

Date: 11/4/2020

*Fall National Meeting
Conference Call*

VALUATION OF SECURITIES (E) TASK FORCE

Wednesday, November 18, 2020

3:30 p.m. – 5:00 p.m. ET / 2:30 p.m. – 4:00 p.m. CT / 1:30 p.m. – 3:00 p.m. MT / 12:30 pm. – 2:00 p.m. PT

ROLL CALL

| | | | |
|-------------------------|-------------|----------------------|---------------|
| Robert H. Muriel, Chair | Illinois | Gary Anderson | Massachusetts |
| Doug Ommen, Vice Chair | Iowa | Chlora Lindley-Myers | Missouri |
| Lori K. Wing-Heier | Alaska | Bruce R. Range | Nebraska |
| Ricardo Lara | California | Marlene Caride | New Jersey |
| Andrew N. Mais | Connecticut | Linda Lacewell | New York |
| Trinidad Navarro | Delaware | Jessica Altman | Pennsylvania |
| David Altmaier | Florida | Kent Sullivan | Texas |
| Dean L. Cameron | Idaho | Tanji J. Northrup | 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 minutes from the Aug. 7th Summer National Meeting and Sep. 29th interim meeting.
—Kevin Fry (IL) Attachment One & Two
2. Consider Adoption of a Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Update Guidance on Initial and Subsequent Annual Filings, and Methodologies and Documentation
(Doc. ID 2020-025.01, 2020-025.02)
—Kevin Fry (IL), Charles Therriault (NAIC) Attachment Three & Three - A
3. Receive an Updated Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) on Guidance for Working Capital Finance Investments Consistent with the Statutory Accounting Principles (E) Working Group Adoption of Changes to *SSAP No. 105R – Working Capital Finance Investments*
(Doc. ID 2020-022.01, 2020-022.02, 2020-022.03, 2020-022.03b, 2020-022.04, 2020-22.04b, 2018-020.02, 2018-020.01E, 2019-020.01G, 2018-020.01I, 2018-020.01H, 2018-020.01J)
—Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC) Attachment Four & Four A - K
4. Receive a Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Permit the SVO to Rely Upon the Un-rated Subsidiaries of a CRP Rated Parent Entity for Only Working Capital Finance Investments
(Doc. ID 2020-026.01)
—Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC) Attachment Five
5. Discuss Bespoke Securities, and NAIC Reliance on CRP Ratings
(Doc. ID 2020-018.01, 2020-018.02, 2020-018.03, 2020-018.04, 2020-018.05)
—Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC) Attachment Six and Six - A - D

6. Receive a Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Require the Filing of Private Rating Analysis (*Doc. ID 2020-023.01*)
—Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)
7. Hear a Staff Report on Projects Before the Statutory Accounting Principles (E) Working Group
—Julie Gann (NAIC)
8. Adjournment

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Draft Pending Adoption

Draft: 8/18/20

Valuation of Securities (E) Task Force
Virtual Summer National Meeting
August 7, 2020

The Valuation of Securities (E) Task Force met via conference call Aug. 7, 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); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by William Arfanis (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Carolyn Morgan (FL); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Bruce R. Ramge represented by Lindsay Crawford (NE); Marlene Caride represented by John Sirovetz (NJ); Linda A. Lacewell represented by Jim Everett (NY); Todd E. Kiser represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Tim Hays (WA); and Mark Afbale represented by Randy Milquet (WI).

1. Adopted its July 1 and May 14 Minutes

Mr. Fry said he is representing Director Muriel for the Illinois Department of Insurance (DOI), serving as the chair of the Task Force. The first item on the agenda was the adoption of its July 1 and May 14 minutes.

Mr. Fletcher made a motion, seconded by Ms. Clements, to adopt the Task Force's May 14 (Attachment One) and July 1 (Attachment Two) minutes. The motion passed unanimously.

2. Adopted an Amendment to the P&P Manual to Map Short-Term CRP Ratings to NAIC Designation Categories

Mr. Fry said during the May 14 conference call, the National American Securities Valuation Association (NASVA) requested that the table in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) mapping credit rating provider (CRP) ratings for short-term instruments be updated to also map them to NAIC Designation categories. The Task Force directed the Securities Valuation Office (SVO) staff to make this update, and during its July 1 conference call, the Task Force received this amendment updating the table to map short-term CRP ratings to NAIC Designation equivalents, along with updated references to policies related to the use of credit ratings in the P&P Manual and a new footnote. The amendment was exposed for a 25-day public comment period ending July 27. The Task Force did not receive any comments from industry.

Mr. Kozak made a motion, seconded by Ms. Doggett, to adopt this proposed amendment to the P&P Manual to map short-term CRP ratings to NAIC Designation categories. The motion passed unanimously.

3. Adopted an Amendment to the P&P Manual to Add Supranational Entities Filed with the SVO to the Sovereign NAIC Designation Equivalent List

Mr. Fry said the SVO staff reported that they had received several requests from insurers for an NAIC Designation equivalent for supranational entities. The SVO publishes a list of Sovereign NAIC Designation Equivalents, and insurers use that list when reporting on the Supplemental Investment Risk Interrogatories (SIRI). Lines 5–10 of the SIRI requires insurers to list foreign investments by country sovereign rating. The guidance indicates that a country not on the SVO's Sovereign NAIC Designation Equivalents list should be reported as an NAIC 3 or below. Supranational entities like the European Union (EU) and World Trade Organization (WTO) are international groups or unions that share decision making and vote on issues concerning the collective body; however, they are not controlled by a single sovereign country, and they do not currently get added to Sovereign NAIC Designation Equivalents list.

This proposed amendment would permit the SVO to include supranational entities on the Sovereign NAIC Designation Equivalents list if they were submitted to it for review by an insurer and the SVO is able to determine an appropriate NAIC Designation equivalent. The Task Force did not receive any comments from industry.

Ms. Mears made a motion, seconded by Ms. Crawford, to adopt this proposed amendment to the P&P Manual to include supranational entities filed with the SVO to the Sovereign NAIC Designation Equivalents list if the SVO can determine an appropriate NAIC Designation. The motion passed unanimously.

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4. Received a Proposed Amendment to the P&P Manual to Add Instructions for ETFs that Contain a Combination of Preferred Stocks and Bonds

Mr. Fry said this item on the agenda is a proposed amendment to add instructions for exchange-traded funds (ETFs) that contain both preferred stocks and bonds—two security types that the SVO designates. This amendment was first discussed during the Task Force’s Oct. 31, 2019, conference call, but action on it was deferred. Current instructions permit the SVO to consider for inclusion on the bond or preferred stock ETF list only those that predominantly invest in one or another of the security types, but not both.

The SVO brought this proposal before the Task Force because no preferred stock ETFs currently qualify to be on the preferred stock ETF list. This is because preferred stock ETFs have had to include, because of availability, other security types such as hybrids—a security that contains both debt and equity characteristics—and these other securities are considered bonds under the *Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds*. To alleviate this limitation, the SVO is recommending that ETFs that predominately invest in both preferred stocks and bonds, both of which are security types already permitted to receive NAIC Designations, be allowed on the preferred stock ETF list. The SVO would still be responsible for determining if such ETFs would generate predictable and periodic cash flows in a manner broadly similar to a situation in which the holdings were of preferred stock and qualify as fixed income like. This will enable the ETFs that have preferred stock that are mixed with a lot of hybrid principally and are still more like a preferred stock that will give the SVO the policy to include those as a preferred stock on the list. The SVO recommends exposing this for a 30-day public comment period.

Mr. Fry directed the SVO staff to expose this amendment, adding instructions for ETFs that contain a combination of preferred stocks and bonds onto the preferred stock ETF list, for a 30-day public comment period ending Sept. 6.

5. Received a Proposed Amendment to the P&P Manual to Update Guidance on Initial and Subsequent Annual Filings and Methodologies and Documentation

Mr. Fry said the next item is a proposed amendment to the P&P Manual to update guidance on initial and subsequent annual filings, methodologies and documentation.

Charles Therriault (NAIC) said the SVO staff have recently experienced a few insurers declining to provide the documents necessary to analyze the investment filed. The refusal has been accompanied by an unusual challenge, asking where in the P&P Manual it requires these documents to be submitted. This amendment is intended to clarify and fill in any gaps that may exist in the P&P Manual. The amendment reflects a longstanding expectation by the Task Force that insurers will provide the SVO staff with the materials required to analyze investments submitted for review. In the absence of the SVO being specifically named as a party to the transaction, it falls upon insurers to provide the documentation necessary for the SVO analysts to perform their work. The clarifications in this amendment are just that, clarifications of existing guidance requiring insurers to provide items such as financial statements, internal analysis, legal agreements, and any applicable forms. Without this required information and authority to request it, the SVO will not be able to fulfill its analytical responsibilities. This is just a clarification of existing instructions. It should help clarify the SVO’s expectations on what information it will be looking for.

Mr. Fry directed the SVO staff to expose this amendment to update guidance on initial and subsequent annual filings, methodologies and documentation for a 30-day public comment period ending Sept. 6.

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

Mr. Fry said the next item is to hear a report on projects before the Statutory Accounting Principles (E) Working Group.

Julie Gann (NAIC) provided a quick update on four adoptions of the Working Group, and she will cover a few exposures:

- a. *SSAP No. 32R—Preferred Stock* – The Working Group adopted a substantively revised preferred stock SSAP to revise the definitions, measurement and impairment guidance pursuant to the investment classification project. The effective date of the new SSAP is Jan. 1, 2021. There was a question about early adoption, and the Working Group is looking into it.
- b. *Bond Tender Offers* – The Working Group adopted nonsubstantive revisions to clarify that bond tender offers, which function similarly to a call but the holder has to accept the offer, shall follow the guidance in SSAP No. 26R for the recognition of investment income or capital gain/loss when a bond is liquidated prior to its scheduled maturity date. Although reporting entities that historically applied this practice shall not change past practices, an effective date of

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Jan. 1, 2021, with early application permitted, was provided for the companies that need to make system changes.

- c. Financing Derivatives – The Working Group adopted nonsubstantive revisions to *SSAP No. 86—Derivatives* to require the gross reporting of derivatives, without the inclusion of financing components. Furthermore, amounts owed to or from the reporting entity from the acquisition or writing of derivatives shall be separately recognized. Revisions are being incorporated into the Blanks to clarify that financing premiums will be factored into the determination of derivative net exposure.
- d. Update SVO Listings – The Working Group adopted revisions to eliminate references to the “NAIC Bond Fund List” from *SSAP No. 26R* and include reference to the “NAIC Fixed Income-Like SEC Registered Funds List” in *SSAP No. 30R—Unaffiliated Common Stock*. This action was in response to a referral received from the Task Force. Corresponding Blanks revisions will be proposed; but due to the timing of the adoption, they will not be reflected in the year-end 2020 annual statement instructions. These revisions will be reflected in the instructions for 2020. Reporting entities shall follow the adopted SSAP guidance.

The following items were exposed by the Working Group:

- e. Related Party Transactions – The Working Group exposed revisions to *SSAP No. 25—Affiliates and Other Related Parties* to clarify the type of relationships that should be reflected as related parties, that non-controlling ownership interest greater than 10% is a related party subject to related party disclosures, and guidance for disclaimers of affiliation and control for statutory accounting. This item was previously exposed, and the current version reflects consideration of interested party comments, as well as an additional disclosure to capture all owners that hold more than 10% of an ownership interest in an insurance reporting entity.
- f. Participation Mortgages – The Working Group exposed clarifying provisions to assist in identifying the rights that need to be present for a mortgage loan participation agreement to be in scope of *SSAP No. 37—Mortgage Loans*. With the exposed edits, it is clarified that a participation agreement does not require an insurer to have the right to solely initiate legal action; foreclosure; or under normal circumstances, require the ability to communicate directly with the borrower.
- g. Residential Mortgage-Backed Securities (RMBS)/Commercial Mortgage-Backed Securities (CMBS) Designations – The Working Group exposed revisions to *SSAP No. 43R—Loan-Backed and Structured Securities* to reflect the revisions adopted by the Task Force for the mapping of RMBS and CMBS securities to a final NAIC Designation category under the financial modeling process.
- h. Perpetual Bonds – The Working Group exposed revisions to specify that perpetual bonds, which do not have a maturity date and therefore do not amortize, shall be reported at fair value. These revisions are in *SSAP No. 26R*, and they would be in line with the recent revisions adopted to *SSAP No. 32R* for perpetual preferred stock.
- i. Credit Tenant Loans (CTLs) – The Working Group received the CTL referral from the Task Force and exposed an agenda item addressing CTLs for statutory accounting. This agenda item provides detail of CTLs, as well as some of the recent issues with how non-conforming CTLs were reported in scope of *SSAP No. 43R* and on Schedule D. This agenda item provides options to clarify the accounting and reporting of CTLs for statutory accounting. The first option is to clarify that CTLs will continue to be in scope of *SSAP No. 43R*, but only if they are on an SVO identified list. That option will require scope revisions to *SSAP No. 43R* and reference to an SVO list similar to “SVO Identified Bond ETFs.” CTLs that are not on the list would then need to be specified in either *SSAP No. 37* or *SSAP No. 21R—Other Admitted Assets*. The second option is to incorporate all CTLs in scope of *SSAP No. 21R* and report them on Schedule BA, with the CTLs reviewed by the SVO reported with an NAIC Designation for risk-based capital (RBC) purposes. The agenda item was exposed with the two options. After comments are considered, the Working Group will be asked to provide direction to NAIC staff on which option is preferred for drafting accounting revisions. The Working Group also directed a referral back to the Task Force, informing them of this action.
- j. *SSAP No. 43R* – The Working Group, which met on July 30, received notice that comment letters for the exposed *SSAP No. 43R* issue paper were due July 31. Since then, one comment letter (67 pages) has been received from interested parties. This comment letter has been posted with the exposed issue paper. It is anticipated that the Working Group will schedule subsequent calls to discuss this.

The comment deadline for current exposure is Sept. 18.

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7. Heard an SSG Staff Report on RMBS/CMBS Modeling

Mr. Fry said the next item is to hear a report from the Structured Securities Group (SSG) on RMBS/CMBS modeling.

Eric Kolchinsky (NAIC) said he will be discussing the process for year-end 2020. The SSG has started discussions with BlackRock on this year's modeling assumptions. It was hoped that there would be something clear to work with in terms of the cycle resolution. Unfortunately, the aftershocks from the pandemic are still going on. Some of the uncertainty will be incorporated in the scenarios that will be proposed this year. The plan is to provide proforma breakpoints for insurance companies to see where their portfolios would do at year end, possibly in late October or early November. The timing of the whole process is working slightly against us because there is a deadline for publishing and quality assurance (QA). The SSG will provide those numbers to insurance companies, and a data set will be available for those who would like to purchase it.

8. Discussed Other Matters

Mr. Fry said there are 2020 charges identical to the Task Force's 2019 charges. The charges do not have to be adopted today, and they will be considered during an interim meeting.

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

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Attachment Two
Valuation of Securities (E) Task Force
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Draft: 10/20/20

Valuation of Securities (E) Task Force Virtual Meeting September 29, 2020

The Valuation of Securities (E) Task Force met virtually Sept. 29, 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); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak (MD); 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 (PA); Kent Sullivan 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 Afile represented by Randy Milquet (WI).

1. Adopted its 2021 Proposed Charges

Mr. Fry said he is representing Director Muriel for the Illinois Department of Insurance (DOI), serving as the chair of the Task Force. The first item on the agenda is the adoption of the Task Force's 2021 Proposed Charges.

A memorandum was received from the chair and vice chair of the Financial Condition (E) Committee, Commissioner Scott A. White (VA) and Superintendent Eric A. Cioppa (ME), directing the Task Force to include an additional charge for 2021. The Committee met earlier this year and identified reducing reliance on credit ratings as one of its 2020 priorities. The Committee specifically discussed its support for the Task Force's position that reduced reliance on credit ratings is needed in a very targeted way for bespoke securities, which are very individualized. The Committee believes that changes need to be made to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to add additional authority to the responsibilities of Securities Valuation Office (SVO) staff, and the Committee has directed the Task Force to add the following charge: "The Task Force will 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."

Mike M. Monahan (American Council of Life Insurers—ACLI) asked, as a matter of procedure, if the Task Force should be voting on a complete agenda instead of an additional charge being read. Mr. Fry said the new charge is being directed from the Task Force's parent committee with all the other charges the same as last year.

Mr. Thomas made a motion, seconded by Mr. Stolte, to adopt the Task Force's 2021 Proposed Charges. The motion passed unanimously.

2. Adopted an Amendment to the P&P Manual to Add Instructions for ETFs that Contain a Combination of Preferred Stocks and Bonds

Mr. Fry said the amendment being proposed was first discussed during the Task Force's Oct. 31, 2019, call and exposed during its Aug. 7 call for a 30-day public comment period that ended Sept. 6. The proposed amendment adds instructions for exchange-traded funds (ETFs) that contain both preferred stocks and bonds, two security types that the SVO designates. The current instructions permit the SVO to consider for inclusion on the bond or preferred stock ETF list only those that predominantly invest in only one or the other security type, but not both in the same ETF.

The SVO brought this proposal before the Task Force because no preferred stock ETFs currently qualify to be on the preferred stock ETF list. This is because preferred stock ETFs have had to include, because of availability, other security types such as hybrids, a security which combines both debt and equity characteristics, and these other securities are considered bonds under *Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds*. To alleviate this limitation, the SVO recommends that ETFs that predominately invest in both preferred stocks and bonds, both of which are security types already permitted to receive NAIC designations, be allowed on the preferred stock ETF list. The SVO would still be responsible for determining if such

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ETFs would generate predictable and periodic cash flows in a manner broadly similar to a situation where the holdings were of preferred stock and qualify as fixed income like.

The SVO is proposing an additional clean-up to this amendment that was not included in the original exposure.

Charles A. Therriault (NAIC) said the amended paragraph, as exposed, referred only to the SVO-Identified Bond ETF List and made no mention of the SVO-Identified Preferred Stock ETF List. The SVO proposes striking the word “bond” so that this paragraph refers to all SVO-Identified ETF lists. The last sentence in the paragraph identified as 255 in Attachment B would read as follows:

For inclusion on the SVO-Identified ETF List, the ETF must hold a portfolio of bonds, preferred stock or a combination of bonds and preferred that tracks a specified bond index (a passive investment); or it must a portfolio of bonds, preferred stock or a combination of bonds and preferred stock that it actively manages pursuant to a specified investment objective.

Ms. Doggett said one editorial thing. She said the word “be” is also not in that sentence and reads “or it must a portfolio of.” The word “be” should be added there. Mr. Everett stated two other observations. He said on the fourth line where it now says “a combination of bonds and preferred,” it should include the word “stock.” He also said on the third line after the semicolon, where it says “or it must,” the word “hold” should be inserted. Mr. Therriault said he would make those changes and appreciated the comments.

Mr. Everett asked if the criteria for the weighted average ratings factor (WARF) is different for preferred stock and bonds. Mr. Therriault said the same process is used for both.

Mr. Fry said two comment letters were received, the first from the ACLI and the second from State Street Global Advisors, Invesco, and BlackRock.

Josh Bean (TransAmerica), representing the ACLI, said as outlined in the joint comment letter with the North American Securities Valuation Association (NASVA), that the ACLI supports the proposal.

Mr. Fry asked Mr. Therriault to summarize the comment letter from State Street Global Advisors, Invesco, and BlackRock, as no representatives are on the call. Mr. Therriault said the comment letter was also supportive of the proposal.

Ms. Doggett made a motion, seconded by Mr. Fletcher, to adopt this proposed amendment to the P&P Manual to add instructions for ETFs that contain a combination of preferred stocks and bonds to be included on the SVO-Identified Preferred Stock ETF List. The motion passed unanimously.

3. Received 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 this item on the agenda is to receive an updated 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—Working Capital Finance Investments*. There were approximately 10 requested changes by industry, with maybe seven of the requested changes addressed by the Working Group’s adopted revision.

The Task Force directed staff to work with industry to come up with additional language to conform the P&P Manual to the adopted changes. That interaction occurred, but it ran out of time, and there are still some unresolved issues. What is in front of the Task Force now is what was developed so far. Mr. Fry said he believes the best approach, given that there is still a fair amount of disagreement and he understands both sides, is additional collaboration. There may be a few points, or one or two issues, that might boil down to a different point of view. These viewpoints could be outlined and presented to state insurance regulators to decide on because these issues have been around a long time. The Task Force and the Working Group have tried to make changes to this program, which requires investment grade issuers and short duration investments. When this guidance was first developed, there were a lot of required criteria making these deals very hard to structure. The changes that have been made have tried to add some flexibility without compromising the credit quality. Mr. Fry said he believes the amendment is close, but it would benefit from a little more discussion to clearly identify the distinctions and differing points of view. The

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Task Force can then decide on those issues, as this has already taken up a lot of time over the years. Ms. Mears and Ms. Crawford said they both support this approach. Mr. Fry said the next time this is exposed, it will be a more complete package and permit the Task Force to resolve the loose ends to move forward.

4. Received a Referral Response from the Statutory Accounting Principles (E) Working Group on the Proposed P&P Manual Amendment to Update Instructions for Non-Conforming CTL Transactions that Relied Upon Credit Ratings

My Fry said the next item is a referral response from the Statutory Accounting Principles (E) Working Group on the treatment of non-conforming credit tenant loan (CTL) transactions. During the Summer National Meeting, the Working Group exposed agenda item 2020-24: Accounting and Reporting of Credit Tenant Loans for a public comment period ending Sept. 18. The Working Group's agenda item provided information on CTLs and presented two options for the accounting and reporting of these investments:

Option 1 – CTLs that the SVO has determined meet the CTL guidelines of the P&P manual would continue to be captured in scope of *SSAP No. 43R—Loan-Backed and Structured Securities*. This option would require the SVO to establish a listing of qualifying CTLs, similar to its process for other SVO-identified investments. For CTLs that do not qualify for reporting in scope of *SSAP No. 43R*, meaning they are not on the NAIC SVO listing, the agenda item requests direction for specific inclusion in *SSAP No. 37—Mortgage Loans* or *SSAP No. 21—Other Admitted Assets*.

