review of the private rating letter rationale report and in its sole discretion, concurs with the assigned Eligible NAIC CRP Credit Rating** deems the privately rated security eligible to receive an NAIC Designation with a **NAIC CRP Credit Rating,** it assigns an NAIC Designation in accordance with the policy and procedure specified in this Manual. The assumption in the application of this step of the procedure is that **PL** securities are typically assigned a credit rating by only one NAIC CRP. However, if this assumption is inaccurate for any **PL** security, the SVO applies the same procedure specified for FE securities.

21. If the SVO verifies that the security:

- Has been assigned a credit rating but that the credit rating is not an Eligible NAIC CRP Credit Rating; or
- Has not been rated by an NAIC CRP; or

- Is no longer subject to a private letter rating; or
- ~~Has an assigned Eligible NAIC CRP Credit Rating that the SVO, in its sole discretion, does not concur with; or~~
- Is a type of security that is ineligible to receive an NAIC Designation with a NAIC CRP Credit Rating

The SVO shall notify the insurer that the security is not eligible for filing exemption. The insurance company shall then either file that security and necessary documentation with the SVO for an independent credit assessment or assign an **NAIC 5GI** Regulatory Designation to the security in the related Interrogatory.

22. An **NAIC 5GI** Designation may also be used in connection with the designation of **PL** securities rated by an NAIC CRP (i.e., for private letter ratings issued on or after January 1, 2018) when the documentation is not available for the SVO to assign an NAIC Designation. For purposes of this section, the documentation is not available for the SVO to assign an NAIC Designation if the NAIC CRP credit rating is not included in the applicable CRP credit rating feed (or other form of direct delivery from the NAIC CRP) and the insurer is unable to provide a copy of the private letter rating documentation, **including the private rating letter rationale report**, necessary for the SVO to assign an NAIC Designation.

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February 5, 2021

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

Re: Updated – Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Private Rating Letter Rationale Report Only

Dear Mr. Fry and Ms. Mears:

The American Council of Life Insurers (“ACLI”)¹, Private Placement *investors* Association (“PPiA”)², and the North American Securities Valuation Association (“NASVA”)³, (collectively, “the undersigned”) would like to thank the Valuation of Securities Task Force (“VOSTF”) for the opportunity to comment on the exposed proposed amendments to the P&P Manual related to the filing of Private Rating Letter

¹ The *American Council of Life Insurers* (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI’s member companies are dedicated to protecting consumers’ financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI’s 280 member companies represent 94 percent of industry assets in the United States.

² The *Private Placement Investors Association* (PPiA) is a business association of insurance companies, other institutional investors, and affiliates thereof, that are active investors in the primary market for privately placed debt instruments. The association exists to provide a discussion forum for private debt investors; to facilitate the development of industry best practices; to promote interest in the primary market for privately placed debt instruments; and to increase accessibility to capital for issuers of privately placed debt instruments. The PPiA serves 63 member companies and works with regulators, NASVA, the American College of Investors Counsel, and the investment banking community to efficiently implement changes within the private placement marketplace. Learn more at www.usppia.com.

³ The *North American Securities Valuation Association* (NASVA) is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC’s ISIS electronic security filing system, and commenting on year-end processes. Find more information [here](#)

Rationale Reports. We remain committed to assisting the VOSTF in addressing regulatory concerns surrounding bespoke securities, which are often (but not always) found in the private letter rating space.

As previously shared with the NAIC, an April 2019 study, “Society of Actuaries; 2003-2015 Credit Loss Experience Study: Private Placement Bonds” demonstrated the superior track record of private placement bonds compared to public bonds. Specifically, data from the study showed that private placement bonds had lower economic loss rates (which translates to superior performance) than public bonds during the period of the study. Additionally, private placement bonds offer several advantages to investors over public bonds, including the opportunity to negotiate more advantageous terms, additional covenants / credit protection for the investor, call premiums, and additional compensation for illiquidity. This asset class has become essential to insurance companies during this low yield environment, providing a significant source of income and duration to insurance company portfolios. Given this, the undersigned greatly appreciate VOSTF’s recognition that capital uncertainty in the private placement market would pressure insurance companies to reduce allocations to this asset class as well as pressure both issuers and investment bankers to steer such investments away from the insurance market.

The undersigned also appreciate the VOSTF’s decision to gather additional information on insurer’s privately rated securities before making policy decisions regarding the future regulation of these securities. We generally agree that the proposed changes to the P&P Manual will enhance transparency and the Securities Valuation Office’s (SVO) ability to be the eyes and ears of the VOSTF. However, as a friendly amendment, the undersigned offer some proposed amendments (tracked and highlighted in green) that we believe provide necessary clarification in the P&P Manual as to the reasons for which the SVO may deem a privately rated security ineligible to receive an NAIC Designation with a NAIC Credit Rating Provider (CRP) Rating.

Legal and Operational Considerations

As outlined in our letter in response to the Issue Paper “IAO staff concerns about Bespoke Securities, and Reliance on CRP Ratings”, the undersigned proposed a solution to increase the level of transparency and information sharing with the SVO, and by extension regulators, to address potential concerns with Bespoke Securities by sharing private rating letters, and rating rationale reports (where available), and if necessary, deal documents (upon the SVO’s request). This would allow the SVO to identify specific problems so they can be addressed in a public and transparent way and be responsive to the Financial Condition (E) Committee’s charge.

In that letter, the undersigned also raised the practical challenges resulting from the contractual agreements between NAIC CRPs, investors and issuers regarding the nature of the rating services provided. These agreements contain confidentiality provisions as well as terms related to the level of disclosure and analysis that will be provided initially, and on a going forward basis. Previously, industry worked diligently with rating agencies and issuers to amend confidentiality provisions allowing private rating letters to be filed with the SVO and allowing the private ratings to flow through to the SVO on electronic feeds, but for some NAIC CRPS, that did not include the right for insurers to also share ratings rationale reports with the SVO.

Given this, and while the undersigned are clearly supportive of increasing the level of transparency, we request that the VOSTF and the SVO consider the following practical considerations:

- 1) *Timing*: Requiring that insurers provide, for all privately rated securities issued from 1/1/18 thru 1/1/22, rating rationales as well as ratings letters, will in many instances conflict with the agreed upon work product in the contractual agreements between the issuers and the NAIC CRPs. These contracts may also contain limitations on how ratings and any related rationales can be shared. Hence, the undersigned propose that for securities issued in the period from and after 1/1/18 and prior to 1/1/22, the requirement to furnish rating rationales be on a best-efforts basis. This requirement would apply without qualification for securities issued on or after 1/1/22. This avoids the massive disruption that would occur if, for a great many securities issued in the four years commencing 1/1/18, insurers would need to persuade issuers and NAIC CRPs to amend existing contractual arrangements, with no certainty that such efforts would be successful. Further, we note that the SAPWG's SSAP No. 43R Project (or Schedule D Project) will be addressing the scope of Schedule D Bonds and alleviate a significant concern related to Bespoke Securities. Such a friendly amendment is included in Paragraphs 11 and 22 (tracked and highlighted in blue).
- 2) *Ongoing versus initial reports*: The undersigned would also like to clarify that the expectation to provide fulsome ratings rationales only applies upon the initial issuance by a NAIC CRP of a security specific rating. The initial issuance of an NAIC CRP rating usually occurs in connection with a newly issued security, but it may also occur after the fact, for a security that was initially unrated, or when an additional or different NAIC CRP starts to issue ratings specific to the same security. Once a ratings rationale by the applicable NAIC CRP has been furnished, subsequent changes by the NAIC CRP to the rating for the relevant security may be made by ratings letters only without any requirement for rationale reports as well. This is reflective of a very common commercially negotiated point between the issuer and the NAIC CRP, as it lowers the ongoing cost for the issuers that may otherwise seek to issue debt in a competing market.
- 3) *Rating rationale reports*: In our discussions with NAICCRPs, some have expressed a desire to better understand what type of work product is expected in a rating rationale report (e.g. how in depth the report should be, and what are the key topics that should be covered?). To help minimize any expectation gap with regards to rating rationale reports among rating agencies, insurers, issuers and the SVO, specifically on the level of detail and information most beneficial to the SVO (as broadly outlined in paragraph 12), we stand ready to continue working with the rating agencies and SVO to ensure this process goes as smoothly as possible.