Option 2 – All CTLs would be captured in scope of *SSAP No. 21* and reported on Schedule BA. With this approach, all CTLs would be reported on the same schedule, allowing state insurance regulators the ability to quickly identify the extent of investments in this asset class. Additionally, CTLs that qualify for an NAIC SVO credit assessment could be reported with an NAIC designation, and life insurance entities could receive risk-based capital (RBC) treatment based on the credit quality of the instrument under the SVO methodology.

Given that the Working Group is still considering the treatment for these investments, it is the SVO staff's recommendation that the proposed amendment, dated April 30, should be withdrawn until the Working Group finishes its work. The Task Force can issue new guidance at that time defining its involvement with these transactions. This agenda item is to alert everyone that the amendment is being withdrawn. Ms. Belfi and Mr. Sirovets said there is still a lot of debate going on, and they agreed that the Task Force should wait and see what the results are there.

Mr. Everett asked what the nature of the considerations in the Working Group are and what issues are being discussed. Julie Gann (NAIC) said the Working Group has a current exposure that is asking to clarify guidance regarding the reporting of CTLs and whether they should be in scope of *SSAP No. 43R*; if they should go to *SSAP No. 37*, which is a mortgage loan standards, if they are not in scope of *SSAP No. 43R*; or whether they should be reported on Schedule BA. The Working Group did receive comments, and discussion on this matter is expected at the upcoming Fall National Meeting.

Mr. Everett asked if the concerns have to do with the nature of the notes themselves as to the investment characteristics. Ms. Gann said a review of CTLs has recently been done, as defined in the NAIC model law, as well as the P&P Manual as a mortgage loan. Several years ago, dating back to 1994, there were some revisions provided that if a CTL meets certain criteria, then it could be reported within scope on Schedule D. The issue that is currently being discussed is that there are CTLs that do not meet that criteria that were reported on Schedule D. The Working Group is reevaluating the current guidance. There is also some confusion regarding *SSAP No. 37* because that is for mortgage and it has guidance regarding excluding securities, and CTLs may meet that security definition. The Working Group is going to clarify the actual reporting location, perhaps based on characteristics of CTLs because that is what was done in the past. The exposure occurred at the Summer National Meeting, and comments have been received. The Working Group plans to discuss this at the upcoming Fall National Meeting.

Mr. Fry directed staff to withdraw this amendment, as recommended, and the Task Force will wait for the Working Group's decision.

5. Discussed Other Matters

Mr. Everett asked when the next set of economic assumptions for structured securities are going to be generated. Eric Kolchinsky (NAIC) said the economic assumptions are currently being worked on, and they are close to being completed. As soon as they are complete, they will be reported to the Task Force and publicly exposed. Mr. Everett asked if there are any

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developments in the real estate industry being reflected in the creation of the current scenario and whether they are noticeable. Mr. Kolchinsky said yes, they are absolutely being reflected, but he did not want to comment if they are noticeable.

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)
Marc Perlman, 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 Update Guidance on Initial and Subsequent Annual Filings, and Methodologies and Documentation

DATE: July 15, 2020

1. **Summary** – The SVO has recently encountered several situations where insurance companies have requested clarification or have declined to provide information necessary to enable it to complete its analysis. The SVO is not a party to the transactions it reviews and, therefore, is dependent upon the insurance companies to provide this information critical to its analysis. The attached proposed amendment reinforces the expectation that insurance companies will provide necessary documentation in a timely manner to the SVO and further outlines the types of information the SVO may require.
2. **Recommendation** – The SVO recommends that the Task Force update the guidance in the P&P Manual for initial and subsequent annual filings and assessment methodologies to reinforce documentation and information requirements.
3. **Proposed Amendment** – The following text in red shows the proposed revisions in Part One, Part Two, and Part Three of the P&P Manual.

PART ONE

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

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FILING SECURITIES WITH THE SVO

NOTE: See “General Filing Procedures” and “Filing Process and Required Documents” in Part Two and the various asset specific sections in Part Three for filing instructions and documentation requirements specific to the security or asset type discussed in those section.

Obligation to File Securities with the SVO

48. Insurance companies domiciled in any state of the United States, or any of its territories or possessions, that have adopted laws incorporating the standards in the NAIC Financial Regulation Standards and Accreditation Program that require the use of NAIC Designations or other analytical products for Investment Securities are required by those laws to file purchases of Investment Securities with the SVO as indicated in this Manual to obtain the NAIC Designation or other analytical product required by state law.
49. Investment Security means an instrument that documents a lending transaction between an insurance company as lender and a non-affiliated borrower, where the borrower’s sole motivation is to borrow money and the insurance company’s sole motivation is to make a profit on the loan that the state of domicile regulates by reference to the NAIC Financial Regulation Standards and Accreditation Program.
50. The SVO shall have no authority to issue NAIC Designations or any other NAIC analytical product to an insurance company for a Regulatory Transaction. This Manual provides that the SVO may assist a state insurance department in the assessment of the security component of a Regulatory Transaction and may issue an SVO Analytic Value to the department at the conclusion of the assessment. This Manual also provides instructions to insurance companies on how to report the security component of a Regulatory Transaction on investment schedules.

Who Must File

51. Filing a security with the SVO is the responsibility of the insurance company within 120 days after settlement of the investment. The expectation is that the filing of a security with the SVO is the responsibility of the insurance company lender with the largest dollar investment in the individual security (i.e., CUSIP or issue specific); however, all insurers are responsible to comply with all filing requirements in this Manual.

States May Require a Filing of Exempt or Other Transactions

52. Any provision in this Manual that exempts a transaction, security, financial asset or investment from being filed with the SVO does not prohibit a state insurance regulator from requiring its domiciled insurance company to file the transaction, security, financial asset or investment with the SVO for analysis and/or assignment of an NAIC Designation. Also, nothing in this Manual prohibits a state insurance regulator from asking for SVO or SSG analytical assistance with respect to any investment related activity, or in connection with assessment of investment-related aspects of a Regulatory Transaction, and directing an insurance company to file relevant information with the SVO or the SSG for that purpose.

Filing Requirements

53. **Initial** – Insurers that file a security must provide the SVO with the information necessary to evaluate the credit risk for the security.
54. **Annual** – Insurers that file a security are also required to provide the SVO with the information necessary to evaluate the credit risk for the security on an annual basis.
55. **Material Credit Events Filing** – It is the responsibility of the insurance company to file all information that indicates a change in the credit characteristics of the issuer or a material change in the terms of the agreement. A material change is an event that affects or is substantially likely to affect the issuer's ability to pay the insurer the obligation due to it in accordance with the original terms of the transaction. If an insurer determines that a bond is impaired under the statutory accounting procedures in *SSAP No. 26R—Bonds*, then the impairment should also be considered to be a material change. Material changes should be reported to the SVO on the Material Change/Additional Information ATF.
56. **Information and Documentation Requirements** – This can be found in Part Three as part of the description of the methodology that applies to specific types of securities or investments and the instructions on how to submit through VISION is on the NAIC website: www.naic.org/svo_vision.htm.

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS
APPLICABLE TO THE SVO

GENERAL FILING PROCEDURES

...

FILING PROCESS AND REQUIRED DOCUMENTS

Initial and Subsequent Annual Filings

57. An insurance company makes an initial **and subsequent annual** filing by providing the SVO with ~~the~~ **any applicable** completed form(s) and the information, documents and data necessary for the SVO to conduct an analysis of the issuer's creditworthiness and the terms of the security.

Informational Deficiencies

58. When an insurance company submits an initial **or subsequent annual** filing, the SVO logs the submission by date and time received and the filing is assigned to the appropriate staff analyst. If the ~~staff analyst~~ **SVO** determines that there is an informational deficiency, **then the SVO he or she** will advise the insurance company that submitted the filing.
59. If the SVO identifies an information deficiency, the transaction is held by the SVO without processing for a period not to exceed 45 days. If the insurance company has not filed the necessary information with the SVO at the completion of the 45 days, the SVO discards the filing and all documentation submitted with it and enters a note in VISION to reflect that the filing was discarded due to insufficient information.
60. On an exception basis, the SVO may grant an extension to the insurance company not to exceed 90 days in total with the time period to begin on the date that the SVO issues an information request. If the SVO grants this extension, and if the insurance company fails to provide the information requested within the time provided, the SVO will discard the filing and all documentation submitted with it at the end of the 90-day period and Work Flow will reflect that the filing was discarded due to insufficient information.
61. If the SVO determines it requires additional information after it has received a response to its request for additional information, a new 45-day period begins, unless an extension is granted as indicated above, in which case a new 90-day period will begin.

Filing Procedures and Documentation Requirements

62. Filing procedures and documentation requirements can be accessed at <https://vision.naic.org>.

NOTE: See Part Three, which contain filing procedures and documentation requirements for the asset classes identified there.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS

GENERAL CORPORATE AND MUNICIPAL METHODOLOGY FOR INDEPENDENT CREDIT QUALITY ASSESSMENT

NOTE: See “Special Instructions” (discussing Short-Term Investments, Circular Transactions, Mandatory Convertible Securities, Unrated Hybrid Securities and Sub-Paragraph D Companies) in Part One for policies that impact assignment of NAIC Designations.

27. Corporate bonds defined as the Obligations¹ of domestic and foreign corporations, and preferred stock shall be distinguished on the basis of the categories discussed below. The creditworthiness of the issuer of any particular category of Obligation shall be assessed by reference to the general, and any special, rating methodology discussed in this Part, unless the context of the analysis requires a different approach.
28. Consistent with the SVO’s authority to use reasonable analytical discretion in its assessments, the SVO may utilize methodologies or request additional documents and information from insurance companies, if the SVO deems it appropriate and necessary to conduct its analysis for any investment that it reviews.

Independent Assessment

29. If the security under consideration is unrated, or if an analyst has conducted an independent analysis of the NAIC CRP-rated security, the analyst shall make an independent assessment of the issuer, the security or both.

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| FINANCIAL ANALYSIS |
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Audited Financial Statement Required

29. As a first step in the independent assessment, the analyst shall conduct an independent financial analysis of the issuer based on the financial information presented in the Audited Financial Statement, as defined in this Manual, submitted by the insurance company.
30. The SVO shall base its financial analysis on at least three years of historical audited financial information and a minimum of one year of projected financial information (if available) when the issuer has an operating history of three years or more.
31. The SVO may request and consider interim financial statements, if the SVO deems the information necessary for its analysis or to maintain a previously assigned NAIC Designation and NAIC Designation Category.

¹ **Obligation** means bonds, notes, debentures, certificates, including equipment trust certificates, production payments, bank certificates of deposit, bankers’ acceptances, credit tenant loans, loans secured by financing net leases and other evidences of indebtedness for the payment of money (or a participation, certificates or other evidences of an interest in any of the foregoing), whether constituting general obligations of the issuer or payable only out of certain revenues or certain funds pledged or otherwise dedicated for payment.

32. However, the SVO may assign an NAIC Designation based on less than three years of financial information in circumstances where the issuer's operating history is less than three years or because the issuer's legal identity has been subsumed as a result of a merger into a new entity or due to other documentable business circumstances.
33. Where three years of financial information is not available, the analyst shall review such information as is available, and shall determine if the time period for which information is available is sufficient to produce a professionally sound opinion.

Calculation of Ratios

34. Financial analysis shall culminate in the calculation of such financial ratios as the analyst feels highlight appropriate aspects of the financial performance of the issuer that bear on its ability to meet the obligation owed to the insurance company.

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| LEGAL ANALYSIS |
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Legal review

35. The SVO shall review legal agreement(s) related to the transaction (e.g. prospectus, indenture, loan agreement, note purchase agreement, guarantee or equivalent legal documents) along with any amendments, waivers, compliance certifications and opinions of counsel it deems necessary for its analysis.

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| OTHER ANALYSIS |
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Other information

36. The SVO may review and consider any other public or private information (including insurance company internal credit analysis memoranda) provided by the insurance company or obtained through its own research, that it considers relevant or necessary to analyze the transaction and consistent with its Use of Generally Accepted Techniques or Methodologies.

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October 6, 2020

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, Suite 1500
Kansas City, MO 64106-2197

Re: Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Update Guidance on Initial and Subsequent Annual Filings, and Methodologies and Documentation

Dear Mr. Fry and Ms. Mears:

The American Council of Life Insurers (ACLI)¹, the Board of Directors of the Private Placement investors Association ("PPiA")², and North American Securities Valuation Association ("NASVA")³ appreciate the opportunity to provide input on the exposure dated July 15, 2020, entitled "Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Updated Guidance on Initial and Subsequent Annual Filings, and Methodologies and Documentation" (the Exposure).

The undersigned have no concerns with the proposed changes in the Exposure, when viewed in isolation, and we are generally supportive of the Exposure overall.

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 acli.com.

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 44 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](#)

The undersigned would like clarity about what documents are required by the SVO to perform their analysis for both initial and subsequent filings. The current P&P references a link to VISION to provide this information. To date, the VISION platform has not been updated with a list of required documents by asset type for insurers to reference.

While we understand there may be other documents that would assist the SVO in their analysis and determination of a designation, the inability to provide anything outside of the required documents should not result in an insurer reporting a 5GI designation for Schedule D. We believe this should be discussed by the Task Force and codified in the P&P Manual. With that said, we believe a list of the general types of documents required for the filing of certain asset types, along with examples of their formal names, as well as some of the additional documents that may be requested would be helpful. It would facilitate an understanding of what is used in the credit analysis, provide transparency, and be a valuable resource for new or infrequent filers, and for the filing of complex asset types.

We stand ready to assist, should the SVO wish to further define its expectations. Industry's goal would be to minimize the number of "one off" requests, reduce the need for Information Requests, and create a consistent body of information to share with the SVO at point of filing.

The undersigned believe that in working together, insurers and the SVO can provide more specific guidance, both for Initial and subsequent filings minimizing the burden on industry and the SVO, as well as making the process more efficient and transparent. Thank you for your consideration.

Sincerely,



Mike Monahan
American Council of Life Insurers

Tracey Lindsey

Tracey Lindsey
NASVA

John Petchler

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. 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: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Incorporate Updates Made to SSAP No. 105R – Working Capital Finance Investments.

DATE: September 10, 2020

1. **Summary** – The Statutory Accounting Principles (E) Working Group adopted updates to SSAP No. 105R Working Capital Finance Investments on May 20, 2020. Key revisions are summarized as follows:

- Functionally Equivalent Foreign Regulators - Removed the requirement that the Securities Valuation Office (SVO) determine if the International Finance Agent is the functional equivalent of the U.S. regulator.
- Commingling Prohibitions - Removed the finance agent prohibitions on commingling.
- Investor Rights Edit - Removed duplicative text regarding exercising of investor rights.
- Requirements for filer to Certify Perfected Interest – Removed requirements, with revisions allowing the SVO to determine if a first priority perfected interest has been obtained.
- Finance Agent Validation Requirements – Broadened the independent review requirements to allow independent review of the finance agent by either audit or through an internal control report.
- Default Date - Changed the default provisions from 15 to 30 days so the default date and the cure period are consistent.
- Possible Domestic Regulator Approval – Removed the statement that the reporting entity may need to seek approval from the domestic regulator.

2. **Revisions** - The SVO submitted a proposed amendment to the Valuation of Securities (E) Task Force (the Task Force), dated June 15, 2020, to amend the Working Capital Finance Investments (WCFI) section of the P&P Manual to remove any inconsistencies with SSAP No. 105R, as revised. The proposed amendment was received and exposed on July 1, 2020 for a 45-day public comment period that ended on August 17, 2020. The American Council of Life Insurers (ACLI) submitted a detailed comment letter, dated August 17, 2020, recommending additional updates to this section. The SVO staff has reviewed the ACLI's recommendations and has attached an updated proposed amendment that reflects where the SVO agrees with the ACLI and, as explained below, where it does not.

Generally, the ACLI's recommendations fall into two categories: (1) those which remove inconsistencies between SSAP No. 105R and the WCFI section of the P&P Manual, thereby adhering to the original purpose of this amendment and, (2) those which would amend WCFI provisions in the P&P Manual which are not identified in SSAP No. 105R and which would impede the SVO's ability to assess investment risk in WCFI transactions. These analytic provisions were intentionally included in the P&P Manual's WCFI guidelines to enable the SVO to more accurately assess investment risk in WCFI transactions and they reflect the functional differences between the Accounting Practices & Procedures Manual (AP&P), which is intended to define accounting standards, and the P&P Manual, which is intended guide the assessment of investment risk. The AP&P is not intended to be a substitute for the P&P Manual as only the Task Force is charged to, "... establish and maintain all aspects of the NAIC's credit assessment process for insurer-owned securities." The SVO staff has identified the analytical issues below that should be retained in the P&P Manual. These changes are outside of the scope of the SSAP 105R revisions and are necessary for the SVO to perform its responsibility to assess investment risk.

- a. **A Certification** (paragraph 102, bullet 5) from the insurance company Investment Officer 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 Program, and that the Working Capital Finance Program does not include any insurance or insurance related assets. *This certification relates to the requirements of SSAP No. 105R, paragraph 19 and provides a means by which the SVO can verify that a transaction meets those requirements.*
- b. **Process and Methodology** (paragraphs 121) - An NAIC Designation shall be assigned to a Working Capital Finance Program on the basis of a thorough assessment of credit, dilution, operational and other risks, an assessment of protections provided by operative documents to the Investor and the quality of transaction participants. *The assessments of credit, dilution and operational risk are core components of the SVO investment risk assessment for WCFI transactions and none of them conflict with SSAP No. 105R.*
- c. **Credit Risk** (paragraphs 122) – The NAIC Designation for a Working Capital Finance Program shall be linked to the credit quality of the Obligor, which may be determined by reference to a credit rating assigned by a NAIC 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 this Manual for corporate obligors. *The assessments of credit is a core component of the SVO investment risk assessment for WCFI transactions and does not conflict with SSAP No. 105R.*
- d. **Dilution Risk** (paragraphs 107, 121, and 123) – *This element of the SVO's analysis 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 impact the insurance company investor.*

- e. **Operational Risk** (paragraphs 111, 121, and 124) – *This element of the SVO's analysis 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. This is a common investment analysis consideration as reflected in the methodology to review Power Generation Projects in Part Three of the P&P Manual.*
- 3. **Recommendation** – The SVO staff recommends re-exposure of this amendment with the changes recommended by the ACLI, excluding the analytically necessary items identified above, to align with the adopted updates to *SSAP No. 105R – Working Capital Finance Investments*.
- 4. **Proposed Amendment** – The following shows the proposed revisions in Part Three with text in red identifying the changes proposed on July 15, 2020 and additional revisions and comment letter responses in yellow highlight.

PART THREE

SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

WORKING CAPITAL FINANCE INVESTMENTS

NOTE: See “Specific Populations of Securities Not Eligible for Filing Exemption” in “Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities” above.

Initial Filing Requirements

102. An insurance company requesting an analysis of a proposed Working Capital Finance Program shall provide the SVO with the documentation described in this subparagraph:

- An RTAS Application.
- The Obligor’s Audited Financial Statements, if the Obligor is not rated for credit risk by a NAIC CRP.
- The insurance company’s Investment Committee Memorandum for the proposed Working Capital Finance Program.
- ~~The audited consolidated financial statements of the group of which the Finance Agent for the Working Capital Finance Program is a part, and o~~One of the following:
 - An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment.
 - An annual audit of the financial statement and internal controls of the consolidated group of which the Finance Agent is part, which does not note any material weakness related to servicing working capital financial investments.
- A Certification from ~~an the~~ insurance company’s Chief Investment Officer 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 Program, and that the Working Capital Finance Program does not include any insurance or insurance related assets.
- ~~A Certification from the insurance company’s Legal Counsel.~~
- ~~In the case of a participation, that it has a commercially reasonable belief that its participation interest meets the Uniform Commercial Code’s standards for creating and preserving first priority security interests in the payments due and in the Confirmed Supplier Receivables.~~

- ~~In the case of a certificate, note or other manifestation, representing a right to payment from a trust, other special purpose entity, or special purpose pool holding confirmed supplier receivables, that it has a commercially reasonable belief that the documents establishing and governing the Working Capital Finance Program create and preserve interests in the Confirmed Supplier Receivables capable of being enforced by the trustee or other entity holding Confirmed Supplier Receivables as first priority perfected security interests under the Uniform Commercial Code.~~

~~NOTE: Please refer to SSAP No. 105 – Working Capital Finance Investments for the definition of a “commercially reasonable belief.”~~

- A copy of:
 - The document(s) that create the Working Capital Finance Investments (i.e., the short-term receivables) that is the subject of the RTAS – Emerging Investment Vehicle Service Application, and establishes the obligations of the Obligor to, and the protection afforded owners of, Working Capital Finance Investments (including the Investors). This agreement is sometimes referred to as the Invoice Payment Terms Acknowledgement, the Payable Services Agreement or the Paying Services Agreement.

NOTE: Please refer to “The Regulatory Treatment Analysis Service – Emerging Investment Vehicle” in Part Two for guidance regarding the filing of an RTAS Application with the SVO.
 - The agreement(s) between the Obligor and the Finance Agent governing the administration of the Working Capital Finance Program and the Working Capital Finance Investments issued thereunder. These agreements may be included in the documents mentioned above or may be a stand-alone agreement which are sometimes referred to as the Settlement Services Agreement or the Invoice-Related Electronic Services Agreement.
 - The agreement governing the sale of the Working Capital Finance Investments from the Supplier to the Finance Agent. This agreement is sometimes referred to as the Receivables Purchase Agreement or the Supplier Agreement. The agreement governing the ongoing purchase of Working Capital Finance Investments or an interest in Working Capital Finance Investments by the Investor from the Finance Agent. This agreement is sometimes referred to as the Agency Agreement, the Participation Agreement or the Program Trust Agreement.

Subsequent Filing Requirements

103. Subsequent filing requirements include:

- Copies of any of the documents originally submitted with the RTAS Application subsequently amended.
- ~~The audited consolidated financial statements of the group of which the Finance Agent for the Working Capital Finance Program is a part, and~~ One of the following:
 - An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment; or
 - An annual audit of the financial statements and internal controls of the consolidated group of which the Finance Agent is part, which does not note any material weakness related to servicing working capital financial investments.

Definitions in SSAP No. 105R—Working Capital Finance Investments

104. Please refer to SSAP No. 105R—Working Capital Finance Investments, for the definitions and associated definitional guidance insurance companies must understand and comply with before applying for an NAIC Designation for Working Capital Finance Programs that would permit them to purchase Working Capital Finance Investments.
105. With the exception of the definitions for Dilution Risk and Operational Risk below, the definitions shown below are summaries of those contained in SSAP No. 105R—Working Capital Finance Investments intended only to facilitate a discussion and in all cases subordinate to the definitions in SSAP No. 105R.

Summary of Key Definitions

106. **Confirmed Supplier Receivable** – A receivable sold by a Supplier to a Finance Agent or Investor (or by a Finance Agent to an Investor) under a Working Capital Finance Program designated by the SVO that requires the Obligor to confirm to the Finance Agent or Investor, prior to the sale of the receivable from the Supplier to the Finance Agent or Investor, that it has no defenses to payment of the monetary obligation represented by the receivable against the Supplier and, therefore, no defenses to payment of the same monetary obligation to the Finance Agent and/or Investor after such sale. The confirmation by the Obligor that it has no defenses to payment includes confirmation that the Obligor does not have a right to refuse payment that it may have acquired with respect to underlying commercial trade transaction and that, if it has such a right, it will not assert such defenses against the Finance Agent or Investor.
107. **Dilution Risk** – With respect to any Working Capital Finance Program, dilution risk refers to disputes or contractual provisions that may reduce the amount of the obligation owed by the Obligor to the Supplier under the original receivable or the obligation owed by the Obligor to the Finance Agent and/or Investor under the Confirmed Supplier Receivable. Examples of dilution risk are credit for returns of defective goods or an allegation of fraud, such as that the invoice is not legitimate or is a duplicate invoice.
108. **Finance Agent** – A bank, financial institution, financial intermediary or service provider that facilitates the Working Capital Finance Program that arranges the sale, assignment or transfer of the Confirmed Supplier Receivable to the Investor and administers payment.
109. **Investor** – The insurance company that files the RTAS Application with the SVO in order to obtain an NAIC Designation for a proposed Working Capital Finance Program.
110. **Obligor** – An entity that purchases the goods or services from the Supplier and thereby generates the original supplier receivable—and which Obligor has, or can be designated, **NAIC 1** or **NAIC 2** by the SVO or has been assigned an equivalent credit rating by a NAIC CRP.
111. **Operational Risk** – With respect to any Working Capital Finance Program, operational risk refers to the combined effect of the procedures and parties employed to implement the program and their responsibility under the documents and to the determination by the SVO of whether these procedures and parties will ensure full and timely performance by the Obligor of the payment obligation to the Investor. An example of an operational risk is the confirmation process employed to verify that the Obligor has no defenses to payment.

112. **Supplier** – The entity that sells the goods or services to the Obligor, obtains a receivable from the Obligor in exchange and subsequently chooses to sell the right to receive the payment associated with the receivable to the Finance Agent or Investor under the terms of a Working Capital Finance Program designated **NAIC 1** or **NAIC 2** by the SVO.
113. **Working Capital Finance Program** – The program created for the Obligor and its Suppliers by a Finance Agent the terms of which permits Suppliers to the Obligor to negotiate the sale of a right to receive payment from the Obligor (which is associated with and evidenced by a receivable) to the Finance Agent or an Investor.
114. **Working Capital Finance Investment** – The right to receive the payment associated with a Confirmed Supplier Receivable purchased by an Investor under a Working Capital Finance Program designated **NAIC 1** or **NAIC 2** by the SVO and is the subject of *SSAP No. 105R—Working Capital Finance Investments*.

NOTE: *SSAP No. 105R—Working Capital Finance Investments* imposes reporting and statutory accounting requirements on insurance company investments in Working Capital Finance Investments ~~and specifies analytical procedures to be applied or analytical controls to be verified by the SVO that are not detailed above.~~ Insurance companies are strongly advised to become familiar with *SSAP No. 105R* before filing an RTAS Application with the SVO.

Direction and Program Parameters

115. The SVO may assign an NAIC Designation to a Working Capital Finance Program that would generate Working Capital Finance Investment that meet the criterion and standards identified in this Section.
116. **RTAS Submission Required** – A request that the SVO assign an NAIC Designation to a Working Capital Finance Program is made by filing an RTAS Application. The RTAS Application is available at www.naic.org/documents/svo_rtas_app.pdf.
117. Upon completion of its risk assessment, the SVO will issue an RTAS Letter indicating a preliminary NAIC Designation; i.e., the NAIC Designation that would be assigned if the Investor enters into a Working Capital Finance Program with a Finance Agent and sought to report it to the SVO.
- NOTE:** A preliminary NAIC Designation cannot be used for statutory reporting purposes.
118. The SVO shall issue a final NAIC Designation to the Investor for the Working Capital Finance Program and the Working Capital Finance Investments generated thereunder upon receipt of fully executed final copies of the required documentation.

Variations in Structure

119. Working Capital Finance Programs may differ in structure and in the protection afforded the Investor. Structural strength and weaknesses of various structures in such programs will be reflected in the NAIC Designation assigned by the SVO.

Program Quality

120. The SVO shall only assign an NAIC Designation to Working Capital Finance Programs that can be designated **NAIC 1** or **NAIC 2**. Credit quality is measured by reference to a NAIC CRP credit rating or an NAIC Designation assigned by the SVO. The SVO shall withdraw the NAIC Designation assigned to a Working Capital Finance Program on the date the Obligor's NAIC CRP credit rating or NAIC Designation is downgraded to **NAIC 3** or its NAIC CRP equivalent.

NOTE: *SSAP No. 105R—Working Capital Finance Investments* provides that Working Capital Finance Investments generated under a Working Capital Finance Program of an Obligor that falls below the equivalent of **NAIC 1** or **NAIC 2** becomes nonadmitted.

Process and Methodology

121. An NAIC Designation shall be assigned to a Working Capital Finance Program on the basis of a thorough assessment of credit, dilution, operational and other risks, an assessment of protections provided by operative documents to the Investor and the quality of transaction participants.

Risk-Assessment Process

122. **Credit Risk** – The NAIC Designation for a Working Capital Finance Program shall be linked to the credit quality of the Obligor, which may be determined by reference to a credit rating assigned by a NAIC 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 this Manual for corporate obligors.
123. **Dilution Risk** – To achieve an **NAIC 1** or **NAIC 2** Designation, the Working Capital Finance Program must eliminate dilution risk in the Working Capital Finance Investment proposed to be eligible for purchase by the Investor. The terms governing the Investor's Working Capital Finance Investment must eliminate Obligor recourse to its Supplier as a condition to payment of the obligation to the Investor so as to result in an unconditional right to receive payment on a full and timely basis.
124. **Operational Risk** – To achieve an **NAIC 1** or **NAIC 2** Designation, all operational risks shall be identified and assessed. Key participants shall have a NAIC CRP credit rating or an NAIC Designation assigned by the SVO at a level at least that of the Obligor.

Legal, Structural and Regulatory Considerations

125. Events of default remedies should provide the Investor at least those rights and privileges, unimpaired, of a trade creditor upon default with no Obligor defenses that could cause dilution of principal.
126. ~~The SVO shall verify that either, (i) the Finance Agent is ~~must be~~ an entity regulated or supervised by a financial regulator in one of the countries in the List of Foreign (non-US) Jurisdictions Eligible for Netting for Purposes of Determining Exposures to Counterparties for Schedule DB, Part D, Section 1 and that the regulator is the functional equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC) or the Federal Deposit Insurance Corporation (FDIC). In the alternative, or (ii) the SVO shall verify that~~ payments due the Investor are made directly by the Obligor (a) to the Investor or (b) into an account maintained by a regulated financial institution for the benefit of Investors in the Working Capital Finance Program, and, in either case, the Finance Agent cannot be the beneficiary of such payment. ~~with no commingling of funds or assets with those of the Obligor, Supplier, Servicer or Trust Administrator or other Investors.~~
127. The SVO will verify that the Certification from the insurance company's Chief Investment Officer confirms that the Investor is not affiliated with Obligor and that Working Capital Finance Investment excludes insurance or insurance-related assets.
128. The SVO will verify that the Certification from the insurance company's Legal Counsel confirms the existence of a commercially reasonable belief that the documents establishing and governing the Working Capital Finance Program establishes the rights and UCC code standard for preserving first priority perfected interest in Confirmed Supplier Receivables.
129. The remedies available to the participants in the Working Capital Finance Program should be expressly identified in the documentation for the Working Capital Finance Investment.
130. Characteristics that shall be present in a proposed Working Capital Finance Investment include, but are not limited to, the following, or a substantial equivalent:
131. The Obligor makes payments directly to the (a) Investor; (b) Finance Agent; or (c) servicer for the Working Capital Finance Program.
132. The Investor must have the option, and not an obligation, to purchase subsequent Working Capital Finance Investment so as to ensure the Investor can exit the Working Capital Finance Investment by permitting existing investments to mature.

133. *SSAP No. 105R—Working Capital Finance Investments* provides that the documentation governing Working Capital Finance Programs must provide that disputes arising under the agreements shall be submitted to a court of competent jurisdiction in the U.S. or be subject to an alternative dispute resolution process sanctioned by state law. Given the nature of Working Capital Finance Programs, the SVO anticipates that documentation governing Working Capital Finance Investments will be subject to the laws and jurisdiction of the courts of California, Delaware or New York, or a similar legal jurisdiction with significant exposure to sophisticated institutional financial transactions.
134. Events of default must be clearly defined, and provide a mechanism that gives the Investor the ability to pursue collection unfettered by actions taken or not taken by participants such as the Servicer or Trustee, or other named persons performing similar functions.

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Updates to WCFI\2020-022.02 PP Manual Amend - Updates to SSAP No. 105 for WCFI - Revised.docx

Mike Monahan

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

August 17, 2020

Mr. Kevin Fry, Chairman
Valuation of Securities Task Force
National Association of Insurance
Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Ms. Carrie Mears, Vice Chair
Valuation of Securities Task Force
National Association of Insurance
Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Incorporate Updates Made to SSAP No. 105R – Working Capital Finance Investments.

Dear Mr. Fry and Ms. Mears:

ACLI appreciates the opportunity to comment on the exposure drafts released for comment by the Valuation of Securities Task Force regarding the Statutory Accounting Principles (E) Working Group adopted updates to SSAP No. 105R Working Capital Finance Investments on May 20, 2020. The revisions to the SSAP adopted by the Working Group incorporate seven of the industry requested modifications to the Working Capital Finance Investments program requirements and are effective on June 30, 2020.

We offer the following comments on the proposed revisions dated June 15, 2020 under memorandum from Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO) and Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO) for exposure:

- Paragraph 102, fourth bullet and Paragraph 103, second bullet – SSAP 105R does not require the audited consolidated financial statements of the group of which the Finance Agent is a part. The requirement should be removed from the P&P Manual.
- Paragraph 102, fourth bullet, fourth sub-bullet and Paragraph 128 – SSAP 105R does not require the referenced legal certification. The requirement should be removed from the P&P Manual.
- Paragraph 131 – This language should be updated to align with the exact language of SSAP 105R.

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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.

We would like to further observe the following, which do not align with the requirements of SSAP 105R nor with the superseded SSAP 105:

- Paragraph 102, second bullet – The SSAP does not require audited financial statements of the Obligor. It only speaks to the Obligor needing an NAIC 1 or 2 designation or the equivalent from a CRP.
- Paragraph 102, third bullet – The SSAP does not require the insurance company's Investment Committee Memorandum.
- Paragraphs 105 and 107 – "Dilution Risk" is not defined in the SSAP, but the concepts are included.
- Paragraphs 105, 111, 121, and 124 – "Operational Risk" is not defined or contemplated in the SSAP.
- Paragraph 122 – The SSAP does not contemplate the SVO analyst assessing credit risk "in accordance with any permitted methodology" in the P&P Manual.
- Paragraph 132 – The SSAP does not require that the investor only have an option, and not an obligation, to purchase subsequent investments.

Additionally, we point out the following editorial comments:

- Paragraph 102, fourth bullet, first sub-bullet – An "or" should be inserted at the end of this bullet.
- Paragraph 102, fourth bullet, third sub-bullet – We do not believe the requested certification is an alternative to the first and second sub-bullets. The requirement should be promoted to make that clear.

A redline of our proposed changes is attached. Most importantly, we would like to draw your attention to the fact that neither SSAP 105R or the superseded SSAP 105 contain any language about the operational risk or credit risk requirements, other than the Obligors' as determined by reference to a credit rating assigned by a NAIC CRP or by an NAIC Designation assigned by the SVO.

Sincerely,



Mike Monahan
Senior Director, Accounting Policy

Attachment

Copy to Charles A. 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. 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: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Incorporate Updates Made to SSAP No. 105R – Working Capital Finance Investments.

DATE: June 15, 2020

1. **Summary** – The Statutory Accounting Principles (E) Working Group adopted updates to SSAP No. 105R Working Capital Finance Investments on May 20, 2020. These updates originate from industry comments that the SSAP’s fixed approach to a number of legal or structural issues in these transactions, which are routinely handled differently, prevents the SVO from exercising proper analytical discretion. Industry therefore requested the Task Force to update the program requirements that was then referred to the Working Group on March 7, 2019. The revisions adopted by the Working Group incorporate seven of the industry requested modifications to the Working Capital Finance Investments program requirements and are effective on June 30, 2020. Key revisions are summarized as follows:
 - Functionally Equivalent Foreign Regulators - Removed the requirement that the Securities Valuation Office (SVO) determine if the International Finance Agent is the functional equivalent of the U.S. regulator.
 - Commingling Prohibitions - Removed the finance agent prohibitions on commingling.
 - Investor Rights Edit - Removed duplicative text regarding exercising of investor rights.
 - Requirements for filer to Certify Perfected Interest – Removed requirements, with revisions allowing the SVO to determine if a first priority perfected interest has been obtained.
 - Finance Agent Validation Requirements – Broadened the independent review requirements to allow independent review of the finance agent by either audit or through an internal control report.
 - Default Date - Changed the default provisions from 15 to 30 days so the default date and the cure period are consistent.
 - Possible Domestic Regulator Approval – Removed the statement that the reporting entity may need to seek approval from the domestic regulator.
2. **Recommendation** – The SVO staff reviewed the adopted updates to *SSAP No. 105R – Working Capital Finance Investments* to identify edits needed in the P&P to reflect those changes. The proposed amendments reflect only the SSAP changes that are relevant to the P&P guidance. The SVO recommends exposing this amendment.

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3. Proposed Amendment – The following shows the proposed revisions in Part Three with text in red identifying the changes.

PART THREE

**SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS**

WORKING CAPITAL FINANCE INVESTMENTS

NOTE: See “Specific Populations of Securities Not Eligible for Filing Exemption” in “Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities” above.







Initial Filing Requirements

102. An insurance company requesting an analysis of a proposed Working Capital Finance Program shall provide the SVO with the documentation described in this subparagraph:

- An RTAS Application.
- The Obligor’s Audited Financial Statements, if the Obligor is not rated for credit risk by a NAIC CRP.
- The insurance company’s Investment Committee Memorandum for the proposed Working Capital Finance Program.
- ~~The audited consolidated financial statements of the group of which the Finance Agent for the Working Capital Finance Program is a part, and one of the following:~~
 - An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment.
 - An annual audit of the financial statement and internal controls of the consolidated group of which the Finance Agent is part, which does not note any material weakness related to servicing working capital financial investments.
 - A Certification from the insurance company’s Chief Investment Office 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 Program, and that the Working Capital Finance Program does not include any insurance or insurance related assets.
- ~~A Certification from the insurance company’s Legal Counsel.~~
- ~~In the case of a participation, that it has a commercially reasonable belief that its participation interest meets the Uniform Commercial Code’s standards for creating and preserving first priority security interests in the payments due and in the Confirmed Supplier Receivables.~~

Summary of Comments on 2020-022.01 PP Manual Amend - Updates to SSAP No. 105 for WCFI -- 8.12.2020 comments.pdf

Page: 4

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|--|-----------|----------------------------|------------------------|----------------------------|
|  | Number: 1 | Author: Interested Parties | Subject: Sticky Note | Date: 8/12/2020 8:26:10 PM |
| The SSAP does not require financial statements; only speaks to the Obligor needing an NAIC 1 or 2 designation or the equivalent from a CRP. | | | | |
|  | Number: 2 | Author: Interested Parties | Subject: Sticky Note | Date: 8/12/2020 8:26:21 PM |
| This is not specifically required by the SSAP. | | | | |
|  | Number: 3 | Author: Interested Parties | Subject: Cross-Out | Date: 8/12/2020 8:26:32 PM |
| This is no longer a requirement under SSAP 105R. See SSAP 105R new paragraph 14 (old paragraph 16) that specifically removed this requirement. | | | | |
|  | Number: 4 | Author: Interested Parties | Subject: Inserted Text | Date: 8/12/2020 2:44:07 PM |
| or | | | | |
|  | Number: 5 | Author: Interested Parties | Subject: Sticky Note | Date: 8/12/2020 2:48:11 PM |
| This section is not an alternative to the first two bullets. It should be promoted one level to the black square bullet. | | | | |
|  | Number: 6 | Author: Interested Parties | Subject: Cross-Out | Date: 8/12/2020 8:27:41 PM |
| This is no longer a requirement under SSAP 105R. | | | | |

- ~~In the case of a certificate, note or other manifestation, representing a right to payment from a trust, other special purpose entity, or special purpose pool holding confirmed supplier receivables, that it has a commercially reasonable belief that the documents establishing and governing the Working Capital Finance Program create and preserve interests in the Confirmed Supplier Receivables capable of being enforced by the trustee or other entity holding Confirmed Supplier Receivables as first priority perfected security interests under the Uniform Commercial Code.~~

~~NOTE: Please refer to SSAP No. 105 – Working Capital Finance Investments for the definition of a “commercially reasonable belief.”~~

- A copy of:
 - The document(s) that create the Working Capital Finance Investments (i.e., the short-term receivables) that is the subject of the RTAS – Emerging Investment Vehicle Service Application, and establishes the obligations of the Obligor to, and the protection afforded owners of, Working Capital Finance Investments (including the Investors). This agreement is sometimes referred to as the Invoice Payment Terms Acknowledgement, the Payable Services Agreement or the Paying Services Agreement.

NOTE: Please refer to “The Regulatory Treatment Analysis Service – Emerging Investment Vehicle” in Part Two for guidance regarding the filing of an RTAS Application with the SVO.
 - The agreement(s) between the Obligor and the Finance Agent governing the administration of the Working Capital Finance Program and the Working Capital Finance Investments issued thereunder. These agreements may be included in the documents mentioned above or may be a stand-alone agreement which are sometimes referred to as the Settlement Services Agreement or the Invoice-Related Electronic Services Agreement.
 - The agreement governing the sale of the Working Capital Finance Investments from the Supplier to the Finance Agent. This agreement is sometimes referred to as the Receivables Purchase Agreement or the Supplier Agreement. The agreement governing the ongoing purchase of Working Capital Finance Investments or an interest in Working Capital Finance Investments by the Investor from the Finance Agent. This agreement is sometimes referred to as the Agency Agreement, the Participation Agreement or the Program Trust Agreement.

Subsequent Filing Requirements

103. Subsequent filing requirements include:

- Copies of any of the documents originally submitted with the RTAS Application subsequently amended.
- ~~1. The audited consolidated financial statements of the group of which the Finance Agent for the Working Capital Finance Program is a part, and one of the following:~~
 - An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment; or
 - An annual audit of the financial statements and internal controls of the consolidated group of which the Finance Agent is part, which does not note any material weakness related to servicing working capital financial investments.

Definitions in SSAP No. 105R—Working Capital Finance Investments




104. Please refer to SSAP No. 105R—Working Capital Finance Investments, for the definitions and associated definitional guidance insurance companies must understand and comply with before applying for an NAIC Designation for Working Capital Finance Programs that would permit them to purchase Working Capital Finance Investments.


105. With the exception of the definitions for Dilution Risk and Operational Risk below, the definitions shown below are summaries of those contained in SSAP No. 105R—Working Capital Finance Investments intended only to facilitate a discussion and in all cases subordinate to the definitions in SSAP No. 105R.

Summary of Key Definitions


106. **Confirmed Supplier Receivable** – A receivable sold by a Supplier to a Finance Agent or Investor (or by a Finance Agent to an Investor) under a Working Capital Finance Program designated by the SVO that requires the Obligor to confirm to the Finance Agent or Investor, prior to the sale of the receivable from the Supplier to the Finance Agent or Investor, that it has no defenses to payment of the monetary obligation represented by the receivable against the Supplier and, therefore, no defenses to payment of the same monetary obligation to the Finance Agent and/or Investor after such sale. The confirmation by the Obligor that it has no defenses to payment includes confirmation that the Obligor does not have a right to refuse payment that it may have acquired with respect to underlying commercial trade transaction and that, if it has such a right, it will not assert such defenses against the Finance Agent or Investor.