As it pertains to the above considerations, industry commits to work in good faith with the issuers, investment bankers, and NAIC CRPs to take the necessary actions that will allow for the sharing of ratings rationales going forward. We do, however, expect this process to take time. As we work towards adopting this change, we will ensure the SVO is continually aware of our progress towards our shared goal of increased transparency and information sharing.

We look forward to continued dialogue with the Members and staff on this critical issue. Do not hesitate to contact us if you require any clarity or have questions on this submission.

Sincerely,



Mike Monahan
American Council of Life Insurer



Tracey Lindsey
NASVA



John Petchler
on behalf of PPIA Board of Directors

cc: Charles Therriault, Director, Securities Valuation Office



MEMORANDUM

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

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

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

RE: **Updated** - Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Private Rating Letter Rationale Report Only

DATE: **December 7, 2020** ~~October 30, 2020~~

1. Summary –The IAO staff discussed with the Task Force at its May 14th meeting the IAO’s concerns with bespoke securities and the NAIC’s excessive reliance on credit rating provider (CRP) ratings to assess investment risk and for regulatory purposes. At that meeting the Task Force exposed the IAO’s memorandum, dated February 27, 2020, summarizing these concerns. The Task Force requested the SVO make incremental recommendations to address these issues.

On October 23rd of this year the Financial Condition (E) Committee directed the Task Force to include a new charge for 2021; specifically, to, “*implement policies to oversee the NAIC’s staff administration of rating agency ratings used in NAIC processes, including, staff’s discretion over the applicability of their use in its administration of Filing Exemption.*” In furtherance of the proposed new Task Force charge and the Task Force’s request for incremental recommendations, the SVO proposes taking a first step towards implementation of some of its recommendations in its memo by increasing SVO scrutiny of PL securities, many of which are bespoke securities.

At the Task Force meeting on November 14th, the Task Force directed the SVO to update its proposed amendment to have the Private Rating Letter Rationale Reports filed with the SVO but without the SVO’s discretion over evaluating the appropriateness of the rating or methodology utilized, at least at this time. The SVO still recommends that it be granted this oversight authority and will be scheduling a regulator-only call in 2021 to review with the Task Force PLR transactions which appear to be either ineligible for filing exemption, ineligible for Schedule D reporting and/or where there is a material difference in opinion as to the risk

2. Recommendation for oversight of PL Securities – In its bespoke securities memo the SVO described its concern that its lack of authority to use its judgment in determining whether a CRP rating is useful for NAIC purposes (meaning its rating methodology may not be appropriate for, or consistent with, the assessment of investment risk for statutory purposes) has led to an increase in the use of bespoke securities, many of which are assigned NAIC designations through the Filing Exempt (FE) process, which includes the private letter rating process. To begin to address this lack of meaningful oversight of CRP ratings, the SVO proposes, as it did in its memo, that securities assigned private letter ratings be submitted to it for review. Understanding the many CRP private rating letters include little or no analysis

beyond the assigned private rating, the SVO recommends that for a PL security to receive an NAIC Designation the SVO must receive, along with the private rating letter, a related private rating letter rationale report providing more in-depth analysis of the transaction, the methodology used to arrive at the private rating, and, as appropriate, discussion of the transaction's credit, legal and operational risks and mitigants. With both the private rating letter and the private rating letter rationale report the SVO would be able to determine (i) whether the private credit rating is an Eligible NAIC CRP Rating, meaning the security type is eligible to be reported on Schedule D and that it is appropriate for and NRSRO credit rating to be used to determine the regulatory treatment of the security, and (ii) whether the SVO agrees with the private credit rating. The SVO would have full discretion, based on its reasonable review of the private rating letter and the supporting rationale report, to assign an NAIC designation equivalent to the CRP PLR, to require the security to be filed for review or, to decline to assign any NAIC designation.

The SVO understands there are potential obstacles to attaining private rating letter rationale reports such as CRP confidentiality policies. However, the SVO thinks such analysis is crucial to its ability to best determine whether a rating is a satisfactory assessment of investment risk for statutory purposes due to the typical private rating letter's lack of analysis and transparency. As such the SVO is committed to working with industry and CRPs to find solutions to possible obstacles.

3. Proposed Amendment – The SVO proposes the following amendments to Parts One and Three of the Purposes and Procedures Manual of the Investment Analysis Office to permit the SVO to review all PL securities whether processed through a feed or submitted directly to the SVO and would require insurance company filers to provide private rating letter rationale reports for each security. The following text in red shows the proposed Purposes and Procedures Manual revisions. Updates are highlighted in yellow.

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

FILING EXEMPTIONS

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<p>POLICIES APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL) RATING SECURITIES</p>
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Policy Considerations

83. In connection with the implementation of the verification procedure for PL securities, the VOS/TF acknowledges that the practices adopted by NAIC CRPs in relation to the distribution of private rating letters for what the NAIC refers to as PL securities, including their confidentiality procedures and agreements, are integral to the business models of private for-profit entities that the NAIC does not regulate and which the NAIC stands in the relation of a customer of rating services. Accordingly, the SVO, as NAIC staff, shall not be responsible for negotiating with NAIC CRPs to modify their confidentiality practices or provide data-feeds to the SVO. However, if an NAIC CRP shall determine that it is willing to modify its confidentiality provisions or provide such data-feed or an alternative process so that the SVO can obtain electronically, copies of private rating letters and private rating letter rationale reports for PL securities issued by that NAIC CRP instead of by requiring insurers to provide PDF files, then the SVO is authorized to work with the NAIC CRP to obtain and integrate the private rating letters and private rating letter rationale reports or the data-feeds into NAIC systems to create electronic processes that will permit electronic verification that the insurer-owned PL security have been assigned an NAIC CRP Eligible Credit Rating. Individual insurers and/or representatives of the insurance industry are encouraged to find ways to resolve confidentiality restrictions imposed by NAIC CRPs on the private rating letter and private rating letter rationale report or to influence the process as investors to encourage NAIC CRPs to provide the data-feeds to the SVO or alternative methods to permit the SVO to obtain NAIC CRP credit ratings and private rating letter rationale report for PL securities to be used to administer the PL securities verification procedure specified in this section.



PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS

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**PROCEDURE APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL)
RATING SECURITIES**

...

PL SECURITIES

Effective Date of Verification Procedure for PL Securities

9. Effective January 1, 2022, for each PL security received by the SVO either through a copy of a private rating letter or in a CRP credit rating feed, insurance companies shall be responsible for providing the SVO a copy of the related private rating letter rationale report from the applicable NAIC CRP, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs.
10. Effective July 1, 2018, insurance companies shall be responsible for providing the SVO copies of private rating letters for PL securities, where applicable, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs.
11. For PL Securities issued prior to January 1, 2018, if an insurance company cannot provide a copy of the rating letter to the SVO due to confidentiality concerns and the rating is not included in a CRP credit rating feed (or other form of direct delivery from the NAIC CRP), or for PL Securities issued from January 1, 2018 to January 1, 2022, if an insurance company cannot provide a copy of a “rating rationale report” to the SVO due to confidentiality or contractual reasons, the insurer shall report such securities on such securities’ General Interrogatory to be developed for this purpose (i.e., a PL GI security).