Page: 6

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-  Number: 1 Author: Interested Parties Subject: Cross-Out Date: 8/12/2020 8:27:50 PM
This is no longer a requirement under SSAP 105R. See SSAP 105R new paragraph 14 (old paragraph 16) that specifically removed this requirement.
-
-  Number: 2 Author: Interested Parties Subject: Sticky Note Date: 8/12/2020 8:28:06 PM
"Dilution Risk" is not defined in the SSAP, but the concepts are included.
-
-  Number: 3 Author: Interested Parties Subject: Cross-Out Date: 8/12/2020 8:28:14 PM
"Operational Risk" is not defined in the SSAP.
-

-  ¹
107. **Dilution Risk** – With respect to any Working Capital Finance Program, dilution risk refers to disputes or contractual provisions that may reduce the amount of the obligation owed by the Obligor to the Supplier under the original receivable or the obligation owed by the Obligor to the Finance Agent and/or Investor under the Confirmed Supplier Receivable. Examples of dilution risk are credit for returns of defective goods or an allegation of fraud, such as that the invoice is not legitimate or is a duplicate invoice.
108. **Finance Agent** – A bank, financial institution, financial intermediary or service provider that facilitates the Working Capital Finance Program that arranges the sale, assignment or transfer of the Confirmed Supplier Receivable to the Investor and administers payment.
109. **Investor** – The insurance company that files the RTAS Application with the SVO in order to obtain an NAIC Designation for a proposed Working Capital Finance Program.
110. **Obligor** – An entity that purchases the goods or services from the Supplier and thereby generates the original supplier receivable—and which Obligor has, or can be designated, **NAIC 1** or **NAIC 2** by the SVO or has been assigned an equivalent credit rating by a NAIC CRP.
111. ~~² **Operational Risk** – With respect to any Working Capital Finance Program, operational risk refers to the combined effect of the procedures and parties employed to implement the program and their responsibility under the documents and to the determination by the SVO of whether these procedures and parties will ensure full and timely performance by the Obligor of the payment obligation to the Investor. An example of an operational risk is the confirmation process employed to verify that the Obligor has no defenses to payment.~~
112. **Supplier** – The entity that sells the goods or services to the Obligor, obtains a receivable from the Obligor in exchange and subsequently chooses to sell the right to receive the payment associated with the receivable to the Finance Agent or Investor under the terms of a Working Capital Finance Program designated **NAIC 1** or **NAIC 2** by the SVO.
113. **Working Capital Finance Program** – The program created for the Obligor and its Suppliers by a Finance Agent the terms of which permits Suppliers to the Obligor to negotiate the sale of a right to receive payment from the Obligor (which is associated with and evidenced by a receivable) to the Finance Agent or an Investor.
114. **Working Capital Finance Investment** – The right to receive the payment associated with a Confirmed Supplier Receivable purchased by an Investor under a Working Capital Finance Program designated **NAIC 1** or **NAIC 2** by the SVO and is the subject of *SSAP No. 105R—Working Capital Finance Investments*.

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 Number: 1 Author: Interested Parties Subject: Sticky Note Date: 8/12/2020 8:28:18 PM
"Dilution Risk" is not defined in the SSAP, but the concepts are included.

 Number: 2 Author: Interested Parties Subject: Cross-Out Date: 8/12/2020 8:28:26 PM
The term "Operational Risk" and these concepts are not defined in the SSAP.

NOTE: *SSAP No. 105R—Working Capital Finance Investments* imposes reporting and statutory accounting requirements on insurance company investments in Working Capital Finance Investments ~~and specifies analytical procedures to be applied or analytical controls to be verified by the SVO that are not detailed above.~~ Insurance companies are strongly advised to become familiar with SSAP No. 105R before filing an RTAS Application with the SVO.

Direction and Program Parameters

115. The SVO may assign an NAIC Designation to a Working Capital Finance Program that would generate Working Capital Finance Investment that meet the criterion and standards identified in this Section.
116. **RTAS Submission Required** – A request that the SVO assign an NAIC Designation to a Working Capital Finance Program is made by filing an RTAS Application. The RTAS Application is available at www.naic.org/documents/svo_rtas_app.pdf.
117. Upon completion of its risk assessment, the SVO will issue an RTAS Letter indicating a preliminary NAIC Designation; i.e., the NAIC Designation that would be assigned if the Investor enters into a Working Capital Finance Program with a Finance Agent and sought to report it to the SVO.

NOTE: A preliminary NAIC Designation cannot be used for statutory reporting purposes.

118. The SVO shall issue a final NAIC Designation to the Investor for the Working Capital Finance Program and the Working Capital Finance Investments generated thereunder upon receipt of fully executed final copies of the required documentation.

Variations in Structure

119. Working Capital Finance Programs may differ in structure and in the protection afforded the Investor. Structural strength and weaknesses of various structures in such programs will be reflected in the NAIC Designation assigned by the SVO.

Program Quality

120. The SVO shall only assign an NAIC Designation to Working Capital Finance Programs that can be designated **NAIC 1** or **NAIC 2**. Credit quality is measured by reference to a NAIC CRP credit rating or an NAIC Designation assigned by the SVO. The SVO shall withdraw the NAIC Designation assigned to a Working Capital Finance Program on the date the Obligor's NAIC CRP credit rating or NAIC Designation is downgraded to **NAIC 3** or its NAIC CRP equivalent.

NOTE: *SSAP No. 105R—Working Capital Finance Investments* provides that Working Capital Finance Investments generated under a Working Capital Finance Program of

an Obligor that falls below the equivalent of **NAIC 1** or **NAIC 2** becomes nonadmitted.

Process and Methodology

121. An NAIC Designation shall be assigned to a Working Capital Finance Program on the basis of a thorough assessment of ¹~~credit, dilution, operational and other risks~~, an assessment of protections provided by operative documents to the Investor and the quality of transaction participants.


Risk-Assessment Process


122. **Credit Risk** – The NAIC Designation for a Working Capital Finance Program shall be linked to the credit quality of the Obligor, which may be determined by reference to a credit rating assigned by a NAIC CRP or by an NAIC Designation assigned by the SVO. ²~~Credit risk is assessed by the SVO analyst in accordance with any permitted methodology set forth in this Manual for corporate obligors.~~
123. **Dilution Risk** – To achieve an **NAIC 1** or **NAIC 2** Designation, the Working Capital Finance Program must eliminate dilution risk in the Working Capital Finance Investment proposed to be eligible for purchase by the Investor. The terms governing the Investor's Working Capital Finance Investment must eliminate Obligor recourse to its Supplier as a condition to payment of the obligation to the Investor so as to result in an unconditional right to receive payment on a full and timely basis.
124. ³~~**Operational Risk** – To achieve an **NAIC 1** or **NAIC 2** Designation, all operational risks shall be identified and assessed. Key participants shall have a NAIC CRP credit rating or an NAIC Designation assigned by the SVO at a level at least that of the Obligor.~~


Legal, Structural and Regulatory Considerations

125. Events of default remedies should provide the Investor at least those rights and privileges, unimpaired, of a trade creditor upon default with no Obligor defenses that could cause dilution of principal.

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 Number: 1 Author: Interested Parties Subject: Cross-Out Date: 8/12/2020 3:45:55 PM
credit and dilution risks, and


 Number: 2 Author: Interested Parties Subject: Cross-Out Date: 8/12/2020 8:28:30 PM
This is not a requirement of the SSAP.


 Number: 3 Author: Interested Parties Subject: Cross-Out Date: 8/12/2020 8:28:35 PM
The term "Operational Risk" and these concepts are not defined in the SSAP.

126. ~~The SVO shall verify that either, (i) the Finance Agent is ~~must be~~ an entity regulated or supervised by a financial regulator in one of the countries in the List of Foreign (non-US) Jurisdictions Eligible for Netting for Purposes of Determining Exposures to Counterparties for Schedule DB, Part D, Section 1 and that the regulator is the functional equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC) or the Federal Deposit Insurance Corporation (FDIC). In the alternative, or (ii) the SVO shall verify that~~ payments due the Investor are made directly by the Obligor or into an account maintained by a regulated financial institution for the benefit of Investors in the Working Capital Finance Program and, in either case, the Finance Agent cannot be the beneficiary of such payment. ~~with no commingling of funds or assets with those of the Obligor, Supplier, Servicer or Trust Administrator or other Investors.~~
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Page: 10

 Number: 1 Author: Interested Parties Subject: Cross-Out Date: 8/12/2020 8:28:41 PM
This is no longer a requirement under SSAP 105R.

 Number: 2 Author: Interested Parties Subject: Inserted Text Date: 8/12/2020 2:45:16 PM
or (b) into an account maintained by a regulated financial institution for the benefit of investors in the working capital finance program.

 Number: 3 Author: Interested Parties Subject: Cross-Out Date: 8/12/2020 8:28:46 PM
This is not a requirement of the SSAP.

134. Events of default must be clearly defined, and provide a mechanism that gives the Investor the ability to pursue collection unfettered by actions taken or not taken by participants such as the Servicer or Trustee, or other named persons performing similar functions.

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WCFI\2020-022.01 PP Manual Amend - Updates to SSAP No. 105 for WCFI.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)
Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO)

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

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DATE: June 15, 2020

1. **Summary** – The Statutory Accounting Principles (E) Working Group adopted updates to SSAP No. 105R Working Capital Finance Investments on May 20, 2020. These updates originate from industry comments that the SSAP’s fixed approach to a number of legal or structural issues in these transactions, which are routinely handled differently, prevents the SVO from exercising proper analytical discretion. Industry therefore requested the Task Force to update the program requirements that was then referred to the Working Group on March 7, 2019. The revisions adopted by the Working Group incorporate seven of the industry requested modifications to the Working Capital Finance Investments program requirements and are effective on June 30, 2020. Key revisions are summarized as follows:
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 - Finance Agent Validation Requirements – Broadened the independent review requirements to allow independent review of the finance agent by either audit or through an internal control report.
 - Default Date - Changed the default provisions from 15 to 30 days so the default date and the cure period are consistent.
 - Possible Domestic Regulator Approval – Removed the statement that the reporting entity may need to seek approval from the domestic regulator.
2. **Recommendation** – The SVO staff reviewed the adopted updates to *SSAP No. 105R – Working Capital Finance Investments* to identify edits needed in the P&P to reflect those changes. The proposed amendments reflect only the SSAP changes that are relevant to the P&P guidance. The SVO recommends exposing this amendment.

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3. Proposed Amendment – The following shows the proposed revisions in Part Three with text in red identifying the changes.

PART THREE

SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

WORKING CAPITAL FINANCE INVESTMENTS

NOTE: See “Specific Populations of Securities Not Eligible for Filing Exemption” in “Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities” above.

Initial Filing Requirements

102. An insurance company requesting an analysis of a proposed Working Capital Finance Program shall provide the SVO with the documentation described in this subparagraph:

- An RTAS Application.
- The Obligor’s Audited Financial Statements, if the Obligor is not rated for credit risk by a NAIC CRP.
- The insurance company’s Investment Committee Memorandum for the proposed Working Capital Finance Program.
- The audited consolidated financial statements of the group of which the Finance Agent for the Working Capital Finance Program is a part, and one of the following:
 - An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment.
 - An annual audit of the financial statement and internal controls of the consolidated group of which the Finance Agent is part, which does not note any material weakness related to servicing working capital financial investments.
 - A Certification from the insurance company’s Chief Investment Office 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 Program, and that the Working Capital Finance Program does not include any insurance or insurance related assets.
 - A Certification from the insurance company’s Legal Counsel.
- ~~In the case of a participation, that it has a commercially reasonable belief that its participation interest meets the Uniform Commercial Code’s standards for creating and preserving first priority security interests in the payments due and in the Confirmed Supplier Receivables.~~

- ~~In the case of a certificate, note or other manifestation, representing a right to payment from a trust, other special purpose entity, or special purpose pool holding confirmed supplier receivables, that it has a commercially reasonable belief that the documents establishing and governing the Working Capital Finance Program create and preserve interests in the Confirmed Supplier Receivables capable of being enforced by the trustee or other entity holding Confirmed Supplier Receivables as first priority perfected security interests under the Uniform Commercial Code.~~

~~NOTE: Please refer to SSAP No. 105 – Working Capital Finance Investments for the definition of a “commercially reasonable belief.”~~

- A copy of:
 - The document(s) that create the Working Capital Finance Investments (i.e., the short-term receivables) that is the subject of the RTAS – Emerging Investment Vehicle Service Application, and establishes the obligations of the Obligor to, and the protection afforded owners of, Working Capital Finance Investments (including the Investors). This agreement is sometimes referred to as the Invoice Payment Terms Acknowledgement, the Payable Services Agreement or the Paying Services Agreement.

NOTE: Please refer to “The Regulatory Treatment Analysis Service – Emerging Investment Vehicle” in Part Two for guidance regarding the filing of an RTAS Application with the SVO.
 - The agreement(s) between the Obligor and the Finance Agent governing the administration of the Working Capital Finance Program and the Working Capital Finance Investments issued thereunder. These agreements may be included in the documents mentioned above or may be a stand-alone agreement which are sometimes referred to as the Settlement Services Agreement or the Invoice-Related Electronic Services Agreement.
 - The agreement governing the sale of the Working Capital Finance Investments from the Supplier to the Finance Agent. This agreement is sometimes referred to as the Receivables Purchase Agreement or the Supplier Agreement. The agreement governing the ongoing purchase of Working Capital Finance Investments or an interest in Working Capital Finance Investments by the Investor from the Finance Agent. This agreement is sometimes referred to as the Agency Agreement, the Participation Agreement or the Program Trust Agreement.

Subsequent Filing Requirements

103. Subsequent filing requirements include:
- Copies of any of the documents originally submitted with the RTAS Application subsequently amended.
 - The audited consolidated financial statements of the group of which the Finance Agent for the Working Capital Finance Program is a part, and one of the following:
 - An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment; or
 - An annual audit of the financial statements and internal controls of the consolidated group of which the Finance Agent is part, which does not note any material weakness related to servicing working capital financial investments.

Definitions in SSAP No. 105R—Working Capital Finance Investments

104. Please refer to SSAP No. 105R—Working Capital Finance Investments, for the definitions and associated definitional guidance insurance companies must understand and comply with before applying for an NAIC Designation for Working Capital Finance Programs that would permit them to purchase Working Capital Finance Investments.
105. With the exception of the definitions for Dilution Risk and Operational Risk below, the definitions shown below are summaries of those contained in SSAP No. 105R—Working Capital Finance Investments intended only to facilitate a discussion and in all cases subordinate to the definitions in SSAP No. 105R.

Summary of Key Definitions

106. **Confirmed Supplier Receivable** – A receivable sold by a Supplier to a Finance Agent or Investor (or by a Finance Agent to an Investor) under a Working Capital Finance Program designated by the SVO that requires the Obligor to confirm to the Finance Agent or Investor, prior to the sale of the receivable from the Supplier to the Finance Agent or Investor, that it has no defenses to payment of the monetary obligation represented by the receivable against the Supplier and, therefore, no defenses to payment of the same monetary obligation to the Finance Agent and/or Investor after such sale. The confirmation by the Obligor that it has no defenses to payment includes confirmation that the Obligor does not have a right to refuse payment that it may have acquired with respect to underlying commercial trade transaction and that, if it has such a right, it will not assert such defenses against the Finance Agent or Investor.

107. **Dilution Risk** – With respect to any Working Capital Finance Program, dilution risk refers to disputes or contractual provisions that may reduce the amount of the obligation owed by the Obligor to the Supplier under the original receivable or the obligation owed by the Obligor to the Finance Agent and/or Investor under the Confirmed Supplier Receivable. Examples of dilution risk are credit for returns of defective goods or an allegation of fraud, such as that the invoice is not legitimate or is a duplicate invoice.
108. **Finance Agent** – A bank, financial institution, financial intermediary or service provider that facilitates the Working Capital Finance Program that arranges the sale, assignment or transfer of the Confirmed Supplier Receivable to the Investor and administers payment.
109. **Investor** – The insurance company that files the RTAS Application with the SVO in order to obtain an NAIC Designation for a proposed Working Capital Finance Program.
110. **Obligor** – An entity that purchases the goods or services from the Supplier and thereby generates the original supplier receivable—and which Obligor has, or can be designated, **NAIC 1** or **NAIC 2** by the SVO or has been assigned an equivalent credit rating by a NAIC CRP.
111. **Operational Risk** – With respect to any Working Capital Finance Program, operational risk refers to the combined effect of the procedures and parties employed to implement the program and their responsibility under the documents and to the determination by the SVO of whether these procedures and parties will ensure full and timely performance by the Obligor of the payment obligation to the Investor. An example of an operational risk is the confirmation process employed to verify that the Obligor has no defenses to payment.
112. **Supplier** – The entity that sells the goods or services to the Obligor, obtains a receivable from the Obligor in exchange and subsequently chooses to sell the right to receive the payment associated with the receivable to the Finance Agent or Investor under the terms of a Working Capital Finance Program designated **NAIC 1** or **NAIC 2** by the SVO.
113. **Working Capital Finance Program** – The program created for the Obligor and its Suppliers by a Finance Agent the terms of which permits Suppliers to the Obligor to negotiate the sale of a right to receive payment from the Obligor (which is associated with and evidenced by a receivable) to the Finance Agent or an Investor.
114. **Working Capital Finance Investment** – The right to receive the payment associated with a Confirmed Supplier Receivable purchased by an Investor under a Working Capital Finance Program designated **NAIC 1** or **NAIC 2** by the SVO and is the subject of *SSAP No. 105R—Working Capital Finance Investments*.

NOTE: *SSAP No. 105R—Working Capital Finance Investments* imposes reporting and statutory accounting requirements on insurance company investments in Working Capital Finance Investments ~~and specifies analytical procedures to be applied or analytical controls to be verified by the SVO that are not detailed above.~~ Insurance companies are strongly advised to become familiar with *SSAP No. 105R* before filing an RTAS Application with the SVO.

Direction and Program Parameters

115. The SVO may assign an NAIC Designation to a Working Capital Finance Program that would generate Working Capital Finance Investment that meet the criterion and standards identified in this Section.
116. **RTAS Submission Required** – A request that the SVO assign an NAIC Designation to a Working Capital Finance Program is made by filing an RTAS Application. The RTAS Application is available at www.naic.org/documents/svo_rtas_app.pdf.
117. Upon completion of its risk assessment, the SVO will issue an RTAS Letter indicating a preliminary NAIC Designation; i.e., the NAIC Designation that would be assigned if the Investor enters into a Working Capital Finance Program with a Finance Agent and sought to report it to the SVO.

NOTE: A preliminary NAIC Designation cannot be used for statutory reporting purposes.

118. The SVO shall issue a final NAIC Designation to the Investor for the Working Capital Finance Program and the Working Capital Finance Investments generated thereunder upon receipt of fully executed final copies of the required documentation.

Variations in Structure

119. Working Capital Finance Programs may differ in structure and in the protection afforded the Investor. Structural strength and weaknesses of various structures in such programs will be reflected in the NAIC Designation assigned by the SVO.

Program Quality

120. The SVO shall only assign an NAIC Designation to Working Capital Finance Programs that can be designated **NAIC 1** or **NAIC 2**. Credit quality is measured by reference to a NAIC CRP credit rating or an NAIC Designation assigned by the SVO. The SVO shall withdraw the NAIC Designation assigned to a Working Capital Finance Program on the date the Obligor's NAIC CRP credit rating or NAIC Designation is downgraded to **NAIC 3** or its NAIC CRP equivalent.

NOTE: *SSAP No. 105R—Working Capital Finance Investments* provides that Working Capital Finance Investments generated under a Working Capital Finance Program of

an Obligor that falls below the equivalent of **NAIC 1** or **NAIC 2** becomes nonadmitted.

Process and Methodology

121. An NAIC Designation shall be assigned to a Working Capital Finance Program on the basis of a thorough assessment of credit, dilution, operational and other risks, an assessment of protections provided by operative documents to the Investor and the quality of transaction participants.

Risk-Assessment Process

122. **Credit Risk** – The NAIC Designation for a Working Capital Finance Program shall be linked to the credit quality of the Obligor, which may be determined by reference to a credit rating assigned by a NAIC 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 this Manual for corporate obligors.
123. **Dilution Risk** – To achieve an **NAIC 1** or **NAIC 2** Designation, the Working Capital Finance Program must eliminate dilution risk in the Working Capital Finance Investment proposed to be eligible for purchase by the Investor. The terms governing the Investor's Working Capital Finance Investment must eliminate Obligor recourse to its Supplier as a condition to payment of the obligation to the Investor so as to result in an unconditional right to receive payment on a full and timely basis.
124. **Operational Risk** – To achieve an **NAIC 1** or **NAIC 2** Designation, all operational risks shall be identified and assessed. Key participants shall have a NAIC CRP credit rating or an NAIC Designation assigned by the SVO at a level at least that of the Obligor.

Legal, Structural and Regulatory Considerations

125. Events of default remedies should provide the Investor at least those rights and privileges, unimpaired, of a trade creditor upon default with no Obligor defenses that could cause dilution of principal.

126. ~~The SVO shall verify that either, (i) the Finance Agent is ~~must be~~ an entity regulated or supervised by a financial regulator in one of the countries in the List of Foreign (non-US) Jurisdictions Eligible for Netting for Purposes of Determining Exposures to Counterparties for Schedule DB, Part D, Section 1 and that the regulator is the functional equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC) or the Federal Deposit Insurance Corporation (FDIC). In the alternative, or (ii) the SVO shall verify that~~ payments due the Investor are made directly by the Obligor or into an account maintained by a regulated financial institution for the benefit of Investors in the Working Capital Finance Program. and, in either case, the Finance Agent cannot be the beneficiary of such payment. ~~with no commingling of funds or assets with those of the Obligor, Supplier, Servicer or Trust Administrator or other Investors.~~
127. The SVO will verify that the Certification from the insurance company's Chief Investment Officer confirms that the Investor is not affiliated with Obligor and that Working Capital Finance Investment excludes insurance or insurance-related assets.
128. The SVO will verify that the Certification from the insurance company's Legal Counsel confirms the existence of a commercially reasonable belief that the documents establishing and governing the Working Capital Finance Program establishes the rights and UCC code standard for preserving first priority perfected interest in Confirmed Supplier Receivables.
129. The remedies available to the participants in the Working Capital Finance Program should be expressly identified in the documentation for the Working Capital Finance Investment.
130. Characteristics that shall be present in a proposed Working Capital Finance Investment include, but are not limited to, the following, or a substantial equivalent:
131. The Obligor makes payments directly to the (a) Investor; (b) Finance Agent; or (c) servicer for the Working Capital Finance Program.
132. The Investor must have the option, and not an obligation, to purchase subsequent Working Capital Finance Investment so as to ensure the Investor can exit the Working Capital Finance Investment by permitting existing investments to mature.
133. *SSAP No. 105R—Working Capital Finance Investments* provides that the documentation governing Working Capital Finance Programs must provide that disputes arising under the agreements shall be submitted to a court of competent jurisdiction in the U.S. or be subject to an alternative dispute resolution process sanctioned by state law. Given the nature of Working Capital Finance Programs, the SVO anticipates that documentation governing Working Capital Finance Investments will be subject to the laws and jurisdiction of the courts of California, Delaware or New York, or a similar legal jurisdiction with significant exposure to sophisticated institutional financial transactions.

134. Events of default must be clearly defined, and provide a mechanism that gives the Investor the ability to pursue collection unfettered by actions taken or not taken by participants such as the Servicer or Trustee, or other named persons performing similar functions.

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Updates to WCFI\2020-022.01 PP Manual Amend - Updates to SSAP No. 105 for WCFI.docx

TO: Kevin Fry (IL), Chair of the Valuation of Securities (E) Task Force
FROM: Dale Bruggeman (OH), Chair of the Statutory Accounting Principles (E) Working Group
DATE: June 4, 2020
RE: Updates to Working Capital Finance Program Requirements

During its May 20, 2020 conference call, the Statutory Accounting Principles (E) Working Group finalized consideration of a referral from the Valuation of Securities (E) Task Force, pertaining to Working Capital Finance program requirements. With the action taken, the Working Group adopted substantive revisions to *SSAP No. 105R—Working Capital Finance Investments* and *Issue Paper No. 163—Working Capital Finance Investments Updates*. The revisions incorporate seven of industry requested modifications to the Working Capital Finance Investments program requirements and are effective on June 30, 2020. Key revisions, which are reflected as tracked changes in the attached, are summarized as follows:

1. **Functionally Equivalent Foreign Regulators** - Removed the requirement that the Securities Valuation Office (SVO) determine if the International Finance Agent is the functional equivalent of the U.S. regulator.
2. **Commingling Prohibitions** - Removed the finance agent prohibitions on commingling.
3. **Investor Rights Edit** - Removed duplicative text regarding exercising of investor rights.
4. **Requirements for filer to Certify Perfected Interest** – Removed requirements, with revisions allowing the SVO to determine if a first priority perfected interest has been obtained.
5. **Finance Agent Validation Requirements** – Broadened the independent review requirements to allow independent review of the finance agent by either audit or through an internal control report.
6. **Default Date** - Changed the default provisions from 15 to 30 days so the default date and the cure period are consistent.
7. **Possible Domestic Regulator Approval** – Removed the statement that the reporting entity may need to seek approval from the domestic regulator.

With the action taken, the Working Group also directed notification to the Valuation of Securities (E) Task Force for purposes of coordinating corresponding revisions to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). Please contact NAIC staff of the Statutory Accounting Principles (E) Working Group with any questions.

Cc: Charles A. Theriault, Julie Gann, Robin Marcotte, Jim Pinegar, Fatima Sediqzad and Jake Stultz

Attachment: SSAP No. 105R.

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Statement of Statutory Accounting Principles No. 105R

Working Capital Finance Investments

STATUS

| Type of Issue | Common Area |
|------------------------------|---|
| Issued | December 15, 2013; <u>Substantively revised May 20, 2020</u> |
| Effective Date | January 1, 2014; <u>Substantive revisions documented in Issue Paper No. 163 effective June 30, 2020</u> |
| Affects | No other pronouncements |
| Affected by | No other pronouncements |
| Interpreted by | INT 06-07 |
| Relevant Appendix A Guidance | None |

| | |
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SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for working capital finance investments held by reporting entities. This statement amends *SSAP No. 20—Nonadmitted Assets* (SSAP No. 20) to allow working capital finance investments as admitted assets to the extent they conform to the requirements of this statement.

SUMMARY CONCLUSION

2. Working capital finance investments represent a confirmed short-term obligation¹ to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program currently designated by the NAIC Securities Valuation Office. Pursuant to the working capital finance investment program, this short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third party investor.

3. Working capital finance investments held by a reporting entity represent a right of the reporting entity to receive future payment. This Statement provides accounting and reporting guidelines for the right to receive payment under working capital finance programs that meet particular criteria.

Working Capital Finance Program - Definitions and Conditions

4. A “working capital finance program” is an open account program under which an investor may purchase interests, or evidence thereof, in commercial non-insurance receivables. A working capital finance program is created for the benefit of a commercial investment-grade obligor and its suppliers of goods or services, and facilitated by a finance agent.

5. A working capital finance program transfers a right to payment to an investor from a short term obligation and arises from transactions among:

- a. a buyer of goods or services that becomes an obligor to the supplier of goods or services,
- b. the supplier(s) of those goods or services,
- c. a finance agent, and
- d. an investor.

6. A “working capital finance investment” is an interest in payment(s) from a confirmed supplier receivable issued pursuant to a working capital finance program. The payment (maturity) date must not exceed one year from the date of invoice from the supplier to the obligor. This investment is created when the investor purchases from a working capital finance program that is currently designated as NAIC “1” or “2” by the NAIC Securities Valuation Office, any of the following:

- a. One or more confirmed supplier receivables;
- b. in case of a participation, a participation interest in one or more confirmed supplier receivables issued by the finance agent or lead lender holding confirmed supplier receivables; or
- c. a certificate, note or other interest manifestation, documented in a way that is verifiable ~~by regulators~~, representing a legally enforceable interest in a right to ~~payment~~ payment either directly to the investor or from a trust, other special purpose entity or pool holding confirmed supplier receivables.

7. “Obligor” is the party that purchases the goods or services that generates the original supplier receivable ~~(and which is the payable for~~ that the Obligor). The obligor must ~~be a single entity, which has~~ have an NAIC designation of “1” or “2” or a Credit Rating Provider equivalent. The obligor must confirm the supplier receivable described in paragraph 11 as described in the confirmation process in paragraphs 12-~~13~~ 14.

¹ All references to short-term obligations in this statement to refer to obligations not exceeding one year.

Working Capital Finance Investments

8. “Supplier” is the party that sells the goods or services to the obligor. The supplier sells the confirmed supplier receivable in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office at a price agreed to by the finance agent and/or investor.

9. “Investor” is the party purchasing a working capital finance investment in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office.

10. The “finance agent” is a bank, financial institution, other financial intermediary, or service provider that facilitates the working capital finance program, arranges the sale, assignment or transfer of the confirmed supplier receivable to the investor for a fee and administers the payment mechanism. In the case of participation, the finance agent must inform the reporting entity investor of a default or event of default as soon as it becomes aware of such default or event of default. For the working capital finance program to qualify under this SSAP, the finance agent must meet the requirements of either paragraph 10.a. or 10.b.:

- a. The finance agent is directly regulated by, or falls under the supervision of, a financial regulator of its domiciliary country provided that such country appears on the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* List of Jurisdictions Eligible for Netting ~~and that the Securities Valuation Office determines that the regulator is the functional equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation;~~ or
- b. Payments from the obligor must ~~1) be paid directly to the reporting entity (investor) or into an account maintained by a regulated financial institution for the benefit of investors in the working capital finance program and, in either case, cannot flow through the finance agent cannot be the beneficiary of such payment and 2) there can be no commingling of payments or assets with those of the obligor, supplier, servicer or trust administrator or other investors.~~ 1) be paid directly to the reporting entity (investor) or into an account maintained by a regulated financial institution for the benefit of investors in the working capital finance program and, in either case, cannot flow through the finance agent cannot be the beneficiary of such payment and 2) there can be no commingling of payments or assets with those of the obligor, supplier, servicer or trust administrator or other investors.

11. A “confirmed supplier receivable” is a first priority perfected security interest or right to payment of a monetary obligation from the obligor arising from the sale of goods or services from the supplier to the obligor the payment of which has been confirmed by the obligor committing and stating that the obligations under the agreement and any payment shall not be affected by the invalidity, unenforceability, existence, performance or non-performance of the underlying commercial trade transaction or any related contract or undertaking nor that it will not protest, delay, or deny, nor offer nor assert any defenses, personal or otherwise, against payment to the supplier or any party taking claims, interests, or rights to payments made by the supplier.

- a. The confirmed supplier receivable must be sold, assigned or otherwise transferred in a manner that results in an absolute, irrevocable and legally enforceable obligation that has been confirmed by the Obligor.
- b. In the case of a participation, the certificates or other evidence of participation provide an absolute, irrevocable, and legally enforceable obligation of the finance agent or holder of the confirmed supplier receivable to pay to the reporting entity investor all of the amounts due to it under the confirmed supplier receivable, without reduction or delay arising from any claims that the finance agent may have against the reporting entity investor. ~~The reporting entity investor’s ability to exercise its rights as creditor, or to direct the finance agent to exercise the rights of a creditor on its behalf, shall not be subject to the discretion of the finance agent or other lenders or investors.~~ The reporting entity investor’s ability to exercise its rights as creditor, or to direct the finance agent to exercise the rights of a creditor on its behalf, shall not be subject to, other than during a cure period not to exceed thirty days, the discretion of the finance agent or other lenders or investors.

Confirmation Process

12. In the case of a purchase, the investor shall verify, prior to the sale that the obligor has confirmed the respective amounts, payment dates and related invoice numbers’ specified dates and has waived all defenses to

payment. In the case of a participation, the finance agent must verify that the obligor has confirmed the respective amounts, payment dates and related invoice reference numbers' specified due dates, and has waived all defenses to payment in accordance with the confirmation process.

13. The obligor must commit and state that upon confirmation of a supplier receivable it is obligated to pay to the investor, the finance agent, or any third party acting as agent or trustee for the investor, a sum equal to the full amount of that confirmed supplier receivable(s) on a date certain stated in the confirmation and that it waives any right of setoff or other defenses to avoid or delay the full and timely payment of that Confirmed Supplier Receivable. The documents establishing the working capital finance program or the confirmation must state and confirm that the obligation to pay must be independent of any other contracts or claims that might be raised in defense arising from any transaction financed in connection with the WCFPWCFI program, the confirmed supplier receivable, or any other courses of performance or courses of dealing with the supplier.

~~14. — In the case of participation, the investor must certify that it has a commercially reasonable belief that its participation interest meets the Uniform Commercial Code's standards for creating and preserving first priority security interests in the payments due and in the confirmed supplier receivables. Commercially reasonable belief shall mean the SVO deems the investor's belief reasonable in light of the systems, policies, or practices commonly recognized in the field of investing in participations. The investor must be able to demonstrate to a regulator or to the SVO, upon either's request, the basis for its commercially reasonable belief that the WCFP creates and preserves the investor's ability to enforce a first priority perfected security interest in the confirmed supplier receivables.~~

~~15. — In the case of a certificate, note, or other manifestation, capable of verification, representing a right to payment from a trust, other special purpose entity, or special purpose pool holding confirmed supplier receivables, the investor must certify that it has a commercially reasonable belief that the documents establishing and governing the working capital finance program create and preserve interests in the confirmed supplier receivables capable of being enforced by the trustee or other entity holding confirmed supplier receivables as first priority perfected security interests under the Uniform Commercial Code. The investor must be able to demonstrate the basis for such belief to a regulator or to the SVO upon either's request. Commercially reasonable belief shall mean the SVO deems the investor's belief reasonable in light of the systems, policies, and practices commonly recognized in the field of investing in securitizations, loan backed, structured, or trust issued securities.~~

Program Requirements

~~16.14.~~ The working capital finance program investor must provide in its annual filing with the Securities Valuation Office ~~an annual audit of the consolidated financial statements of which the finance agent is part, which does not report any qualifications related to servicing, and~~ one of the following:

- a. An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment; or
- b. An annual audit of the financial statements and internal controls of the consolidated group of which the finance agent is part, which does not note any material weaknesses related to servicing working capital financial investments.

The NAIC Securities Valuation Office would review the materiality of the report findings in making their determination of the assignment of a designation.

~~17.15.~~ If the credit rating of the working capital finance program or obligor falls to non-investment grade (below the equivalent of NAIC designation "1" or "2"), the reporting entity shall nonadmit, the working capital finance investments obtained under the related working capital finance program and/or the related obligor. Due to the short-term nature of these investments, once an investment is nonadmitted due to the credit rating of the working capital finance program or the obligor, those investments will continue to be nonadmitted.

Working Capital Finance Investments

~~18.16.~~ Reporting entity investors must have the ability to monitor the working capital finance program and the credit-related activities of the obligor. Reporting entity investors must provide information as requested to the state of domicile indicating that they have the ability to monitor on an ongoing basis the activities of the working capital finance program. ~~Initial permission to invest in Working Capital Finance Investment Programs may be required by the domiciliary commissioner.~~

~~19.17.~~ All contracts or agreements that are a part of or that together constitute a working capital finance program must provide that if a dispute arises among any of the parties under any of the contracts or agreements that are a part of or that together constitute the working capital finance program, each party agrees that the dispute will be submitted to a court of competent jurisdiction in the United States or a constituent state thereof or of an alternative dispute resolution process recognized thereby. All contracts or agreements that are a part of or that together constitute a working capital finance program must provide that any dispute arising under any of the contracts or agreements that are a part of or that together constitute the working capital finance program must be resolved pursuant to the laws of the United States or a constituent state thereof that address the substance of the dispute but excluding those laws addressing conflicts of law.

Exclusions

~~20.18.~~ A working capital finance investment excludes any receivables financed through:

- a. Factoring: the purchase of receivables in bulk from a supplier where the receivables represent the payment obligations of potentially thousands of buyers to a single supplier, in which the buyers have no relationship with or contractual obligation to pay the factor and retain all legal defenses to payment they may have against the supplier;
- b. Forfaiting: the purchase of one or a series of receivables from exporters by a forfaiter to enable the exporter (seller) to finance a commercial transaction with a buyer in which the Obligor has no relationship with or contractual obligation to pay the forfaiter and retains all legal defenses to pay it may have against the seller; or
- c. Invoice discounting: the advancement of funds by a finance company to a business entity with the funds advanced limited to a defined percentage of the business entity's eligible and outstanding receivables.

~~21.19.~~ Eligible Confirmed Supplier Receivables must not:

- a. Include insurance or insurance related assets;
- b. Be impaired or in default at the time of purchase;
- c. Have a payment (maturity) date longer than one year from the date of the invoice from the Supplier to the Obligor giving rise to the confirmed supplier receivable, and the maturity date must not be subject to change or rolling; nor
- d. Include any receivable of any parent or affiliate of the reporting entity investor, and neither the Obligor nor any Supplier may be affiliated with the reporting entity investor. Working Capital Finance Investments that have obligors or vendors that are affiliated with the investor are ineligible, and therefore, nonadmitted assets.

Accounting and Reporting

~~22.20.~~ The right to receive payment generated by a working capital finance investment issued under a working capital finance program is considered to meet the definition of an asset as defined in *SSAP No. 4—Assets and Nonadmitted Assets*, and is an admitted asset to the extent the investment conforms to the requirements set forth in this Statement and the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. For programs that

comply with all of these elements, working capital finance investments shall be valued and reported in accordance with this Statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and the designation assigned in the NAIC Valuations of Securities product. Programs that do not comply with the elements set forth in this Statement, or the provisions set forth in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* are nonadmitted. Working capital finance investments are reported as other invested assets in the financial statements.

23.21. A working capital finance investment shall be recorded on the trade date. At acquisition, the Working Capital Finance Investment shall be initially reported at cost, excluding brokerage and other related fees, and all other costs (internal costs, or costs paid for origination, purchase or commitment to purchase such investments), which shall be expensed as incurred.

24.22. After initial acquisition, the Working Capital Finance Investment shall be reported at amortized cost until the specified maturity date, unless the investment, or a portion thereof, is deemed uncollectible or when an other-than-temporary impairment has occurred. In the event that a working capital finance investment is purchased by a reporting entity investor at a premium (amount to be received by the entity under the confirmed supplier receivable is less than the price paid for the investment), the excess paid by the reporting entity investor in comparison to the amount receivable under the confirmed supplier receivable must be immediately expensed.

25.23. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses from working capital finance investments shall be in accordance with SSAP No. 7—*Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an IMR, realized gains and losses from working capital finance investments shall be reported as net realized capital gains or losses in the statement of income. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

26.24. A Working Capital Finance Investment may provide for a prepayment penalty or acceleration fee in the event the working capital finance investment is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

27.25. SSAP No. 34—*Investment Income Due and Accrued* shall be followed for determining and recording investment income earned on working capital finance investments acquired at a discount. In accordance with SSAP No. 34—*Investment Income Due and Accrued*, investment income shall be reduced for amounts that have been determined to be uncollectible, however amounts more than 15 days overdue are nonadmitted.

Default

28.26. A working capital finance investment payment that is uncollected by the reporting entity within ~~fifteen~~ thirty days after the due date shall be considered in default and nonadmitted. If the reporting entity has any other working capital finance investment assets from the same defaulting counterparty, all other working capital finance investments from that counterparty shall be nonadmitted. All working capital finance investments from a counterparty identified in default shall be evaluated for impairment.

Impairment

29.27. An other-than-temporary impairment^(INT 06-07) shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a confirmed supplier receivable including the payment on the established due date. Pursuant to this guidance, assessment of other-than-temporary impairment shall include an evaluation of the financial condition and short-term prospects of the obligor. If it is determined that a decline in the fair value of a working capital finance investment below book/adjusted carrying value is due to an other-than-temporary impairment, an impairment loss shall be recognized as a realized loss equal to the entire difference between the working capital finance investment's carrying value and fair value as of the reporting period for which the assessment is made. Fair value shall be determined in accordance with SSAP

Working Capital Finance Investments

Ref #2019-25

No. 100R—Fair Value (SSAP No. 100R), and reflect the price to sell the asset in an orderly market between market participants. As such, the fair value shall reflect the assumptions market participants will use in pricing the asset, including assumptions about risk.

~~30.28.~~ For reporting entities required to maintain an AVR/IMR, the entire amount of the realized loss from the other-than-temporary impairment shall be recorded through the AVR, in accordance with SSAP No. 7.

~~31.29.~~ Upon recognition of an other-than-temporary impairment, the fair value of the working capital finance investment on the measurement date shall become the new cost basis of the working capital finance investment and the new cost basis shall not be adjusted for subsequent recoveries in fair value. Once an investment is determined to be other-than-temporarily impaired, until all expected payments are received, the reporting entity must re-evaluate the investment quarterly and reassess fair value, with recognized realized losses for the difference between the book/adjusted carrying value and the current fair value. This process shall continue until either all expected payments are received, or the entity has recognized a realized loss for the entire uncollected carrying value.

Disclosures

~~32.30.~~ The financial statements shall include the following disclosures:

- a. Fair value in accordance with SSAP No. 100R.
- b. Concentrations of credit risk in accordance with SSAP No. 27—*Off-Balance-Sheet and Credit Risk Disclosures* (SSAP No. 27) in the annual audited statutory financial reports only.
- c. Information regarding the aggregate book/adjusted carrying value of working capital finance investment by designation including gross assets with nonadmitted and net admitted amounts annually. (Note that programs designated 3-6 are nonadmitted.)

| | Gross Asset CY | Non-Admitted Asset CY | Net Admitted Asset CY |
|--------------------|----------------|-----------------------|-----------------------|
| WCFI Designation 1 | | | |
| WCFI Designation 2 | | | |
| WCFI Designation 3 | | | |
| WCFI Designation 4 | | | |
| WCFI Designation 5 | | | |
| WCFI Designation 6 | | | |
| Total | | | |

- d. Annual and quarterly information regarding the aggregate book/adjusted carrying value maturity distribution on the underlying working capital finance investments by the categories of maturities up to 180 days and 181 to 365 days.
- e. Any events of default of working capital finance investments during the reporting period.

~~33.31.~~ Refer to the Preamble for further discussion regarding disclosure requirements.

Effective Date and Transition

~~34.32.~~ This statement is effective for years on or after January 1, 2014. Substantive revisions documented in *Issue Paper No. 163—Working Capital Finance Investments Updates* are effective for financial reporting periods on or after June 30, 2020. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 147—Working Capital Finance Investments*
- *Issue Paper No. 163— Working Capital Finance Investments Updates*

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MEMORANDUM

TO: Dale Bruggeman, Chair Statutory Accounting Principles (E) Working Group

FROM: Kevin Fry, Chair Valuation of Securities (E) Task Force

Cc: Charles Therriault, NAIC, Director Securities Valuation Office
Bob Carcano, NAIC Consultant
Julie Gann, Senior Manager, NAIC Financial Regulatory Division

DATE: March 7, 2019

RE: Referral –Proposed Adjustments to SSAP No. 105 - Working Capital Finance Investments

1. Project Summary – In 2018, industry representatives requested that the Valuation of Securities (E) Task Force (VOS TF) consider whether Working Capital Finance Investments (WCFI) could be facilitated if SVO were given analytical discretion to interpret its guidance on two recurring issues. Industry also requested that the VOS TF consider a referral to the Statutory Accounting Principles (E) Working Group (Working Group) on two other requirements. At our direction, the SVO assessed industry's request and presented its response on an Oct. 11th conference call. After that call the SVO was directed to refer its memorandum and related comment letters to the Working Group and to work with industry to produce a mark-up of SSAP No. 105 that would show industry requested changes. SVO held discussions with industry and FRS in December informed and used those discussions as the basis for a report to the VOS TF on a conference call held March 4, 2019. Industry prepared additional material for that call, asked that it be exposed for comment so that the VOS TF could refer the material to the Working Group when it met in April at the Spring National Meeting. The SVO was the directed to prepare this referral for consideration by the VOS TF at the Spring National Meeting.

2. Summary of Staff Position – The SVO notes that the WCFI text in the Purposes and Procedures Manual was drafted to track and align with the text of SSAP 105. The SSAP provides a fixed approach to a number of legal or structural issues that are routinely handled differently in transactions. Because these are expressed as requirements they cannot be administered by the SVO as part of its analytical process; neither can the SVO exercise analytical discretion to permit otherwise appropriate investments. The SVO supports the requests for changes advanced by industry¹ as impediments to investment that do not advance regulatory objectives; as further amplified below.