Definitions

12. For purposes of this section:
 - The phrase “private rating letter” means a letter or report issued by an NAIC CRP on its letterhead or its controlled website to an issuer or investor, obtained by an insurer in its capacity as an investor in the issuance or by following the confidentiality process established by the NAIC CRP.
 - The phrase “privately rated security” means a security issued by an issuer wherein the issuer has solicited a credit rating for the issuance from an NAIC CRP and the NAIC CRP has agreed to issue a credit rating for the issuance to be communicated to the issuer and a specified group of investors only and not publicly released via the NAIC CRP’s public data feed or website. The privately rated security is the

subject of the private rating letter and is referred to herein as a private letter (PL) security.

- The phrase “private rating letter rationale report” means an analytical review of the privately rated security explaining the transaction structure, methodology relied upon, and, as appropriate, analysis of the credit, legal and operational risks and mitigants supporting the assigned NAIC CRP rating, in a report issued by an NAIC CRP on its letterhead or its controlled website to an issuer or investor, obtained by an insurer in its capacity as an investor in the issuance or by following the confidentiality process established by the NAIC CRP.

Conditions to Filing Exemption for PL Securities Issued on or After January 1, 2018

13. **PL** securities are exempt from filing with the SVO for assignment of an analytically determined NAIC Designation if the security has been assigned an Eligible NAIC CRP Credit Rating, ~~and~~ the insurer verifies the rated status of the **PL** security to the SVO, ~~the insurer or NAIC CRP provides the SVO with the private rating letter rationale report, and the SVO concurs with the assigned Eligible NAIC CRP Credit Rating and the SVO~~ deems the privately rated security eligible to receive an NAIC Designation with an NAIC CRP Credit Rating (i.e., it is not ineligible per paragraph 21 below).
14. If the **PL** security is not rated by an NAIC CRP; or a credit rating is assigned that is not an Eligible NAIC CRP Credit Rating; or if the insurer cannot provide the SVO a private rating letter verifying that the assigned credit rating is an Eligible NAIC CRP Credit Rating; or the NAIC CRP cannot provide the Eligible NAIC CRP Credit Rating on the **PL** security to the NAIC through an electronic data feed approved by the SVO and that specifically identifies the **PL** securities rated by that NAIC CRP; ~~or the insurer or NAIC CRP cannot provide the private rating letter rationale report; or the SVO does not concur with the assigned Eligible NAIC CRP Credit Rating based on its review of the private rating letter rationale report;~~ or the SVO deems the privately rated security ineligible to receive an NAIC Designation with a NAIC CRP Credit Rating, the **PL** security is not filing exempt (i.e., it is ineligible per paragraph 21 below).
15. An insurer that owns a **PL** security that is not filing exempt shall either: (a) file the security with the necessary documentation with the SVO for an analytically determined NAIC Designation; or (b) self-assign an **NAIC 5GI** to the security and report using the Interrogatory procedure; in either case within 120 days of purchase.

Conditions to Filing Exemption for PL Securities Issued Prior to January 1, 2018

16. **PL** securities issued prior to January 1, 2018 are exempt from filing with the SVO for assignment of an analytically determined NAIC Designation if the security has been assigned an Eligible NAIC CRP Credit Rating. If the **PL** security CRP rating is not included in the applicable CRP credit rating feed (or other form of direct delivery from the CRP) or the insurer cannot submit the private letter rating to the SVO because of confidentiality provisions, the security shall be designated **PLGI**. Insurers shall report on all such securities in a General Interrogatory with an attestation that all such securities have an Eligible CRP Credit and are reflected in the financial statements and risk-based capital calculation commensurate with that rating

Procedure

17. The NAIC shall create systems and develop and staff administrative and operational procedures to be administered by the SVO to identify insurer-owned **PL** securities; verify whether or not the assigned credit rating is an Eligible NAIC CRP Credit Rating, review the private rating letter rationale report, and either translate that credit rating into its equivalent NAIC Designation and input the NAIC Designation for the security into the appropriate NAIC systems or notify the insurer that the security is not eligible for filing exemption.

SVO to Administer Verification Procedures

18. It shall be the responsibility of the NAIC to create and maintain for the SVO, electronic facilities to accept: (a) electronic data-feeds provided by NAIC CRPs containing and specifically identifying the **PL** securities rated by that NAIC CRP, and the credit rating assigned to the **PL** securities and the supporting private rating letter rationale report; or (b) PDF files of private rating letters provided by insurers to the SVO containing the NAIC CRP credit rating for the **PL** security and a copy of the supporting private rating letter rationale report.

The PL Process

19. It shall be the responsibility of the SVO to identify **PL** securities in the AVS+ system for insurance companies to use when reporting **PL** securities to the NAIC as part of the NAIC's Financial Statement Blank reporting process. The SVO identifies **PL** securities when it conducts the quarterly compilation of the SVO List of Securities.

Producing NAIC Designations for PL Securities

20. The SVO shall produce NAIC Designations for securities subject to private letter ratings as follows:

- The insurance company shall file a copy of the private rating letter with the SVO if not included in the applicable NAIC CRP Rating feed(s) (or other form of direct delivery from the CRP) noted above in Conditions to Filing Exemption for PL Securities and **the supporting private rating letter rationale report, if the SVO has not received it directly from the CRP, within the initial filing deadline for newly acquired securities or securities in transition (as explained in “SVO Analytical Department Symbols” in Part Two of this Manual) and each calendar year thereafter along with any changes in PL Securities rating.** In instances where the **PL** security is included in the applicable NAIC CRP Rating feed(s), the SVO shall follow the procedure for Filing Exempt (FE) securities **only after the SVO receives both the private rating letter and private rating letter rationale report either directly or through a NAIC CRP Rating feed(s), and ~~if, in its sole discretion, it concurs with the assigned Eligible NAIC CRP Credit Rating after reviewing the private rating letter rationale report and the SVO~~ deems the privately rated security eligible to receive an NAIC Designation with an NAIC CRP Credit Rating (i.e., it is not ineligible per paragraph 21 below).**
- In instances where a private letter **and private rating letter rationale report** is filed, the SVO shall evaluate the private letter **and private rating letter rationale report** to determine whether the security has been assigned an Eligible NAIC CRP Rating **and if the privately rated security is eligible to receive an NAIC Designation with a NAIC CRP Credit Rating (i.e., it is not ineligible per paragraph 21 below).** Similar to public securities where a rating is received directly from the CRP via electronic feeds, **there is a similar assumption for the PL security,** that the **rating** meets the definition of an Eligible NAIC CRP Rating as a normal part of the CRP rating process, absent evidence to the contrary in the rating letter **or private rating letter rationale report** (e.g., evidence that the rating applies only to principal or interest, in a deviation from the normal CRP rating process).
- If the SVO verifies that the security has been assigned an Eligible NAIC CRP Rating and **if the SVO, ~~upon review of the private rating letter rationale report and in its sole discretion, concurs with the assigned Eligible NAIC CRP Credit Rating~~ deems the privately rated security eligible to receive an NAIC Designation with a NAIC CRP Credit Rating (i.e., it is not ineligible per paragraph 21 below),** it assigns an NAIC Designation in accordance with the policy and procedure specified in this Manual. The assumption in the application of this step of the procedure is that **PL** securities are typically assigned a credit rating by only one NAIC CRP. However, if this assumption is inaccurate for any **PL** security, the SVO applies the same procedure specified for FE securities.