¹ As expressed by PacLife in the discussions with the SVO held September. Through November 2018 - **Source:** PacLife – Overview of Requested Changes to SSAP No. 105 dated November 19, 2018

Standardization revisions – removal of provisions inconsistent with other asset classes

Essential revisions – business requirements

1. Unrated subsidiaries - Codifying authorized unrated subsidiary relationships for look through to rated parent company – SSAP No. 105 – Paragraph 7
2. Finance agents - Codifying authorized finance agent roles – SSAP No. 105 – Paragraph 10
3. Statutory accounting - Moving investments to Schedule DA – SSAP No. 105 – Paragraph 22

Finance agent validation requirements

1. Removing documentation review related to finance agents – SSAP No. 105 – Paragraph 16
2. Certification requirements - Removing requirement for insurer to seek prior approval from their domestic regulator – SSAP No. 105 – Paragraph 18
3. Removing requirement for legal officer to certify compliance of each submission – SSAP No. 105 – Paragraphs 14 and 15
3. Private placement rating requirements - Removing limitation to NAIC 1 and 2 obligors – SSAP No. 105 – Paragraph 7

As expressed by the ACLI in its letter dated Feb. 27, 2019

- Treatment of Unrated Subsidiaries
- Treatment of Finance Agents
- Reporting Schedule move from BA to DA

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- 1) The SVO believes whether WCFI are reported on Schedule BA or on Schedule D is predominantly a reporting issue.
 - 2) The requirement of state pre-approval to invest in WCFI runs counter to the NAIC paradigm. The Accounting Practices and Procedures Manual, of which SSAP No. 105 is a part, is an NAIC standard incorporated into state law by the Accreditation Program. If the motivation for the requirement is to exclude small companies, the SVO notes that a practical matter small insurers are not suitable partners to the large banks engaged in WCFI.
 - 3) The SVO agrees that the elimination of the finance agent validation requirement, the removal of the legal officer certification and other similar changes will facilitate transactions without detriment to regulation.
 - 4) However, there are a few issues that require a more nuanced response.
 - a) The SVO has reported that the request that unrated subsidiaries be permitted to perform the function of Obligor in WCFIs runs counter to accepted corporate practice. Acceptance of that request by the Working Group would require a policy determination based on information yet to be provided by industry that the unique nature of working capital arrangements provides would ensure that the rated entity would always respond for the debt of its unrated subsidiaries, thereby overcoming the concerns reflected in corporate practice.
 - b) Industry also requests that WCFI be expanded to encompass NAIC 3 and 4 credit quality programs. The SVO is not opposed to the concept per-se but notes that the many restrictions in the SSAP has also not permitted the staff to acquire the experience necessary to permit the SVO to assess the impact of that change to regulation.
- 3) Referral** – The Task Force refers to the Working Group a marked up copy of SSAP No. 105 with materials produced by industry to identify and explain the concerns that lead to the request for the requested adjustments and materials produced by the SVO at our direction expressing opinions on the issues raised. The Task Force recommends that the Working group consider making the amendments. Among the material included are industry recommendations for modifications to the Purposes and Procedures Manual. These may provide insight with respect to the alignment of these two sources of NAIC guidance. The Task Force will consider what changes should be made to the P&P Manual once the Working Group has provided a response to this referral. Please communicate with Charles Therriault on any questions.

-
- Other Administrative WCFI Requirements
 - The requirement of documentation review related to finance agents.
 - Statement on Standards for Attestation Engagements (“SSAE”) SSAE No. 16 r an audit of the internal controls of the consolidated group of which the finance agent is part, which does not note any material weaknesses related to servicing.
 - A requirement that insurers obtain prior approval from their domestic regulator to invest in WCFI.
 - A limitation of approved investments solely to NAIC 1 and 2 investments.
 - Deletion of Legal Certifications.



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

From: Charles Therriault, NAIC, Director, Securities Valuation Office

Re: Staff Report and Referral Recommendation to the Statutory Accounting Principles (E) Working Group on WCFI

Date: February 14, 2019

1. Introduction – In 2018, the Task Force requested that the SVO assess four issues pertaining to the assessment of working capital finance investments (WCFI). The SVO report was presented and discussed on October 11. (A copy of that report is included in your document package.) The SVO reported that three of the four issues evaluated would require resolution by the Statutory Accounting Principles (E) Working Group because the issues involved SSAP No. 105 and that the fourth (involving unrated subsidiaries) would require a policy determination by the Working Group and the Task Force. The documents discussed on the October call were referred to the Working Group and the Working Group was advised that industry would provide a mark-up of SSAP No. 105 to identify the changes they seek. Industry indicated it would provide material on the issue and NAIC staff was instructed to work with industry to review that material and report to the Task Force after that material had been evaluated.

2. Report and Recommendation – SVO held discussions with ACLI representatives and with FRS staff in November and December of 2018 to discuss information provided by the ACLI. FRS staff considered that the expectations of the Working Group would be better served if the SVO moved a referral that focused on a mark-up of SSAP No. 105. You will find in your document package a document produced by PacLife which fulfills this request. The SVO supports the changes requested in the mark-up subject to two observations. The mark-up suggests that the WCFI program should be expanded to encompass NAIC 3 and 4 Obligor. SVO would want to consider information on the market before providing the Task Force an opinion on that request. The SVO can pursue discussions with the ACLI on that point. The second observation involves attribution of the credit quality of a rated parent to an unrated subsidiary. SVO reported that the concept has no support in law or corporate practice but that the nature of working capital arrangements might provide a very different economic environment that could justify the Task Force adopting that practice as policy. The SVO observes that the text in the SSAP mark-up on this issue provides some important protections that mitigate some of the concerns we would have. We therefore recommend that the material in the document package be referred to the Working Group with a request that they consider the proposed modifications to SSAP No. 105.

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Mike Monahan
Senior Director, Accounting

February 27, 2019

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

Mr. Stewart Guerin, Vice Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64016-2197

Re: Comprehensive Proposal on Working Capital Finance Investments ("WCFI") ("the Proposal")

Dear Messrs. Fry and Guerin:

ACLI¹ appreciates the opportunity to provide the Proposal in response to the ongoing efforts of the NAIC Securities Valuation Office ("SVO") to conduct a review of WCFI through its support of the Valuation of Securities Task Force ("the Task Force") and via Task Force referrals to other groups, including the Statutory Accounting Principles Working Group ("SAPWG").

The Proposal, which represents months of constructive partnership dialogue amongst our member companies, the SVO and NAIC Staff, is an effort to provide all suggested WCFI enhancements in one comprehensive Proposal that recommends changes to: 1) the treatment of unrated subsidiaries; 2) the treatment of finance agents; 3) Schedule DA reporting; and 4) other administrative requirements.

We understand that this topic will be discussed on the Task Force's next conference call scheduled on March 4, 2019 and we wanted to provide the Proposal for consideration at that meeting.

Background

In the four years since the adoption of *Statement of Statutory Accounting Principles ("SSAP") No. 105 – Working Capital Finance Investments ("SSAP 105")*, out of the hundreds of working capital finance programs that banks and other investors participate in, Pacific Life, a major investor in these programs, has submitted three new programs to the SVO for approval, as these three programs were the only ones that Pacific Life believed to be compliant with every one of the requirements of SSAP 105. Of those three programs, one was rejected (General Mills with Orbion as Finance Agent) and two received conditional approval (Pepsi with Citibank as Finance Agent and P&G with JPMorgan as Finance Agent). The strict confines and complexity of the SSAP has limited the number of programs that qualify as investable. And other insurers, despite a desire to invest in this asset class, have concluded that the programs that have

¹ The American Council of Life Insurers (ACLI) advocates on behalf of 280 member companies dedicated to providing products and services that promote consumers' financial and retirement security. 90 million American families depend on our members for life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, dental and vision and other supplemental benefits. ACLI represents member companies in state, federal and international forums for public policy that supports the industry marketplace and the families that rely on life insurers' products for peace of mind. ACLI members represent 95 percent of industry assets in the United States. Learn more at www.acli.com.

been presented to them for investment do not meet all of the extensive requirements set forth in SSAP 105, thus creating a complete bar to entry for new insurance company investors. Further, the NAIC fee structure for the asset class limits the commercial suitability ONLY to large companies as the private placement fee required is such that only a company with plans to significantly implement the asset class in their portfolio would do so. As outlined in Robert Carcano's August 2018 memorandums to the Task Force and as discussed during the Task Force meeting on October 11, 2018, the NAIC went through an arduous multi-year process to adopt SSAP 105 and implemented more requirements and restrictions than any other admitted asset. Without significant changes that work will be for naught.

In a macroeconomic environment where short-term interest rates have steadily increased and outpaced the negligible growth in long-term interest rates, WCFI provides insurers with exposure to short-term higher yielding floating rate investments as well as an attractive alternative to fixed-rate investments whose interest rates are not keeping pace with increases in short-term rates and a stagnant private placement market. The size of the WCFI market is immense (approaching \$100 billion in outstanding issuance) and Pacific Life has experienced zero defaults (and currently has over \$400 million in outstanding investments while having owned over \$4 billion in paid WCFI since 2014). Pacific Life has provided further information in the Appendix on the asset class and its experience with it.

Accompanying this memorandum are the changes ACLI believes are necessary to SSAP 105 to facilitate increased industry participation in this asset class and the discussion below explains the rationale behind the changes. The four key categories of issues needing to be addressed are as follows:

- Treatment of Unrated Subsidiaries
- Treatment of Finance Agents
- Schedule DA Reporting
- Other Administrative Requirements

Treatment of Unrated Subsidiaries

Under SSAP 105, the obligor must be a single entity that has an NAIC designation of "1" or "2" or a Credit Rating Provider equivalent. The issue is how to determine the rating of the obligor where unrated subsidiaries of the rated entity are involved as transaction participants (including as the obligor). For the reasons discussed below, the rated entity's rating should be attributed to the obligor regardless of whether the rated entity serves in that capacity or an unrated subsidiary serves as a transaction participant so long as the factors discussed below are met and warrant a finding that the rating of the rated entity should be attributed to the obligor.

With respect to unrated subsidiaries as transaction participants, programs fit into three distinct categories:

- Programs that use the rated parent AND unrated subsidiaries as obligors
 - In these programs, the risk that a rated parent would permit its unrated subsidiary to default, while continuing to perform its obligations, is extremely remote, particularly if the rated entity contractually acknowledges that it has operational control over the performance of each entity's obligations and/or the rated entity's treasury department disburses funds on behalf of both entities. It is not practical for insurers to require finance agents to segregate out WCFI related only to the rated parent because this creates an administrative burden for finance agents. Finance agents will generally not make such an accommodation since insurers make up such a small segment of their investor base and other investors are not concerned with the distinction. Pacific Life advises that in the cases of the conditionally programs approved by the SVO, both the Pepsi and P&G programs received approval only for the rated entity portion of these programs which has created limitations in dealing with both finance agents operationally and commercially. We propose that the rating of the rated entity should nonetheless be attributed to the obligor so long as the rated entity is an obligor with respect to a portion of the working capital

- finance investments in the working capital finance program and either (i) the rated entity has documented operational control over the performance of the unrated subsidiaries or affiliates that also serve as obligors in the program or (ii) there is documentary evidence in the program documents or appended thereto that sufficiently demonstrates the importance of the inter-relationship between the rated entity and the unrated subsidiaries or affiliates.
- Programs that involve a rated entity as obligor and unrated subsidiaries or affiliates that are deemed to be key transaction participants
 - The SVO should be permitted to evaluate the ability of unrated entities to perform the functions expected of them, and may use analytical discretion to permit consideration of off-setting factors that provide for comfort that the unrated entities could reliably perform the role(s) expected of them. So long as the rated entity is an obligor with respect to the working capital finance investments in the program and the insurer and the SVO are comfortable that the unrated subsidiaries or affiliates that serve as key transaction participants can reasonably perform the functions expected of them, the rating of the rated entity should be attributed to the obligor.
 - Programs where an unrated subsidiary is the obligor and the rated entity is not party to the transaction documents
 - In these programs, ACLI contends that there are circumstances where the rating of the parent company should nonetheless be attributed to the unrated subsidiary provided legal, operational and strategic ties, program characteristics and/or other tangible and intangible factors warrant a finding that the rating of the parent should be attributed to the obligor. Such a determination reflects the view that a rated parent is unlikely to permit its unrated subsidiary obligor to default on its WCFI program obligations because the default would cause the consolidated company's supply chain finance program to collapse and may cause suppliers to refuse to continue to supply the parent or its affiliates. However, ACLI is not requesting that these programs be admitted for investment at this time. ACLI would like to work with the SVO to develop criteria for evaluating these programs in the future after the SVO has had an opportunity to evaluate more transactions based on the current proposed changes to SSAP 105.

Treatment of Finance Agents

Under SSAP 105, a program must have a finance agent that is either a regulated financial institution or a "financial intermediary or service provider". The definition of what constitutes a regulated financial institution requires the SVO to determine that the finance agent is regulated by a regulator that is the "functional equivalent" of the Board of Governors of the Federal Reserve System, the OCC or the FDIC. It is not clear how the SVO is supposed to conclusively make this determination. For example, if BNP Paribas is the finance agent with respect to a program, it is possible that the SVO would not approve such a program because the SVO cannot conclude that BNP Paribas is regulated by an authority that is the "functional equivalent" of the Board of Governors of the Federal Reserve System, the OCC or the FDIC.

With respect to financial intermediaries and service providers, SSAP 105 requires that payments to investors be paid "directly to the reporting entity (investor)" and there "be no commingling of payments or assets with those of the obligor, supplier, servicer or trust administrator or other investors." This language arguably prohibits insurers from investing in any programs that use a service provider since all service provider programs deposit investor funds into one collection account (it is not practicable, nor should it be necessary to set up an individual account for each investor). In these programs, the service provider's platform is used to electronically and automatically debit the obligor's account and transfer the funds to a collection account that exists for the benefit of all program investors. Once in the collection account, funds are disbursed to investors. These collection accounts are "zero balance" accounts that are held with regulated financial institutions (which must currently be rated NAIC "1" or "2" pursuant to the SSAP).

Because funds are held in these “zero balance” accounts for such a short time and these accounts are separate from the regulated financial institution’s assets, commingling risk is not a significant risk. Even if the funds somehow are caught up in a bankruptcy proceeding, investors have a first priority perfected security interest in the accounts in which the funds are held and Uniform Commercial Code Section 9-315 makes clear the secured interest in commingled property survives bankruptcy and courts have the authority and a procedure to identify and segregate property of a secured party. On a more simplistic level, there is no difference between this arrangement and a bond offering that uses a fiscal agent or trustee, where payments from the obligor on a corporate bond are sent to an investor collection account maintained by the fiscal agent or trustee, and are shortly thereafter disbursed to the investors.

Programs that Pacific Life currently invests in that qualify under SSAP 105 use service provider platforms in their programs. For example, the Citibank program uses the Orbian platform. While insurers can invest in the program if Citibank serves as finance agent (collecting a fee for its services), insurers cannot invest in the exact same program if Citibank is not involved in the process. It does not make sense to reduce the insurer’s return by requiring the insurer to pay Citibank a fee to provide an unnecessary agency service. By investing directly in programs that use a service provider platform, insurers receive the same protections that the banks that use these platforms receive and earn a better return by not having to pay the banks’ agency fee. This was the basis of the SVO’s rejection for the General Mills program with Orbian as finance agent even though prior programs using the Orbian platform that had a bank as finance agent were approved.

Reporting Schedule move from BA to DA

Under SSAP 105, WCFI are reported as other invested assets in the financial statements (Schedule BA). Schedule BA embraces a heterogeneous group of investments which includes private equity and hedge funds, mineral rights, aircraft leases, surplus notes, secured and unsecured loans to corporations and individuals, and housing tax credits. Short-term investments are reported on Schedule DA including Treasury, Agency & GSE Bonds, Industrial Bonds, Structured Bonds and Mortgages. The characteristics of WCFI reflect the same characteristics of these investments and WCFI reporting should be moved to Schedule DA.

Other Administrative WCFI Requirements

Additional requirements in SSAP 105 are atypical of all other authorized investments including:

- The requirement of documentation review related to finance agents.
 - Insurers must provide annual audited financial statements of all finance agents, regardless of whether the finance agent is a regulated financial institution or a financial intermediary or service provider. This is a requirement that creates additional hurdles to compliance with SSAP 105 with no intrinsic benefit, as audited financial statements of financial intermediaries or service providers are of little value and do not reveal anything about the controls of the servicing organization.
 - Insurers must file annually either:
 - A Statement on Standards for Attestation Engagements (“SSAE”) SSAE No. 16 (“SSAE 16”) report for WCFI programs that have a financial intermediary or service provider as finance agent. Pacific Life has encountered programs that provide annual independent reports that are the functional equivalent of SSAE 16 reports, but since they are not specifically SSAE 16 reports, Pacific Life could not invest in the programs. The SVO is well-equipped to evaluate whether the report (whether it be a SSAE No. 16 report or a functional equivalent) is adequate, and how the form and contents of the report impact the program’s overall rating (if at all).
 - Or an audit of the internal controls of the consolidated group of which the finance agent is part, which does not note any material weaknesses related to servicing. A finance agent’s having a material weakness related to servicing should not

automatically disqualify a program; an automatic disqualification should only apply if the material weakness relates to servicing WCFI. A material weakness “related to servicing” may have nothing to do with WCFI programs, and may relate to completely different operations and servicing functions. Rather than an automatic disqualification for a material weakness related to servicing (that does not relate to servicing WCFI), the SVO should be able to exercise analytical discretion to evaluate such a material weakness and decide whether or not it should have an impact on the program’s overall rating.

- A requirement that insurers obtain prior approval from their domestic regulator to invest in WCFI.
 - A NAIC standard such as a SSAP is typically understood to eliminate the need for individual states to approve an activity and a state could opt out of the NAIC standards by amending its investment laws. Our recollection is that this requirement was included in SSAP 105 to reflect a desire to keep small companies from investing in this asset class. To address that concern, we note that the SVO is well equipped to determine whether an insurer has the requisite sophistication to invest in WCFI and that small insurers are nevertheless unlikely to be considered suitable partners by a large bank or pay the costs of setting up the necessary documentation and internal processes.
- A limitation of approved investments solely to NAIC 1 and 2 investments.
 - The requirements that define WCFI ensure that the risks of investing are essentially limited to the short-term credit risk of the obligor. Therefore, investments in WCFI programs with a NAIC rating below a 1 or 2 should be permitted and treated with the regulatory capital requirements reflecting the lower NAIC ratings. This is standard among all other authorized investments.
- Deletion of Legal Certifications.
 - We do not see the intrinsic value of the legal certifications set forth in SSAP 105. The definition of “confirmed supplier receivable” already requires a first priority perfected security interest in the right to payment, and the SVO is well-equipped to evaluate whether the security interests established by the documentation meet that standard. It is unnecessary provisions such as these that make SSAP 105 so complicated that it drives away potential insurance company investors. If the purpose behind these certifications is to require insurers to demonstrate that they have a full understanding of the investment, this can be done upon inquiry by the SVO rather than requiring these certifications that provide little value.

These atypical requirements should be eliminated from SSAP 105.

We have attached a mark-up of SSAP 105 to reflect the foregoing as well as a mark-up of the Purposes and Procedures Manual of the NAIC Investment Analysis Office (“P&P Manual”) for consideration and we look forward to discussing these materials with the Task Force and SAPWG.

Please do not hesitate to contact me if you have any questions or require anything further. Thank you.

Sincerely,



Senior Director, Accounting Policy
American Council of Life Insurers

cc: Mr. Charles Therriault, Director, SVO
Mr. Dale Bruggeman, Chair, SAPWG
Ms. Julie Gann, NAIC

Section 6. Working Capital Finance Investments

Part Three
Credit Assessment

SECTION 6. WORKING CAPITAL FINANCE INVESTMENTS

a) Definitions in SSAP No. 105—Working Capital Finance Investments

Please refer to SSAP No. 105—Working Capital Finance Investments, for the definitions and associated definitional guidance insurance companies must understand and comply with before applying for an NAIC Designation for Working Capital Finance Programs that would permit them to purchase Working Capital Finance Investments.

With the exception of the definitions for Dilution Risk and Operational Risk below, the definitions shown below are summaries of those contained in SSAP No. 105—Working Capital Finance Investments intended only to facilitate a discussion and in all cases subordinate to the definitions in SSAP No. 105.

b) Summary of Key Definitions

(i) Confirmed Supplier Receivable

A receivable sold by a Supplier to a Finance Agent or Investor (or by a Finance Agent to an Investor) under a Working Capital Finance Program designated by the SVO that requires the Obligor to confirm to the Finance Agent or Investor, prior to the sale of the receivable from the Supplier to the Finance Agent or Investor, that it has no defenses to payment of the monetary obligation represented by the receivable against the Supplier and, therefore, no defenses to payment of the same monetary obligation to the Finance Agent and/or Investor after such sale. The confirmation by the Obligor that it has no defenses to payment includes confirmation that the Obligor does not have a right to refuse payment that it may have acquired with respect to underlying commercial trade transaction and that, if it has such a right, it will not assert such defenses against the Finance Agent or Investor.

(ii) Dilution Risk

With respect to any Working Capital Finance Program, dilution risk refers to disputes or contractual provisions that may reduce the amount of the obligation owed by the Obligor to the Supplier under the original receivable or the obligation owed by the Obligor to the Finance Agent and/or Investor under the Confirmed Supplier Receivable. Examples of dilution risk are credit for returns of defective goods or an allegation of fraud, such as that the invoice is not legitimate or is a duplicate invoice.

(iii) Finance Agent

A bank, financial institution, financial intermediary or service provider that facilitates the Working Capital Finance Program that arranges the sale, assignment or transfer of the Confirmed Supplier Receivable to the Investor and administers payment.

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(iv) Investor

The insurance company that files the RTAS Application with the SVO in order to obtain an NAIC Designation for a proposed Working Capital Finance Program.

(v) Obligor

An entity that purchases the goods or services from the Supplier and thereby generates the original supplier receivable — and which Obligor has, or can be designated, **NAIC 1, NAIC 2, NAIC 3 or NAIC 24** by the SVO or has been assigned an equivalent credit rating by a NAIC CRP.

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(vi) Operational Risk

With respect to any Working Capital Finance Program, operational risk ~~refer~~ refers to the combined effect of the procedures and parties employed to implement the program and their responsibility under the documents and to the determination by the SVO of whether these procedures and parties will ensure full and timely performance by the Obligor of the payment obligation to the Investor. An example of an operational risk is the confirmation process employed to verify that the Obligor has no defenses to payment.

(vii) Supplier

The entity that sells the goods or services to the Obligor, obtains a receivable from the Obligor in exchange and subsequently chooses to sell the right to receive the payment associated with the receivable to the Finance Agent or Investor under the terms of a Working Capital Finance Program designated **NAIC 1, NAIC 2, NAIC 3 or NAIC 24** by the SVO.

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(viii) Working Capital Finance Program

The program created for the Obligor and its Suppliers by a Finance Agent the terms of which permits Suppliers to the Obligor to negotiate the sale of a right to receive payment from the Obligor (which is associated with and evidenced by a receivable) to the Finance Agent or an Investor.

(ix) Working Capital Finance Investment

The right to receive the payment associated with a Confirmed Supplier Receivable purchased by an Investor under a Working Capital Finance Program designated **NAIC 1, NAIC 2, NAIC 3 or NAIC 24** by the SVO and is the subject of *SSAP No. 105—Working Capital Finance Investments*.

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NOTE: *SSAP No. 105—Working Capital Finance Investments* imposes reporting and statutory accounting requirements on insurance company investments in Working Capital Finance Investments and specifies analytical procedures to be applied or analytical controls to be verified by the SVO that are not detailed above. Insurance companies are strongly

Section 6. Working Capital Finance Investments

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advised to become familiar with SSAP No. 105 before filing an RTAS Application with the SVO.

c) Direction and Program Parameters

(i) Direction

The SVO may assign an NAIC Designation to a Working Capital Finance Program that would generate Working Capital Finance ~~Investment~~Investments that meet the criterion and standards identified in this Section 6.

(ii) Program Parameters

(A) *RTAS Submission Required*

A request that the SVO assign an NAIC Designation to a Working Capital Finance Program is made by filing an RTAS Application. Please refer to Part Four, Section 3 of this Manual for relevant instructions about the RTAS – Emerging Investment Vehicle Service process. The RTAS Application is available at:

http://www.naic.org/documents/svo_rtas_app.pdf.

Upon completion of its risk assessment, the SVO will issue an RTAS Letter indicating a preliminary NAIC Designation; i.e., the NAIC Designation that would be assigned if the Investor enters into a Working Capital Finance Program with a Finance Agent and sought to report it to the SVO. Note: A preliminary NAIC Designation cannot be used for statutory reporting purposes. The SVO shall issue a final NAIC Designation to the Investor for the Working Capital Finance Program and the Working Capital Finance Investments generated thereunder upon receipt of fully executed final copies of the documentation required by Part Two, Section 10 (c) (i) (G) (2) of this Manual. Please refer to Part Two, Section 2 and Part Two, Section 6 of this Manual for instructions on how to file an ATF with the SVO.

(B) *Variations in Structure*

Working Capital Finance Programs may differ in structure and in the protection afforded the Investor. Structural strength and weaknesses of various structures in such programs will be reflected in the NAIC Designation assigned by the SVO.

(C) *Program Quality*

The SVO shall only assign an NAIC Designation to Working Capital Finance Programs that can be designated **NAIC 1, NAIC 2, NAIC 3 or NAIC 24**. Credit quality is measured by reference to a NAIC CRP credit rating or an NAIC Designation assigned by the SVO.

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Section 6. Working Capital Finance Investments

The SVO shall withdraw the NAIC Designation assigned to a Working Capital Finance Program on the date the Obligor's NAIC CRP credit rating or NAIC Designation is downgraded to **NAIC 3-5 or NAIC 6** or its NAIC CRP equivalent.

NOTE: *SSAP No. 105—Working Capital Finance Investments* provides that Working Capital Finance Investments generated under a Working Capital Finance Program of an Obligor that falls below the equivalent of **NAIC 1, NAIC 2, NAIC 3 or NAIC 24** becomes non-admitted.

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(D) *Process and Methodology*

An NAIC Designation shall be assigned to a Working Capital Finance Program on the basis of a thorough assessment of credit, dilution, operational and other risks, an assessment of protections provided by operative documents to the Investor and the quality of transaction participants.

d) **Risk-Assessment Process**

(i) Credit Risk

The NAIC Designation for a Working Capital Finance Program shall be linked to the credit quality of the Obligor, which may be determined by reference to a credit rating assigned by a NAIC 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 this Manual for corporate obligors. If an unrated subsidiary or affiliate of a rated entity is the Obligor with respect to any Working Capital Finance Investment in a Working Capital Finance Program, the rating of the rated entity shall be attributed to such unrated subsidiary or affiliate Obligor so long as the rated entity is also an Obligor with respect to a portion of the Working Capital Finance Investments in the Working Capital Finance Program and either (i) the rated entity has documented operational control over the performance of the unrated subsidiaries or affiliates that also serve as Obligors in the Working Capital Finance Program or (ii) there is documentary evidence in the Working Capital Finance Program documents or appended thereto that sufficiently demonstrates the importance of the inter-relationship between the rated entity and the unrated subsidiaries or affiliates. These credit risk assessments shall be performed by the SVO analyst in accordance with any permitted methodology set forth in this Manual for corporate obligors.~~

(ii) Dilution Risk

To achieve an **NAIC 1, NAIC 2, NAIC 3 or NAIC 24** Designation, the Working Capital Finance Program must eliminate dilution risk in the Working Capital Finance Investment proposed to be eligible for purchase by the Investor. The terms governing the Investor's Working Capital Finance Investment must eliminate Obligor recourse to its Supplier as a

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condition to payment of the obligation to the Investor so as to result in an unconditional right to receive payment on a full and timely basis.

(iii) Operational Risk

To achieve an **NAIC 1, NAIC 2, NAIC 3 or NAIC 24** Designation, all operational risks shall be identified and assessed. Key participants shall have a NAIC CRP credit rating or an NAIC Designation assigned by the SVO at a level at least that of the Obligor. Unrated subsidiaries or affiliates of a rated entity that serve as key participants in a Working Capital Finance Program shall be deemed to have a NAIC CRP credit rating or an NAIC Designation assigned by the SVO at a level equal to that of the rated entity Obligor so long as the SVO analyst determines that such unrated subsidiaries or affiliates can reasonably perform the functions expected by them.

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(iv) Legal, Structural and Regulatory Considerations

Events of default remedies should provide the Investor at least those rights and privileges, unimpaired, of a trade creditor upon default with no Obligor defenses that could cause dilution of principal.

Section 6. Working Capital Finance Investments

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The Finance Agent must be an entity regulated or supervised by a financial regulator in one of the countries in the List of Foreign (non-US) Jurisdictions Eligible for Netting for Purposes of Determining Exposures to Counterparties for Schedule DB, Part D, Section 1 in [Part Six, Section 3 \(d\) of this Manual](#) ~~and that the regulator is the functional equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC) or the Federal Deposit Insurance Corporation (FDIC).~~ In the alternative, the SVO shall verify that payments due the Investor are made ~~directly~~ by the Obligor ~~with no commingling of funds or assets with those of the Obligor, Supplier, Servicer or Trust Administrator or other Investors~~ directly to the Investor or into an account maintained by a regulated financial institution for the benefit of investors in the Working Capital Finance Program and, in either case, the Finance Agent cannot be the beneficiary of such payments.

The SVO will verify that the Certification from the insurance company's Chief Investment Office confirms that the Investor is not affiliated with Obligor and that Working Capital Finance Investment excludes insurance or insurance-related assets.

~~The SVO will verify that the Certification from the insurance company's Legal Counsel confirms the existence of a commercially reasonable belief that the documents establishing and governing the Working Capital Finance Program establishes the rights and UCC code standard for preserving first priority perfected interest in Confirmed Supplier Receivables as more fully discussed in [Part Two, Section 10 \(e\) \(i\) \(G\) \(2\) of this Manual](#).~~

The remedies available to the participants in the Working Capital Finance Program should be expressly identified in the documentation for the Working Capital Finance Investment.

Characteristics that shall be present in a proposed Working Capital Finance Investment include, but are not limited to, the following, or a substantial equivalent:

- The Obligor makes payments directly to (i) the Investor; (ii) Finance Agent; or (iii) ~~the servicer for an account maintained for the benefit of investors in~~ the Working Capital Finance Program.
- The Investor must have the option, and not an obligation, to purchase subsequent Working Capital Finance Investment so as to ensure the Investor can exit the Working Capital Finance Investment by permitting existing investments to mature.
- SSAP No. 105—Working Capital Finance Investments provides that the documentation governing Working Capital Finance Programs must provide that disputes arising under the agreements shall be submitted to a court of competent jurisdiction in the U.S. or be subject to an

alternative dispute resolution process sanctioned by state law. Given

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Section 6. Working Capital
Finance Investments

the nature of Working Capital Finance Programs, the SVO anticipates that documentation governing Working Capital Finance Investments will be subject to the laws and jurisdiction of the courts of California, Delaware or New York, or a similar legal jurisdiction with significant exposure to sophisticated institutional financial transactions.

- Events of default must be clearly defined, and provide a mechanism that gives the Investor the ability to pursue collection unfettered by actions taken or not taken by participants such as the Servicer or Trustee, or other named persons performing similar functions, other than during a cure period not to exceed thirty days.



Appendix

Key Challenges for Investors – Particularly Insurance Investors

The fixed income credit market since the global financial crisis has been a challenging environment particularly for investors with biases to invest in investment grade assets like insurance companies. The following key attributes have constrained the environment:

1. Insurers are one of the largest single investors in the over \$41 Trillion and growing bond market
2. Interest rates have been and are low
3. Short term interest rates have recently been increased
4. Long term rates have not increased
5. Long term rates are not keeping pace with inflation
6. Debt issuance has grown significantly at low effective yields with limited risk premium for purchasing additional risk
7. Debt issuance has been longer maturities post crisis
8. Rising rates not slowing fixed rate issuance with continuing fixed rate issuance at low rates and low risk premium
9. Limited floating rate issuance
10. US capital markets enable greater bond issuance contrasted to rest of world which is more dependent on loans from banks
11. Private placement market not growing

WCFI address a number of these key challenges.

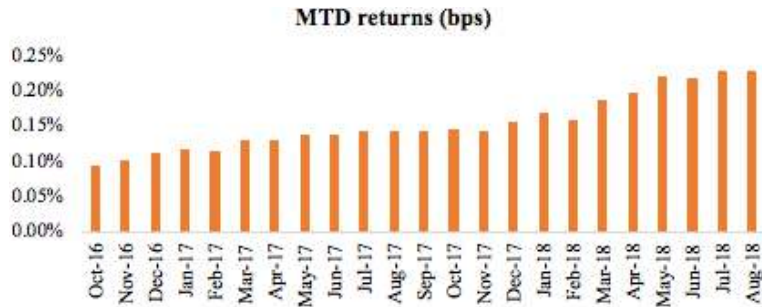
Pacific Life History with Investments

Pacific Life has been investing in what are now known as WCFI for over a decade. During that period Pacific Life has collectively invested in more than \$15 Billion U.S. dollars of these assets without any defaults. These bond-like investments are available for sale from banks and financial technology companies with very few non-banks as investors. As most institutional investors explicitly require an NRSRO rating, the universe of investors is small and like with private placements favors investors capable of performing the necessary underwriting and administration to access such products. Like bonds these investments have detailed protections for investors.

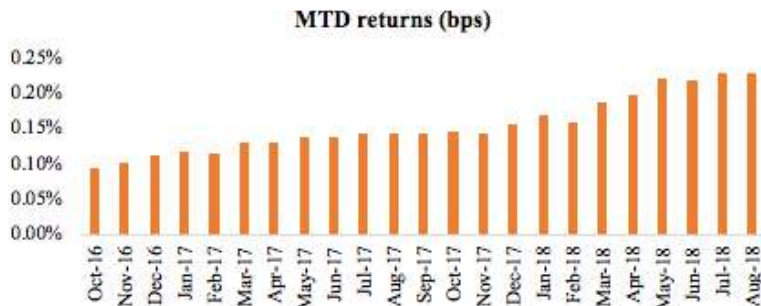
The investment purpose the asset fulfills is access to floating rate, short term assets that are not correlated with other more easily tradeable fixed rate corporate bonds. Further, for these non-financial correlated exposures the pricing basis is LIBOR (with an additional risk premium margin) and not Treasury like most fixed income. Overall these assets offer the following investment benefits:

- ☐ Higher relative yields as a result of the LIBOR basis (as evidenced by the TED Spread (the difference between 90-day LIBOR and 90-day Treasuries))
- ☐ Access to high quality, non-bank corporate exposure

- An illiquidity premium associated with the lack of a NRSRO rating and thus limited secondary trading given the short-term nature of the assets themselves
- Calculation of the risk premium for the comparable issuer for the same excess spread suggests that the asset pays on average about what the 5-year bond of the same issuer offers



Industry experience with the asset class is consistent with dealer reporting.



(G) *Working Capital Finance Investments*

(1) Definition

Please refer to SSAP No. 105—Working Capital Finance Investments for the definitions associated and used with Working Capital Finance Investments and to [Part Three, Section 6 of this Manual](#) for summary definitions of those contained in SSAP No. 105 and other definitions used by the SVO for Working Capital Finance Investments.

(2) Required Documentation

An insurance company requesting an analysis of a proposed Working Capital Finance Program shall provide the SVO with the documentation described in this subparagraph.

- An RTAS Application;
- The Obligor's Audited Financial Statements, if the Obligor is not rated for credit risk by a NAIC CRP;
- The insurance company's Investment Committee Memorandum for the proposed Working Capital Finance Program;

~~The audited consolidated financial statements of the group of which the Finance Agent for the Working Capital Finance Program is a part, and o~~One of the following:

(a) An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment; or

(b) An annual audit of the financial statements and internal controls of the consolidated group of which the Finance Agent is part, which does not note any material weakness related to servicing Working Capital Finance Investments.

- A Certification from the insurance company's Chief Investment Office 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 Program, and that the Working Capital Finance Program does not include any insurance or insurance related assets.

~~■ A Certification from the insurance company's Legal Counsel:~~

~~In the case of a participation, that it has a commercially reasonable belief that its participation interest meets the Uniform Commercial Code's standards for creating and preserving first priority security interests in the payments due and in the Confirmed Supplier Receivables.~~

~~In the case of a certificate, note or other manifestation, representing a right to payment from a trust, other special purpose entity, or special purpose pool holding confirmed supplier receivables, that it has a commercially reasonable belief that the documents establishing and governing the Working Capital Finance Program create and preserve interests in the Confirmed Supplier Receivables capable of being enforced by the trustee or other entity holding Confirmed Supplier Receivables as first priority perfected security interests under the Uniform Commercial Code.~~

~~Please refer to SSAP No. 105 – Working Capital Finance Investments for the definition of a commercially reasonable belief.~~

A copy of:

- The document(s) that create the Working Capital Finance Investments (i.e., the short-term receivables) that is the subject of the RTAS – Emerging Investment Vehicle Service Application, and establishes the obligations of the Obligor to, and the protection afforded owners of, Working Capital Finance Investments (including the Investors). ~~This agreement is sometimes referred to as the Invoice Payment Terms Acknowledgement, the Payable Services Agreement or the Paying Services Agreement.~~

Please refer to [Part Two, Section 9 \(o\)](#) and [Part Four, Section 3 of this Manual](#) for guidance related to filing an RTAS Application with the SVO.

- ~~■ The agreement(s) between the Obligor and the Finance Agent governing the administration of the Working Capital Finance Program and the Working Capital Finance Investments issued thereunder. These agreements may be included in the documents mentioned above or may be standalone agreements. ~~These agreements may be included in the documents mentioned above or may be a standalone agreement which are sometimes referred to as the~~~~

Section 10. Reporting Conventions and Required Documents

Part Two
Filing with the SVO

~~Settlement Services Agreement or the Invoice—Related
Electronic Services Agreement.~~

- The agreement governing the sale of the Working Capital Finance Investments from the Supplier to the Finance Agent. ~~This agreement is sometimes referred to as the Receivables Purchase Agreement or the Supplier Agreement.~~
- The agreement governing the ongoing purchase of Working Capital Finance Investments or an interest in Working Capital Finance Investments by the Investor from the Finance Agent. ~~This agreement is sometimes referred to as the Agency Agreement, the Participation Agreement or the Program Trust Agreement.~~



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: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) regarding a possible Valuation of Securities (E) Task Force directive to the SVO to rely on unrated subsidiaries in WCFI transactions.

DATE: October 16, 2020

1. Summary – The SVO has received comments by some insurers and other industry participants that it should assign NAIC Designations to issues of non-guaranteed, unrated subsidiaries of NAIC Credit Rating Provider (CRP) rated parent entities, based on implied support from the parent to the subsidiary. This topic is most relevant to Working Capital Finance Investments (WCFI) with unrated obligors which are wholly owned, but not guaranteed, by CRP rated parent entities. 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 contends 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. The SVO has reached this conclusion based on its previous legal study of support obligations and on its examination of CRP methodologies and examples of parents not supporting subsidiaries.

2. CRP and NAIC Methodologies – 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 methodologies¹. These factors include, among others, determinations of the parent's willingness and ability to support its subsidiary (Moody's²), strategic importance and core versus non-core businesses (S&P³), and

¹ Fitch Ratings provides one exception to this general approach. Pursuant to Fitch Ratings methodology it is possible to rate a subsidiary issuer without standalone financial information or a parent guarantee when an issuer (subsidiary) had long-term public bonds outstanding at the time it was acquired by an acquiring company (parent). Fitch clarifies that this exception is not meant to be an alternative to its general parent-subsidiary linkage methodology, nor does it apply to new debt issues. ("Parent and Subsidiary Linkage Rating Criteria," Fitch Ratings, 26 August 2020.)

² "Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence of Legally Binding Parent Support," Moody's Investors Service, December 2003. Though originally published in 2003, Moody's maintains this article on its website.

³ "Parent and Subsidiary Ratings," S&P Global, August 29, 2000. Though originally published in 2000, S&P Global maintains this article on its website.

legal, operational and strategic ties between the parent and its subsidiary (Fitch⁴). Neither S&P nor 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. Rather, they make the determination of stand-alone rating a key starting point for determining parent and subsidiary ratings, meaning 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:

During 2002, there were four instances⁵ 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 level⁶.

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."

Reliance on implied support of a parent for its subsidiary also conflicts with the "Credit Substitution" guidelines in Part Three of the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "Purposes and Procedures Manual") 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 must be in place. The Credit Substitution guideline 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 such statements of intended support. While guarantees, when consistent with the Purposes and Procedures Manual guidance, can allow for full credit substitution, comfort letters, by which an entity promises support of a limited kind to an affiliate or subsidiary, only allows 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 Purposes and Procedures Manual's credit substitution guidelines. This rule precludes the SVO from analytically deriving a designation for a subsidiary from its parent when the subsidiary has no stand-alone CRP rating or NAIC designation or for which the SVO cannot derive one.

3. Examples -

The following are examples provided by Moody's to support its determination not to imply a rated parent's support for its unrated, non-guaranteed subsidiary.

⁴ "Parent and Subsidiary Linkage Rating Criteria" Fitch Ratings, 26 August 2020.

⁵ BCE Inc.; AT&T Corp.; Verizon Communications, Inc.; and TXU Corp.

⁶ Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence of Legally Binding Parent Support," Moody's Investors Service, December 2003

Decisions by the parents to cease support were based on the following:

- BCE Inc. decided after a review of strategic alternatives that the incremental investment required to support its subsidiary, Teleglobe Inc., to a self-sustaining status in the deteriorating long-haul telecommunications sector was very unclear, and therefore so was the likelihood of earning an adequate return on its marginal investment.
- AT&T Corp. decided not to make further marginal investments in its partly owned subsidiary, AT&T Canada Inc., (ATTC) likely because the facilities based competitive local exchange carrier (CLEC) business was unable to support existing debt levels. Moreover, regulatory pricing changes in 2002 did not make economic the reselling of the incumbent telcos' own networks by ATTC.
- Verizon Communications, Inc. made a decision to curtail further investment in Genuity Inc., a leading provider of enterprise IP networking services. Verizon opted not to exercise its option to acquire and reintegrate Genuity after reevaluating Genuity's growth prospects in light of the significant slowdown in IT spending and order rates.
- TXU Corp. discontinued financial support for its subsidiary, TXU Europe Ltd., despite publicly stating its willingness to do so, after determining that further funding of TXU Europe would not maximize shareholder value and recognizing that TXU Europe Ltd. was putting the ratings of its other subsidiaries at tremendous risk. TXU Europe's operations were hampered by the effects of increasing competition following deregulation of UK power markets, declining wholesale power prices, and contracts to purchase power at prices above market⁷.

4. Recommendation and proposed amendment – The SVO is aware that some industry participants and certain regulators have a different opinion than the SVO on the likelihood of parental support for their unrated, non-guaranteed subsidiaries and think such implied support exists and should be recognized in NAIC designations. Therefore, if the Task Force deems it essential that the SVO be able assign designations to WCFI transactions with unrated, non-guaranteed obligors, the SVO offers the following proposed amendments to Part One and Part Three of the Purposes and Procedures Manual. Pursuant to the amendment the Task Force would, in Part One, direct the SVO, in regards to WCFI transactions with unrated obligors, to rely upon the NAIC designation or the NAIC designation equivalent of a CRP rating of the obligor's parent entity but authorizes the SVO, based on its analytical judgement and in its sole discretion, to notch such NAIC designation. In Part Three the definition of WCFI "Obligor" would be revised to permit the SVO to follow the directive in Part One. The following text in red shows the proposed revisions in Part One and Part Three.