21. If the SVO verifies that the security:

- Has been assigned a credit rating but that the credit rating is not an Eligible NAIC

CRP Credit Rating; or

- Has not been rated by an NAIC CRP; or

- Is no longer subject to a private letter rating; or
- ~~Has an assigned Eligible NAIC CRP Credit Rating that the SVO, in its sole discretion, does not concur with; or~~
- Is a type of security that is ineligible to receive an NAIC Designation with a NAIC CRP Credit Rating because it is either:
 - i. A security ineligible for filing exemption per the “Specific Population of Securities Not Eligible for Filing Exemption” in “Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities” in Part Three of this Manual. For such a security, the SVO will provide the rationale to the filer so they understand the basis for why the security will not be provided a rating.
 - ii. A security for which the SVO does not believe is within the scope of SSAP No. 26R or SSAP No. 43R. For such a security, the SVO will provide an accounting analysis, to the filer, on why they do not believe the security is within the scope of SSAP No. 26R or SSAP No. 43R so the filer understands the SVO’s rationale and allows for the issuer to challenge the SVO’s rationale with the SVO, their regulator, NAIC accounting staff or SAPWG, as appropriate.

The SVO shall notify the insurer that the security is not eligible for filing exemption. The insurance company shall then either file that security and necessary documentation with the SVO for an independent credit assessment or assign an **NAIC 5GI** Regulatory Designation to the security in the related Interrogatory.

22. An **NAIC 5GI** Designation may also be used in connection with the designation of **PL** securities rated by an NAIC CRP (i.e., for private letter ratings issued on or after January 1, 2018) when the documentation is not available for the SVO to assign an NAIC Designation, ~~or for private letter ratings issued from January 1, 2018 to January 1, 2022, if an insurance company does not provide a copy of a “rating rationale report” to the SVO and there are no confidentiality or contractual reasons, or for any private letter ratings issued after January 1, 2022 for which a rating rationale report is not submitted to the SVO.~~ For purposes of this section, the documentation is not available for the SVO to assign an NAIC Designation if the NAIC CRP credit rating is not included in the applicable CRP credit rating feed (or other form of direct delivery from the NAIC CRP) and the insurer is unable to provide a copy of the private letter rating documentation, ~~including the private rating letter rationale report,~~ necessary for the SVO to assign an NAIC Designation.

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Require Filing Private Rating Analysis\2020-023.03 JointLetter_re_PLR_Bespoke_expo_02052021.docx



MEMORANDUM

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

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)

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

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Update the List of NAIC CRPs

DATE: February 2, 2021

- 1. Summary** – On July 2, 2019, Morningstar, Inc. completed its acquisition of DBRS. The merger was announced on May 29, 2019. DBRS Morningstar reported that they are now the fourth largest credit ratings agency and a market leader in Canada, the U.S. and Europe in multiple asset classes and rate more than 3,000 issuers and 60,000 securities worldwide. The merger resulted in the credit ratings symbols of the two previous entities being combined into a single set of symbols.
- 2. Recommendation** – The SVO recommend adoption of this non-substantive amendment removing references to the legacy entities and instead referring to the new combined national recognized statistical ratings organization (NRSRO) entity, DBRS, Inc., doing business as “DBRS Morningstar Credit Ratings” or “DBRS Morningstar.” This proposed change updates the rating agency names on the List of NAIC Credit Rating Providers to match those on the U.S. Securities and Exchange’s Office of Credit Ratings list of Current NRSROs and the CRP Credit Rating Equivalents to NAIC Designations and NAIC Designation Categories.
- 3. Proposed Amendment** – The text containing the updates to the List of NAIC CRPs is shown below, edits in red, as it would appear in the 2020 P&P Manual format.

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PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS

LIST OF NAIC CREDIT RATING PROVIDERS

~~22.~~ The CRPs that provide Credit Rating Services to the NAIC are:

- **Moody's Investor's Service, Inc.** for credit ratings issued to financial institutions, brokers, or dealers; insurance companies; corporate issuers; issuers of asset-backed securities and issuers of government securities, municipal securities, or securities issued by a foreign government.
- **S&P Global Ratings Standard and Poor's**, for credit ratings issued to financial institutions, brokers, or dealers; insurance companies; corporate issuers; issuers of asset-backed securities and issuers of government securities, municipal securities, or securities issued by a foreign government.
- **Fitch Ratings, Inc.** – For credit ratings issued to financial institutions, brokers, or dealers; insurance companies; corporate issuers; issuers of asset-backed securities and issuers of government securities, municipal securities, or securities issued by a foreign government.
- ~~**Dominion Bond Rating Service (DBRS)** – For credit ratings issued to financial institutions, brokers, or dealers; insurance companies; corporate issuers; issuers of asset-backed securities and issuers of government securities, municipal securities, or securities issued by a foreign government.~~
- **A.M. Best Rating Services, Inc. Company (A.M. Best)** – For credit ratings issued to insurance companies; corporate issuers and issuers of asset-backed securities.
- ~~**Morningstar Credit Ratings, LLC** – For credit ratings issued to financial institutions, brokers, or dealers; corporate issuers and issuers of asset-backed securities.~~
- **DBRS, Inc. (DBRS Morningstar)** - For credit ratings issued to financial institutions, brokers, or dealers; insurance companies; corporate issuers; issuers of asset-backed securities and issuers of government securities, municipal securities, or securities issued by a foreign government.
- **Kroll Bond Rating Agency, LLC.** – For credit ratings issued to financial institutions, brokers, or dealers; insurance companies; corporate issuers; issuers of asset-backed securities and issuers of government securities, municipal securities, or securities issued by a foreign government.
- **Egan-Jones Ratings Co.mpany** – For credit ratings issued to financial institutions, brokers, or dealers; insurance companies and corporate issuers.
- **HR Ratings de Mexico, S.A. de C.V.** – For credit ratings issued to financial institutions, brokers, or dealers; corporate issuers and issuers of government securities, municipal securities, or securities issued by a foreign government.

CRP Credit Rating Equivalent to NAIC Designations and NAIC Designation Categories

23. Please note that the existence of a rating does not eliminate the requirement to file on SAR on any insurer-owned security not currently listed in this Manual unless exempted from filing.

			Credit Rating Providers (*) (Pursuant to the guidance in this Manual; particularly, Part One, "The Use of Credit Ratings of NRSROs in NAIC Processes," "Filing Exemptions," "Policies Applicable to Specific Asset Classes," and Part Three, "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities")									
NAIC Designation	NAIC Designation Modifier	NAIC Designation Category	Moody's Investor's Service, Inc.	S&P Global Ratings Standard and Poor's	Fitch Ratings, Inc.	DBRS, Inc. (DBRS) Morningstar Dominion Bond Rating Service	A.M. Best Rating Services, Inc. Company	Morningstar Credit Ratings, LLC	Kroll Bond Rating Agency LLC	Egan Jones Rating Company	HR Ratings de Mexico, S.A. de C.V.	
1	A	1.A	Aaa	AAA	AAApr, AAA	AAA, Pfd-1 (high)	aaa	AAA	AAA	AAA	HR AAA (G)	
1	B	1.B	Aa1	AA+	AA+	AA (high), Pfd-1	aa+	AA+	AA+	AA+	HR AA+ (G)	
1	C	1.C	Aa2	AA	AA	A, Pfd-1 (low)	aa	AA	AA	AA	HR AA (G)	
1	D	1.D	Aa3	AA-	AA-	AA (low), Pfd-1	aa-	AA-	AA-	AA-	HR AA- (G)	
1	E	1.E	A1	A+	A+	A (high)	a+	A+	A+	A+	HR A+ (G)	
1	F	1.F	A2	A	A	A	a	A	A	A	HR A (G)	
1	G	1.G	A3	A-	A-	A (low)	a-	A-	A-	A-	HR A- (G)	
2	A	2.A	Baa1	BBB+	BBB+	BBB (high), Pfd-2 (high)	bbb+	BBB+	BBB+	BBB+	HR BBB+ (G)	
2	B	2.B	Baa2	BBB	BBB	BBB, Pfd-2	bbb	BBB	BBB	BBB	HR BBB (G)	
2	C	2.C	Baa3	BBB-	BBB-	BBB (low), Pfd-2 (low)	bbb-	BBB-	BBB-	BBB-	HR BBB- (G)	
3	A	3.A	Ba1	BB+	BB+	BB (high), Pfd-3 (high)	bb+	BB+	BB+	BB+	HR BB+ (G)	
3	B	3.B	Ba2	BB	BB	BB, Pfd-3	bb	BB	BB	BB	HR BB (G)	
3	C	3.C	Ba3	BB-	BB-	BB (low), Pfd-3 (low)	bb-	BB-	BB-	BB-	HR BB- (G)	
4	A	4.A	B1	B+	B+	B (high), Pfd-4 (high)	b+	B+	B+	B+	HR B+ (G)	
4	B	4.B	B2	B	B	B, Pfd-4	b	B	B	B	HR B (G)	
4	C	4.C	B3	B-	B-	B (low), Pfd-4 (low)	b-	B-	B-	B-	HR B- (G)	
5	A	5.A	Caa1	CCC+	CCC+	CCC (high), Pfd-5 (high)	ccc+	CCC+	CCC+	CCC+	HR C+ (G)	
5	B	5.B	Caa2	CCC	CCC	CCC, Pfd-5	ccc	CCC	CCC	CCC	HR C (G)	
5	C	5.C	Caa3	CCC-	CCC-	CCC (low), Pfd-5 (low)	ccc-	CCC-	CCC-	CCC-	HR C- (G)	
6	6	6	Ca	CC	CC	CC (high)	cc	CC	CC	CC	HR D (G)	
6	6	6	C	C	C	C	c	C	C	C		
6	6	6		D	DDD	CC (low)	d	D	D	D		
6	6	6			DD	C (high)						
6	6	6			D	C						
6	6	6				C (low)						
6	6	6				D						

Note: * This is a listing of only the "generic" Credit Rating Provider (CRP) rating symbols. CRPs use a variety of symbols; including, combinations of prefixes and suffixes that provide additional information about the rating symbol which are described in the CRP's documentation. There are over 2,000+ unique rating symbols used by CRPs to describe long-term securities. The SVO webpage (<https://www.naic.org/svo.htm>) maintains a master list of Credit Ratings Eligible for Translation to NAIC Designations. The SVO does not currently translate short-term security ratings as part of its Compilation and Publication of the SVO List of Investment Securities incorporated into the NAIC's AVS+ product.

			Credit Rating Providers (Pursuant to the guidance in this Manual; particularly, Part One, "The Use of Credit Ratings of NRSROs in NAIC Processes," "Filing Exemptions," "Policies Applicable to Specific Asset Classes," and Part Three, "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities")								
			Moody's Investor's Service, Inc.	S&P Global Ratings Standard and Poor's	Fitch Ratings, Inc.	DBRS, Inc. (DBRS Morningstar) Dominion Bond Rating Service	A.M. Best Rating Services, Inc. Company	Morningstar Credit Ratings, LLC	Kroll Bond Rating Agency, LLC	Egan Jones Rating Company	HR Ratings de Mexico, S.A. de C.V.
NAIC Designation	NAIC Designation Modifier	NAIC Designation Category	Commercial Paper and Short Term Counterparty Ratings	Commercial Paper	Commercial Paper	Commercial Paper and Short Term Debt	Commercial Paper and Short Term Debt	N/A	Short-Term and Commercial Paper Ratings	Commercial Paper	N/A
1	A	1.A									
1	B	1.B									
1	C	1.C									
1	D	1.D	P1	A-1+	F1+	R1 (high)	AMB-1+		K1+	A1+	
1	E	1.E		A-1	F1	R-1 (middle)	AMB-1		K1	A1	
1	F	1.F									
1	G	1.G				R-1 (low)				A	
2	A	2.A	P2	A-2	F2	R-2 (high)			K2	A2	
2	B	2.B				R-2 (middle)	AMB-2				
2	C	2.C	P3	A-3	F3	R-2 (low)				A3	
3	A	3.A									
3	B	3.B				R-3	AMB-3		K3		
3	C	3.C									
4	A	4.A									
4	B	4.B		B	B				B	B	
4	C	4.C									
5	A	5.A									
5	B	5.B	NP	C	C	R-4			C	C	
5	C	5.C									
6		6		SD	D	R-5	AMB-4		D	D	
6		6		D		D					

Note: * This is a listing of only the "generic" Credit Rating Provider (CRP) rating symbols. CRPs use a variety of symbols; including, combinations of prefixes and suffixes that provide additional information about the rating symbol which are described in the CRP's documentation. There are over 2,000+ unique rating symbols used by CRPs to describe long-term securities. The SVO webpage (<https://www.naic.org/svo.htm>) maintains a master list of Credit Ratings Eligible for Translation to NAIC Designations. The SVO does not currently translate short-term security ratings as part of its Compilation and Publication of the SVO List of Investment Securities incorporated into the NAIC's AVS+ product.

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March 1, 2021

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Re: Request to Consider National GAAP/National IFRS of Spain for Addition to Permitted Financial Performance Presentation Standards Country List

Dear Mr. Therriault:

The American Council of Life Insurers (ACLI) respectfully requests that the Securities Valuation Office (“SVO”) study the feasibility of adding the National GAAP of Spain to Part Two Section 10(c)(i)(D) of the Purposes and Procedures Manual of the NAIC Securities Valuation Office (the “Manual”).

In 2013, a Procedure to Authorize SVO Use of a National Financial Presentation Standard was adopted by the SVO. This procedure provides that a national insurance association may, by written request, ask the SVO to study the feasibility of adding a country and the associated National GAAP or National IFRS to Part Two Section 10(c)(i)(D) of the Manual. The SVO is authorized, but not required, to hold discussions with representatives of the national insurance association to evaluate whether the criteria specified below has been met and to formulate a recommendation to the Valuation of Securities Task Force (“VOSTF”).

Information Supporting the Request – As part of its request the national insurance association shall:

(i) Demonstrate that the request to add a National GAAP or National IFRS standard reflects that the borrower population the insurance industry would target is not required to use a Global Financial Presentation Standard or the Reconciled Financial Presentation Standard to obtain financing in its local market and otherwise lacks the economic or market incentive to use a Global Financial Presentation Standard or the Reconciled Financial Presentation Standard in the absence of a requirement.

American Council of Life Insurers | 101 Constitution Ave, NW, Suite 700 | Washington, DC 20001-2133

The American Council of Life Insurers (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

acli.com

- Spain (A/Baa1/A-) is a highly developed and mature economy with a GDP of c. \$1.3 trillion, making it the 4th largest country in the EU after Germany, France and Italy (and 14th largest country globally). National GAAP issuers in Spain have access to a strong core of local Spanish banks as well as international banks, the European private placement market, private placements under EMTN documents, the public Eurobond market and the growing local alternative fixed income bond market “MARF” – all of which accept local GAAP.

(ii) Provide evidence of both investment opportunity and insurance industry interest to make investments in the country;

- From the late 1990s to 2010, companies in Spain tapped the USPP market opportunistically, with major multinationals including companies like Iberdrola, Grifols, Uralita and Campofrio (amongst others) issuing in the USPP market. There was limited issuance from 2010-2017 as the Spanish banks remained very aggressive and issuers had the opportunity to tap the European PP or local MARF market which accepted both Spanish GAAP and Spanish Law. Since 2018, Spanish issuance (totaling USD 2.3 billion) increased significantly and we believe Spain can be a key source for the U.S. Private Placement market among countries whose National GAAP is not included in Part Two Section 10(c)(i)(D). To date, most if not all investment flows have been from issuers that report under IFRS. Based on a CapIQ screen, there are approximately 1,250 companies in Spain between €200 million and €3 billion in revenues that presumably could consider obtaining financing from the U.S. Private Placement market. Although the number of companies using Spanish GAAP (vs. IFRS) is difficult to ascertain, given the fact that Spanish companies are required by law to file for their taxes using Spanish GAAP, the IFRS standard is mainly used by listed companies and, even then, it is in conjunction with Spanish GAAP (and only for the Consolidated Financial Statements). Given broad access to alternative sources of capital for these potential issuers, the cost and time consumption of the current reconciliation requirement serves as a barrier to their interest in the U.S. Private Placement market.

(iii) Explain the relationship of the proposed National GAAP or National IFRS financial presentation standard within the larger context of the country’s economic, financial, regulatory and legal traditions; and

- See Exhibit 1 for further details on Spanish GAAP.

(iv) Explain how the proposed National GAAP or National IFRS financial presentation standard, viewed from the perspective of an investor and from that of the SVO as a risk assessor, is of a quality and of a transparency sufficient to enable the creation of NAIC Designations analogous to those prepared using a Global Financial Presentation Standard.

- National GAAP of Spain:
 - Is broadly accepted in local and European bank markets and capital markets
 - Benefits from long-standing National accounting standards Boards
 - Issuers are regularly subject to audits on their reported Spanish GAAP Financial Statements which are conducted by independent accounting firms, including the Big Four

- Is considered broadly similar to IFRS and other European National GAAPs
- Only the National Spanish GAAP can be used to file the Company Taxes
- ACLI is prepared to expand on these factors as part of an education process for the SVO on the Spanish National GAAP standard.

In summary, we believe adding the National GAAP of Spain to Part Two Section 10(c)(i)(D) of the Manual will create access for U.S insurance companies to attractive investment flows, from strong companies in a highly developed economy.

Sincerely,



Mike Monahan
Senior Director, Accounting Policy

cc: Marc Perlman, Investment Counsel

Exhibit 1

Spain – National GAAP Accounting Context

- The Spain Generally Accepted Accounting Principles (“Spanish GAAP”) are regulated by law and are mainly based on EU directives. The Code of Commerce establishes the obligation for companies to keep books of accounts and provides the basic legal framework for accounting. As stipulated in the Code of Commerce, all companies must prepare financial statements in accordance with the Spanish General Accounting Plan (Spanish GAAP) and file these with the Mercantile Register.
- In accordance with the Royal Decree 302/1989, the Instituto de Contabilidad y Auditoría de Cuentas (ICAC), an agency within the Ministry of Economy, Industry and Competitiveness (MoEIC), is responsible for proposing a Spanish GAAP adapted to EU Regulations and harmonized with EU-endorsed standards. Throughout the 2000s, Spanish accounting legislation was amended in order to adapt to international standards and the EU accounting requirements. Since 2005, publicly traded companies have been required to prepare their consolidated financial statements in accordance with EU-endorsed IFRS following the EU Regulation (EC) No 1606/2002. In 2007, Royal Decree 1514/2007 approved the revised Spanish GAAP for separate statements of all companies and in 2010 the Royal Decree 1159/2010 approved the Spanish GAAP for consolidated annual statements. In addition, Royal Decree 1515/2007 approved the Spanish GAAP for SMEs and a Spanish GAAP for micro-entities for eligible companies. The above-mentioned decrees were amended by the Royal Decree 602/2016, to transpose the EU Audit Directive 2013/34. There are some differences between the IFRS and Spanish GAAP.¹
- A recent reform was approved with the main objective to adapt and not adopt Spanish Accounting Standards to the relevant differences introduced by the Financial Reporting Standards issued by the IASB and adopted by the European Union in 2018; that is, IFRS 9 on Financial Instruments, IFRS 13 Fair Value Measurement and IFRS 15 on Revenue from Contracts with Customers.
- Like other EU countries, listed companies in Spain are required to report under IFRS (effective 2005).
- National professional organizations in Spain include:
 - ICAC , Accounting and Auditing Institute
 - ICJCE , Institute of Certified Public Accountants of Spain
 - AECE , Professional Association of Certified Public Accountants and Certified Tax Experts of Spain
- The accounting principles set out in the IFRS framework, which include understandability, relevance, materiality, reliability, substance over form, prudence, completeness, comparability, timeliness, and achieving a balance between benefit and cost, apply to

¹ Source: IFAC (International Federation of Accountants)

Spanish GAAP in practice. Financial statements shall give a true and fair view of the company's assets, liabilities, financial position and results.

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MEMORANDUM

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

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

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

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Add Additional Instructions to the Review of Funds

DATE: March 1, 2021

1. Summary –At the request of the Task Force to provide greater clarity and predictability to fund sponsors and investors regarding the acceptable use of derivatives in funds and permit some funds to have greater flexibility in their use of derivatives, the SVO proposes creating two new tests. One test would be for all funds other than those on the NAIC Fixed Income-Like SEC Registered Funds List and the other test would apply only to funds on that list. Pursuant to the P&P Manual, the SVO’s stated objective regarding funds is to “...*assess whether for NAIC regulatory purposes ..., the fund’s portfolio will generate predictable and periodic cash flows so similar to a bond (or a preferred stock) that it should be assigned an NAIC Designation and obtain applicable risk-based capital charges.*” The P&P Manual further requires the SVO, in its opinion, to determine if the 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 holdings of bonds or of preferred stock of a known credit quality were held individually.*” Currently, the P&P Manual grants the SVO discretion in determining whether a fund’s use of derivatives is consistent with a fixed income like security.

On October 28, 2020, the Securities Exchange Commission (SEC) adopted Rule 18f-4 (the Rule) under the Investment Company Act of 1940 related to the use of derivatives by registered investment companies, including funds. The SEC designed the Rule to create a more comprehensive approach to the regulation of the use of derivatives by funds. While the Rule imposes rigorous management, reporting and leverage requirements on funds which use derivatives, limited users of derivatives are exempt from those requirements. Under the Rule, a fund is considered a limited user of derivatives if its gross notional derivatives exposure, exclusive of certain currency and interest rate hedges associated with specific fixed-income or equity investments held by the fund, does not to exceed 10 percent of the fund’s net assets. The SEC recognized the risk derivative transactions pose to funds and wrote, “Many derivatives transactions, such as futures, swaps, and written options, involve leverage or the potential for leverage because they enable the fund to magnify its gains and losses compared to the fund’s investment, while also obligating the fund to

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make a payment or deliver assets to a counterparty under specified future conditions.”¹ The SEC specifically noted the differences in risk to a fund between the hedging, for example, the currency risk of a fund investment denominated in a different currency and the fund taking a speculative position on price movements of two currencies. The SVO contends that such leverage is inconsistent with the “predictable and periodic” standard in the P&P Manual definition of Fixed Income Like and therefore proposes using the Rule’s limited user standards as a guidepost for updated P&P Manual guidance on what is an acceptable use of derivatives use by a fund so that the fund payments can be considered fixed income like.

2. Recommendation – Based on requests from Task Force members that a more definitive limitation on the use of derivatives in funds be established we propose the following two tests. For funds on the SVO-Identified Bond ETF List², the SVO-Identified Preferred Stock ETF List³ and the NAIC List of Schedule BA Non-Registered Private Funds with Underlying Assets Having Characteristics of Bonds or Preferred Stock⁴, we propose, similar to the limited user exception in the Rule, a threshold whereby the gross notional amount of derivatives which impose no future payment or margin posting obligation on the fund, cannot exceed 10% of the net asset value of the fund, under normal market conditions, except for certain currency and interest rate hedges, certain futures or forwards on fixed-income or preferred stock to be held in the fund’s portfolio, reverse-repurchase agreements associated with specific fixed-income or preferred stock investment held by the fund, and non-margin borrowing for purposes other than investment, each of which could impose a future payment or margin posting obligation on the fund.

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 Designations. Therefore, if the Task Force thinks it appropriate, these funds could be permitted a larger derivative threshold of up to 20% of the net asset value of the fund, under normal market conditions. 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 if the fund is a bond fund or 80% of its assets in preferred stock if the funds is a preferred stock fund, *in normal market conditions . . .*” We are not proposing that any types of derivatives be exempt from the 20% threshold calculation because such exemptions could potentially cause such a breach in the aggregate. For both tests we recommend incorporating an assessment of counterparty risk into our Credit Risk Assessment.

3. Proposed Amendment – The text referencing the Investments in Funds is shown below, edits in **red**, as it would appear in the 2020 P&P Manual format.

¹ SEC Release No. IC-34084; File No. S7-24-15, p.11.

² In scope of *SSAP No. 26R- Bonds* and reported on Schedule D, Part 1.

³ In scope of *SSAP No. 32 – Preferred Stock* and reported on Schedule D, Part 2, Section 1.

⁴ In scope of *SSAP No. 48 – Joint Ventures, Partnerships and Limited Liability Companies* or *SSAP No. 97 – Investments in Subsidiary, Controlled and Affiliated Entities*, reported on Schedule BA.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS

NAIC FUND LISTS

...

NAIC FIXED INCOME-LIKE SEC REGISTERED FUNDS LIST

Description

269. This section encompasses SEC registered funds issued by any type of investment-company registered with the SEC under the Investment Company Act of 1940 that sponsors a fund that will predominantly hold bonds or preferred stock. This listing excludes money market mutual funds as those securities are subject to different accounting treatment.) Different type of investment companies can be considered to have business models that operate differently as to redemption of shares, the life of the fund, whether the portfolio is held to maturity or traded over the life of the fund. The four types of investment companies are summarized below:

- **Open End Management Company (OEMC)** – An OEMC sell redeemable shares, directly or through a broker, on a continuous basis at the fund’s approximate net asset value (NAV) per share and invests the proceeds in highly liquid bonds. Investors redeem shares of an OEMC fund by selling them back to the fund or to a broker. OEMC’s may include exchange-traded funds.
- **Closed End Fund (CEFC)** – A CEFC lists its shares on a stock exchange or trades in the over-the-counter market. The assets of a CEFC are professionally managed in accordance with the fund’s investment objectives and policies. The market price of a CEFC share is determined by supply and demand in the marketplace. Because a CEFC does not maintain cash reserves or sell securities to meet redemptions, it can invest in less-liquid portfolio securities. A CEFC has a stated termination date.
- **Unit Investment Trust (UIT)** – A UIT issues a fixed number of securities called “units” in a public offering and uses the proceeds to buy a diversified professionally selected portfolio of securities. UITs have a preset termination date tied to its portfolio investments and investment goals. The portfolio is held for the life of the UIT; but is not actively managed or traded. Although UITs are required by law to redeem outstanding units, the UIT sponsor usually maintains a secondary market so investors can sell units back and other investors can buy units. UIT’s may include exchange-traded funds.

- **Exchange-Traded Fund (ETF)** – An ETF is an investment company that is registered under the Investment Company Act of 1940 either as an OEMC or as a UIT. An ETF combines the valuation feature of an OEMC or UIT, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value.

Regulatory Treatment of Eligible Funds

270. An SEC registered fund on the NAIC Fixed Income-Like SEC Registered Funds List is in the scope of *SSAP No. 30R—Unaffiliated Common Stock* and reported on Schedule D, Part 2, Section 2 with an NAIC Designation. **The NAIC Designation for such funds may reflect assessments of risk other than credit risk, including market risk and liquidity risk. These investments are reported at fair value although reporting at net asset value is permitted if there is no readily determinable fair value.**

...

REQUIRED DOCUMENTATION, ANALYTICAL PROCEDURES AND ELIGIBILITY CRITERIA

Objective

277. The objective of the SVO's review is to assess whether for NAIC regulatory purposes discussed above, the fund's portfolio will generate predictable and periodic cash flows so similar to a bond (or a preferred stock) that it should be assigned an NAIC Designation and obtain applicable risk-based capital charges.

Definitions

278. **Bond** – For fund investment purposes, Bond means debt securities defined or encompassed within *SSAP No. 26R—Bonds* and *SSAP No. 43R—Loan-Backed and Structured Securities*.
279. **Credit Risk Assessment** – A calculation of the credit risk of a fund's underlying investment portfolio using a weighted average rating factor methodology (WARF). The WARF factor for each portfolio security (issue/security specific) is determined by first translating its NAIC CRP rating into an NAIC Designation. For securities that are unrated but have an NAIC Designation, the Designation is used. The WARF factor for that NAIC Designation is then market value-weighted. The weighted factor for each investment is summed to determine the fund's credit rating which is then translated into the equivalent NAIC Designation. **For funds which use derivatives transactions, the WARF analysis will incorporate the derivative counterparties and the credit risk assessment will include an estimate of the fund's obligations 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 payment or otherwise.**

280. **Derivative Transaction Exposure** – means the sum of the gross notional amounts of the fund’s derivative instruments described in the definition of “Derivative Transactions”.
281. **Derivative Transactions** – means any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument (“derivatives instrument”), under which a fund is or shall not be required, except in the case of exempt derivatives, 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 payment or otherwise.
282. **Exempt Derivative** – means a (a) currency or interest rate derivative that hedges currency or interest rate risks associated with one or more specific investments held by the fund (which must be foreign-currency-denominated in the case of a currency derivative) and which shall not be speculative in nature or constitute a borrowing, (b) repurchase agreement, meaning a form of short-term borrowing by which the fund agrees to sell securities for cash and simultaneously agrees to repurchase the same or substantially similar securities at a stated price on a specified date, (c) forward or futures contract by which the fund contracts to purchase for a fixed price at a future date fixed-income securities or preferred stock it intends to hold in the fund portfolio, and for which the fund maintains until the settlement date, cash or other liquid assets sufficient to meet the purchase price and (d) non-margin borrowing for purposes other than investment.
- ~~283. **Financial Commitment Transactions**— Refers to reverse repurchase agreements, short sale borrowing, any firm or standby commitment or similar agreement as these terms are defined and as they may be subsequently amended by the SEC as part of proposed Rule 18 f 4.~~
284. **Fixed Income Like** – An SVO determination that a fund will generate predictable and periodic cash flows in a manner broadly similar to a situation where the holdings of bonds or of preferred stock of a known credit quality were held individually.
285. **Fundamental Policy** – A policy adopted by a fund that requires shareholder approval to change or a policy to provide at least 60 days’ notice to fund shareholders of an intended change of a stated policy. The subject of the policy is that under normal circumstances the fund will invest at least 80% of its net assets plus any leverage for investment purposes in the type of bonds indicated by its name in compliance with Section 13 (a) of the Investment Company Act of 1940 and/or Rule 35d-1 of the 1940 Act. If the fund’s prospectus does not state that this investment objective is a fundamental policy for the fund, the SVO will assume it is not.
286. **Look-through Assessment** – A qualitative and quantitative evaluation of the fund, encompassing the following criteria:
- Verify that the fund’s portfolio, in the case of a bond fund or, preferred stock, in the case of a preferred stock fund *predominantly holds* bonds or preferred stock.

- Confirm that the fund has adopted its investment objective as part of its *fundamental policy* and that other policies are consistent with fixed income investment.
- Review the fund's stated investment objective to ensure it is consistent with a fixed income investment, and evaluate the fund's investment policies and investment strategies for consistency with the investment objective and the fund's portfolio.
- Evaluate the extent to which the composition of the fund's portfolio can vary under normal market conditions given the fund's policies and investment strategies and the extent to which the composition of the fund's portfolio may vary under abnormal market conditions and the extent to which changes in composition of the fund's portfolio in abnormal market conditions may persist given the fund's leverage profile or other relevant factors.

287. **Management Assessment** – The SVO may consider the fund's:

- management and organization, including key-man risk and investment and asset class experience;
- risk management and compliance infrastructure, including operational risk controls;
- credit management standards;
- credit research staff and capabilities;
- and, the derivatives risk management program, for funds required to adopt and implement a written derivatives risk management program pursuant to Rule 18f-4 under the Investment Company Act of 1940.

The SVO may notch the final NAIC Designation down from the quantitative Credit Risk Assessment or, in its sole discretion and based on its analytical judgement, choose not to assign any NAIC Designation, based upon its Management Assessment.

288. **Predominantly Hold** – The fund will hold *at least* 80% of its assets in bonds if the fund is a bond fund or at least 80% of its assets in preferred stock if the fund is a preferred stock fund, *in normal market conditions* and will deviate from this policy only temporarily to respond to abnormal market conditions. In the case of an ETF, **predominantly hold** **also** means that the fund will track a specified bond or preferred stock index, if passively managed, or refers to the bond or preferred stock portfolio the fund will actually hold, if actively managed—under normal market conditions.

289. **Speculative Characteristics Analysis** – Means: ~~(a) an assessment of the fund’s use of leverage, including, but not limited to, its use of derivatives, financial commitment derivative transactions and borrowings, to examine the impact the fund’s use of leverage they may have on the fund’s portfolio cash flow as assessed under the *credit risk assessment* under normal and abnormal market conditions; and (b) a review and evaluation of the fund’s policy and approaches to covering leverage obligations in relation to current and potential future guidance on the issue provided by the SEC. As used herein potential future guidance refers to proposed SEC Rule 18-f-4, “Use of Derivatives by Registered Investment Companies and Business Development Companies, ICA Release No. 31933 (December 11, 2015) [17 CFR Parts 270 and 274] Proposed Rule 18-f-4.”, such *derivative transaction exposure* not to exceed:~~

- (i) for funds other than funds on the NAIC Fixed Income-Like SEC Registered Funds List, 10% of the fund’s net assets in normal market conditions, excluding, for purposes of determining derivatives transaction exposure, *exempt derivatives*;

and

- (ii) for funds on the NAIC Fixed Income-Like SEC Registered Funds List, 20% of the fund’s net assets in normal market conditions.

NOTE: For the avoidance of doubt, funds are not permitted to use (a) derivative instruments, 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 payment or otherwise and (b) any short sale borrowing or other borrowings, except for exempt derivatives. Funds on the NAIC U.S. Government Money Market Fund List are not permitted to use any derivative instruments. ~~Examples of speculative characteristics may include the need to sell assets to meet leverage obligations at a loss; instability in the cash flow introduced by the use of leverage; the need to employ alternative portfolio management strategies as a result of the need to meet payment obligations; the extent to which changes in the composition of the fund’s portfolio in response to abnormal market conditions may persist given the fund’s leverage profile or other relevant factors. The purpose of an analysis of speculative characteristics is to determine whether the fund’s cash flow is inconsistent with a fixed income like determination.~~

Methodology*

290. The SVO shall:

- Conduct a *look-through assessment*
- Conduct a *credit-risk assessment* to determine the credit risk of the fund’s cash flows.
- Conduct a *management assessment*
- Conduct a *speculative characteristics analysis*.

- Determine whether the fund’s cash flow can or cannot be appropriately characterized as *fixed income like* for regulatory purposes.
- For funds on the NAIC Fixed Income-Like SEC Registered Funds List, conduct an assessment of other, non-credit risks, including market and liquidity risk.
- If the SVO determines that the fund’s cash flow can be appropriately characterized as fixed income for regulatory purposes, it assigns an NAIC Designation to reflect the credit risk associated with the fund’s cash flow and includes the name of the fund on the appropriate NAIC List.** Since funds on the NAIC Fixed Income-Like SEC Registered Funds List are reported on Schedule D, Part 2, Section 2, in scope of SSAP No. 30R-Unaffiliated Common Stock, the NAIC Designation for such funds may reflect assessments of risks other than credit risk, including market risk and liquidity risk.
- If the SVO determines that the fund’s cash flow cannot be appropriately characterized as fixed income for regulatory purposes it shall communicate the determination to the insurance company or fund sponsor in writing.

* **NOTE:** *Italicized text* indicates that the term used is a defined term. Please refer to the definition of the term for a description of SVO criteria associated with the methodology component being described.

** **NOTE:** The NAIC Designation does not address the fund’s ability to meet payment obligations because the insurer/shareholder does not own the bonds in the portfolio; the NAIC Designation instead conveys the credit risk/quality of the fixed income like cash flow generated by the ETF.

Documentation

291. An insurance company or the sponsor of a bond or preferred stock fund that request that the SVO conduct the look through and credit assessment submits the following required documentation to the SVO:

- A completed RTAS Application (Information about the RTAS process is contained here: www.naic.org/documents/svo_rtas_app.pdf. Funds with derivatives may be considered a Highly Customized Transaction.
- For all funds subject to look-through and credit risk assessment and to speculative characteristics analysis: the Prospectus and Statement of Additional Information (SAI) for the fund.
- For funds which use derivative instruments or repurchase agreements, the applicable legal documentation.
- In the case of an ETF, copies of the Application, Notice and Order associated with the fund sponsor’s request for Exemptive Relief from the SEC or a link to the SEC’s EDGAR where the SVO can obtain the documents.

- In the case of a private equity fund, the Private Placement Memorandum, Limited Partnership Agreement or Limited Liability Company Agreement, the Subscription Agreement and the Form D, if one has been filed.

NOTE: The documentation provided must enable the SVO to conduct the analysis described below. Applicants are free to provide any supplemental material they believe will assist the SVO to:

- Verify that the fund has adopted a *fundamental (stated) policy to predominantly hold bonds* (or preferred stock).
- Evaluate the fund's use of leverage in relation to the management of portfolio risk and in relation to other purposes relevant to the *speculative characteristics analysis*.
- Understand the fund's policy and approaches to coverage of obligations arising from the use of leverage, in relation to SEC guidance on the subject.
- Schedules of the fund's portfolio securities and assets with a description of the security, the CUSIP or other security identifier and NRSRO credit ratings for the last four quarters of the fund's existence.
- A description of likely changes in the fund's composition under normal market conditions given the fund's investment objective and the strategies to be employed to attain it.

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