⁷ Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence of Legally Binding Parent Support," Moody's Investors Service, December 2003

PART ONE

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

POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES

WORKING CAPITAL FINANCE INVESTMENTS (WCFI)

Description

116. As described in *SSAP No. 105R - Working Capital Finance Investments*, WCFI represents a confirmed short-term obligation to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program for which an NAIC Designation is assigned by the SVO. Pursuant to the working capital finance investment program, this short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third-party investor.

Obligor

117. The Obligor for WCFI transactions is the party that purchases the goods or services that generates the original supplier receivable (which is the payable for that Obligor). The obligor must have an NAIC Designation of “1” or “2” or an Eligible NAIC Credit Rating Provider (CRP) Rating equivalent.

Unrated Subsidiaries

118. Many WCFI programs are structured in a way whereby unrated subsidiaries of a rated parent entity are involved as transaction participants, including as the Obligor. Such programs may have strong operational and strategic linkages between the rated parent entity and its unrated subsidiaries.
119. Given (i) the short-term (less than one year) payment terms of each of the underlying receivables arising from the sale of goods or services, (ii) WCFI investors’ option to stop funding a working capital finance program, and (iii) the necessity of working capital finance programs to obligors due to obligors’ reliance on their suppliers, the Task Force has concluded there is a low probability of default of WCFI investments. Accordingly, the Task Force deems it reasonable to establish a principle to direct the SVO, in its assessment of WCFI programs, to rely upon a parent entity’s rating for purposes of determining the NAIC Designation of the overall WCFI program.
120. Solely for purposes of WCFI transactions, the Task Force directs the SVO to rely upon the NAIC Designation or Eligible NAIC CRP Rating equivalent of the obligor, subsidiary or affiliate’s parent entity if:
- a) the obligor, subsidiary or affiliate does not have an Eligible NAIC CRP Rating and the SVO cannot assign an NAIC Designation to it, and

- b) each relevant obligor, subsidiary or affiliate constitutes a substantial portion of its parent entity's operations representing at least twenty-five percent (25%) or greater of the parent entity's assets, revenue and net income.
121. The Task Force authorizes the SVO, based on its analytical judgement and in its sole discretion, to notch such NAIC Designation based on factors including, but not limited to, whether:
- a) the unrated subsidiaries or affiliates that serve as key transaction participants can reasonably perform the functions expected of them; and/or
 - b) the rated entity has documented operational control over the performance of the unrated subsidiaries or affiliates that also serve as obligors in the program; and/or
 - c) there is documentary evidence in the program documents or appended thereto that sufficiently demonstrates the importance of the inter-relationship between the rated entity and the unrated subsidiaries or affiliates.
122. For the avoidance of doubt, while the Task Force directs the SVO to use the NAIC Designation or Eligible NAIC CRP rating equivalent of the obligor's parent entity, due to the SVO's authority to notch such NAIC Designation or rating, the SVO, based on its analytical judgement and in its sole discretion, may assign an NAIC Designation to the obligor which differs from the correlated Eligible NAIC CRP rating equivalent of the obligor's parent entity. Also, for the avoidance of doubt, the SVO may, based on its analytical judgement and in its sole discretion, choose not to assign any NAIC Designation to the working capital finance program, based on other attributes of the working capital finance program which are unrelated to the obligor or its parent entity.
123. The Task Force acknowledges that reliance upon the NAIC Designation or Eligible NAIC CRP rating equivalent of the obligor's parent entity in the absence of a binding legal obligation for the parent to assume the financial obligations of the obligor, such as a guarantee, is not a generally accepted technique or methodology (as explained in "Use of Generally Accepted Techniques or Methodologies" in Part One of this Manual) and is inconsistent with the credit substitution guidelines detailed in "Credit Substitution" in Part Three of this manual, but it is directing the SVO to so rely.

NOTE: See "Working Capital Finance Investments" in Part Three for filing instructions, documentation requirements, definitions and methodology applicable to Working Capital Finance Investments.

PART THREE

**SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF
NAIC DESIGNATIONS**

WORKING CAPITAL FINANCE INVESTMENTS

...

110. **Obligor** – An entity that purchases the goods or services from the Supplier and thereby generates the original supplier receivable—and which Obligor has, or can be designated, **NAIC 1** or **NAIC 2** by the SVO or has been assigned an equivalent credit rating by a NAIC CRP or, if not so designated, the SVO can imply such designation, as directed by the VOS/TF pursuant to the “Working Capital Finance Investments (WCFI)” section in Part One of this Manual.

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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 Therriault, Director, NAIC Securities Valuation Office
Eric Kolchinsky, Director, NAIC Structured Securities Group

CC: Jeff Johnston, Managing Director, NAIC Financial Regulatory Affairs
Marc Perlman, Investment Counsel, NAIC Securities Valuation Office

DATE: February 27, 2020

RE: Issue Paper – IAO staff concerns about Bespoke Securities, and Reliance on CRP Ratings

1. **Introduction** – During the Task Force’s May educational session, the IAO staff discussed with the Task Force its growing concern with bespoke securities - financial instruments typically constructed by or for a small group of investors, which, due to their private nature, are not subject to or constrained by market forces and competition. As such, their visible characteristics may substantially underrepresent actual risks. We highlighted specific securities to the Task Force as part of our growing concern about what we believe is the NAIC’s excessive reliance on credit rating provider (CRP) ratings to assess investment risk for regulatory purposes. During the session, the Task Force members that participated agreed with these concerns, noting that it would be beneficial for the IAO staff to develop guidance for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) that would allow the IAO staff to flag certain bespoke transactions and in turn create a process that would either dissuade industry’s use of such transactions or limit the risk. While some regulators suggested technology solutions be developed that allow regulators to follow-up with insurers on flagged transactions, most of the regulators questioned their own ability to do so given existing time constraints and the likely expertise needed to analyze the securities and communicate with insurers on each such issue. During that session, the regulators suggested IAO staff develop a summary of the issues and make recommendations to remediate them. This memorandum serves that purpose and builds upon specific direction given to the IAO by the Task Force at the Summer National Meeting held on August 4, 2019, to prepare an issue paper outlining the risks posed by bespoke securities after the IAO’s presentation on this issue at that meeting and make recommendations to mitigate these risks along with the interrelated issue of relying upon CRP ratings.
2. **Analytical Concern** –
 - a. Bespoke securities - The term “bespoke” made its way to finance from the world of London tailors producing “made to measure” suits for their banking clients. For the following reasons these customized financial instruments are typically not constrained by market forces and competition and, as a result, may substantially underrepresent risk:
 - i. These securities are usually not broadly syndicated (i.e. not owned by many parties).
 - ii. They are created by or for one or a few related insurance companies as an investment.

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- iii. They are assigned a credit rating by only one NAIC CRP, often via a private rating.
- iv. Participants often deliberately keep the terms and structure private.

As we mentioned in our presentation, bespoke securities, by definition, exhibit a great deal of flexibility in form making them, as a category, very difficult to describe, beforehand (i.e. they can include all possible variations). Since these are “one-off” and often private securities, no third-party lists or data exist that are sufficient to identify them in any insurer portfolios. Even if they were clearly identifiable, the SVO currently staff lacks the authority to act upon any issues or concerns it may have when, in its opinion, a security or a CRP rating incorrectly reflects how NAIC guidance would treat or view that security.

- b. Reliance on CRP ratings – The Task Force’s use of CRP ratings to determine an NAIC designation pursuant to the filing exempt (FE) policy, and the related historically permitted practice of allowing private ratings for this same purpose, has evolved into the current situation where the NAIC has very little oversight over the use and analytical basis of the CRP ratings being used to assess risk for the vast majority of insurer investments. The NAIC relies on nine different CRPs today with a tenth CRP in the process of being added and other entities considering becoming an U.S. Securities and Exchange Commission (SEC) nationally recognized statistical ratings organization (NRSRO), a necessary step before becoming a CRP to the NAIC. As direct competitors, each rating entity employs different methodologies and processes that make their ratings product unique. The SEC monitors compliance with those processes and adherence to those methodologies but they do not opine on the quality or veracity of the methodologies or their applicability for NAIC purposes.

The Task Force has not required the SVO to monitor CRP ratings or their methodologies for consistency and applicability and the SVO has not been authorized to use its judgement to determine how and when, if at all, a CRP rating should be used for NAIC purposes. We believe this lack of staff oversight has enabled the increased use of bespoke securities and, more importantly, has permitted a very significant population of securities to be assigned NAIC designations through the FE process (~82% of all securities owned by insurers) based on methodologies that are currently unmonitored by the NAIC as to how risk is being assessed for regulatory purposes and how the security complies with NAIC policies. While we believe that the CRPs follow their published methodologies, as required by the SEC, we do not believe that every rating agency methodology is appropriate for, or consistent with, the assessment of investment risk for statutory purposes. The Credit Rating Agency Reform Act of 2006 (CRARA) requires NRSROs to make certain information public to help users of credit ratings compare NRSROs and assess their credibility. The philosophy behind the CRARA regulation of NRSROs is disclosure and “buyer beware”. In keeping with the intent of CRARA, we believe the NAIC, as a consumer of CRP ratings, needs to actively apply its own judgement in how it uses CRP ratings. This is also consistent with the recommendations made by the Rating Agency (E) Working Group that were subsequently adopted by the Financial Condition (E) Committee in the Working Group’s final report dated April 28, 2010 (excerpts of which are included in this paper and the full report accompanies it). The CRPs have thousands of methodologies between them; managing and administering their appropriate use for NAIC purposes would require the SVO to be given additional authority and discretion from the Task Force.

Concerns about inflated CRP ratings are not unique to the NAIC. For example, a letter from a bipartisan group of Senators to the SEC cited a Wall Street Journal article discussing a rating agency practice of changing methodology to gain business. The letter noted that the CRPs “have changed their rating criteria in ways that were followed by big jumps in market shares...”

3. Recommendations –

- a. Bespoke securities “Red Flags” – For any security that trips one or more of the following “red flag” criteria, the SVO would require its legal agreements submitted to the SVO so the SVO could assess whether the security

and/or the CRP rating were appropriate for NAIC purposes. If the SVO deemed the security acceptable but not the CRP rating, the security would need to be filed with the SVO for a complete analysis. If the SVO deemed the security unacceptable, the SVO would work with the appropriate regulatory groups to address any policy matters.

- i. Rating from a single CRP. At least two independent CRP ratings would be required for any NAIC designation to be derived from CRP ratings and the lower of the ratings would be applied. In the absence of two CRP ratings, the security would need to be filed for analysis by the SVO.
 - ii. Private letter rating. The analysis supporting the assignment of any private rating would need to be submitted to the SVO for review. The SVO would have the authority to determine if it would rely upon the private rating or require the security to be filed. The analysis would need to be provided at least annually.
 - iii. Assets backing the security were primarily owned by insurer or affiliates before the transaction and reported differently (i.e. regulatory arbitrage)
 - iv. Assets backing the security do not generate bond-like cash flows (i.e. contractual requirements to pay periodic principal and interest).
 - v. Insurer or affiliated group are sole investors in security
 - vi. Affiliate of company is underwriter or sponsor of the security
- b. Reliance on CRP ratings – The SVO would be tasked with monitoring CRP ratings and methodologies on a case-by-case basis and determining how they are used in the filing exemption process. The production of NAIC designations using CRP ratings is already an SVO administrative responsibility. Authorizing the SVO to oversee the applicability of those CRP ratings would add much needed oversight to the NAIC’s use of CRP ratings. . One of stated objectives of the NAIC’s use CRP ratings should be to achieve the greatest consistency and uniformity in the production of NAIC designations while maximizing the alignment between the assessment of investment risk to the NAIC’s statutory objectives.

4. **Recommendations of the Rating Agency (E) Working Group (“RAWG”)** - The risks and concerns being highlighted in this paper echo those identified in the final report of the Rating Agency (E) Working Group (“RAWG”) dated April 28, 2010, and the recommendations above are consistent with the Working Group’s that were also adopted by the Financial Condition (E) Committee; some of which are listed below in italics (the full report is attached):

a. *Summary of Recommendations*

The Working Group recommends that:

- i. *Regulators explores how reliance on ARO ratings can be reduced when evaluating new, structured or alternative asset classes, particularly by introducing additional or alternative ways to measure risk;*
- ii. *Consider alternatives for regulators’ assessment of insurers’ investment risk, including expanding the role of the NAIC Securities Valuation Office (“SVO”); and*
- iii. *When considering continuing the use of ratings in insurance regulation, the steps taken by the NRSROs in correcting the causes that led to recent rating shortfalls, including the NRSROs’ efforts in implementing the recommended structural reforms, should be take into account.*

... (VOS recommendations) ...

- b. *VOS should study the use of ratings in the financial solvency monitoring of insurance companies to confirm it ratings should differ for municipal, corporate and structured securities as general asset classes. Consideration should also be given to applying ratings differently within segments of these broader categories.*

- c. An evaluation should be made to determine whether the differences between ratings for municipal and other securities is material enough to warrant change how ARO ratings are converted into NAIC designations.*
- d. VOS should continue to develop independent analytical processes to assess investment risks. These mechanisms can be tailored to address unique regulatory concerns and should be developed for use either as supplements or alternatives to ratings, depending upon the specific regulatory process under consideration.*
- e. ARO ratings have a role in regulation; however, since the ratings cannot be used to measure all the risk that a single investment or a mix of investments may represent in an insurer's portfolio, NAIC policy on the use of ARO ratings should be highly selective and incorporate both supplemental and alternative risk assessment benchmarks.*
- f. NAIC should evaluate whether to expand the use of SVO and increase regulator reliance on the SVO for evaluating credit and other risks of securities.*
- g. The NAIC Rating Agency (E) Working Group should establish a process to monitor and evaluate ARO activities. A monitoring function would:*
 - i. Provide information about product offerings and the direction of financial innovation.*
 - ii. Permit timely regulatory intervention to set regulatory treatment of risk securities differently than that suggested by their credit quality.*
 - iii. Promote, if not require, rating agency transparency of process, compensation, staff participation, and collateral underlying the security.*
 - iv. Determine the materiality of risks other than credit to financial solvency.*
 - v. Monitor and assess the changes that ratings agencies are implementing, and whether ratings continue to correctly complement regulatory purposes.*
- h. The SVO does not take part in the structuring of securities transactions for issuers and is not subject to the competitive pressure that can lead to the conflicts of interest discussed throughout this report; therefore, state regulators should evaluate whether to expand the SVO's role.*
- i. Modify the Filing Exempt Rule:*
 - i. VOS should consider developing alternative methodologies for assessing structured security risks. Those structured security classes where an alternative method is adopted would be ineligible for filing exemption.*
 - ii. VOS should consider if new investment productions should be ineligible for filing exemptions and/or instead be subject to regulatory evaluation. Filing exempt status can be granted or withheld on the basis of the regulatory review.*
 - iii. VOS should study the use of ratings in the financial solvency monitoring of insurance companies to confirm if ratings should differ for municipal, corporate and structured securities as general asset classes. Consideration should also be given to applying ratings differently within segments of these broader categories.*

- iv. *Consideration should be given to modifying the filing exempt rule to adjust for securities with new additional ARO ratings and other measures (such as V Scores and Parameter Sensitivities) when deemed applicable. The need for difference RBC and/or some other and additional regulatory process should be evaluated. Such processes could include the use of market information on price direction and of yield trends in addition to ARO ratings for some or all filing exempt securities.*

Securities highlighted by this process can be reviewed by the SVO with the objective of adjusting the ARO rating to help ensure an accurate RBC charge.

- v. *VOS should develop tools to better address market and liquidity risk in structured securities*

- 5. **Next steps** – The IAO recommends sharing the issue paper with Financial Condition (E) Committee to alert them to these continuing risks highlighted in the Rating Agency (E) Working Group’s recommendations and continuing this discussion next year.

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Financial Condition (E) Committee
Conference Call
April 28, 2010

The Financial Condition (E) Committee met via conference call April 28, 2010. The following Committee members participated: Alfred W. Gross, Chair (VA); Joseph Torti, III, Vice Chair (RI); Linda S. Hall represented by Gloria Glover (AK); Steve Poizner represented by Al Bottalico (CA); Susan E. Voss represented by Kim Cross (IA); Ann M. Frohman represented by Jim Nixon (NE); Thomas B. Considine represented by Steve Kerner (NJ); James J. Wrynn represented by Matti Peltonen, Lou Felice and Joseph Fritsch (NY); Mary Jo Hudson represented by Dale Bruggeman (OH); and Sean Dilweg represented by Peter Medley.

1. Rating Agency (E) Working Group Report

Commissioner Gross stated that the report from the Rating Agency (E) Working Group was received by the Committee at the Spring National Meeting. He said there were no objections to the report during that meeting, but he wanted to give each of the chairs of the impacted groups time to review the report before adopting it. He stated that some comments had been received by the chairs since being distributed, and those had been incorporated into the report. He characterized the changes as editorial, noting that they mostly clarified that each of the recommendations would be more fully considered by each of the applicable technical groups. He asked if there were any concerns from the Committee members or the chairs. Mr. Fritsch indicated he had no concerns with the recommendation being sent to the group he chairs. No other regulators expressed any issues. A motion was made by Superintendent Torti to adopt the revised report (Attachment Fifteen-A) from the Rating Agency (E) Working Group. The motion was seconded by Mr. Bottalico and unanimously carried.

2. Rating Agency (E) Working Implementation Matrix

Commissioner Gross asked NAIC staff to provide a summary of the implementation matrix that had been created to track the progress of the recommendations from the Rating Agency (E) Working Group. Dan Daveline (NAIC) described a matrix that he had drafted at the direction of Commissioner Gross. He discussed the columns of the report, and how each group was expected to complete after discussing on a conference call and then distribute it to the Rating Agency Working Group. He discussed how each group was intended to identify if any of the recommendations could not fit into the group's existing charges and if any of the items were more long-term issues that could not be addressed quickly because of competing priorities or the need to coordinate with other projects. An example was provided of a referral to the Capital Adequacy (E) Task Force that involves a decision that will likely need to be made by the Solvency Modernization Initiative (EX) Task Force. The intent is for the report to be updated before each national meeting and provided to the Committee at such time.

Commissioner Gross discussed a charge that was developed as a means to successful implementation of the recommendations from the Rating Agency (E) Working Group. Commissioner Gross read the charge:

Monitor the implementation of recommendations resulting from the NAIC's evaluation of the reliance on nationally recognized statistical rating organization (NRSRO) ratings. Provide a status of the recommendations to the Financial Condition (E) Committee at each NAIC national meeting until the majority of the recommendations have been implemented or disposed.

A motion was made by Superintendent Torti to adopt the charge to the Rating Agency (E) Working Group. The motion was seconded by Mr. Fritsch and unanimously carried.

Having no further business, the Financial Condition (E) Committee adjourned.

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To: The Honorable Alfred Gross, Virginia Commissioner of Insurance and Chair of the Financial Conditions (E) Committee

From: The Honorable Michael McRaith, Director of the Illinois Department of Insurance and Co-Chair of the Rating Agency (E) Working Group
The Honorable James J. Wrynn, Superintendent of the New York Insurance Department and Co-Chair of the Rating Agency (E) Working Group
Matti Peltonen, New York Insurance Department
Kevin Fry, Illinois Insurance Department
Bob Carcano, Senior Counsel, SVO

Re: Evaluating the Risks Associated with NAIC Reliance on NRSRO Credit Ratings – Final Report of the RAWG to the Financial Conditions (E) Committee

Date: April 28, 2010

I. Introduction - The Rating Agency (E) Working Group (“RAWG”) of the NAIC Financial Condition (E) Committee was formed on February 11, 2009, and charged with conducting a comprehensive evaluation of state insurance regulatory use of the credit ratings of nationally recognized statistical rating organizations (“NRSROs”).¹ Specifically, the Working Group was charged to gather and assess information on:

1. The problems inherent in reliance on ratings, including impact on the filing exempt (“FE”) process and Risk-Based Capital (“RBC”);
2. The reasons for recent rating shortcomings, including but not limited to structured security and municipal ratings;
3. The current and potential future impact of ratings on state insurance financial solvency regulation; and
4. The effect of the use of NRSRO ratings on public confidence and public perception of regulatory oversight of the quality of insurance.

This report presents the Working Group’s findings in answer to those charges and recommendations to adjust the use of ratings.

II. Summary of Recommendations

The Working Group recommends that:

1. Regulators explore how reliance on ARO ratings can be reduced when evaluating new, structured, or alternative asset classes, particularly by introducing additional or alternative ways to measure risk;
2. Consider alternatives for regulators’ assessment of insurers’ investment risk, including expanding the role of the NAIC Securities Valuation Office (“SVO”); and
3. When considering continuing the use of ratings in insurance regulation, the steps taken by the NRSROs in correcting the causes that led to recent rating shortfalls, including the NRSROs’ efforts in implementing the recommended structural reforms, should be taken into account.

¹ The NRSROs whose ratings are used by the NAIC are referred to as Acceptable Rating Organizations (“ARO”). Currently, they are Standard & Poor’s, Moody’s, Fitch, DBRS, A.M. Best, and Realpoint.

III. Overview of the RAWG Process

Soon after the RAWG was formed, SVO staff was directed to:

1. summarize federal and international regulators' evaluations of NRSRO rating shortcomings;
2. assess the role of these shortcomings in the current economic crisis;
3. identify the specific NAIC regulatory mechanisms driven by ratings;
4. quantify the impact of rating downgrades on insurance companies.

The RAWG sent a questionnaire based on state regulators' points of interest in the NRSRO structure and process to the AROs. An SVO team of analysts (all of whom are alumni of the AROs with extensive rating agency experience) evaluated the responses and summarized them for the RAWG.

On September 24, 2009, at the NAIC Fall National Meeting, the RAWG held a public hearing and received testimony from capital market participants, ARO representatives and national experts on the use of ratings in regulation. The September 24 hearing provided information and perspective which is included in, or formed the basis for, many of the recommendations contained in this Report.

A second public hearing, via conference call, was held on November 18th to gather information about ARO rating of municipal securities.

IV. Findings of the Working Group

1. Problems Inherent In Reliance on Ratings for Insurance Regulation

AROs are for-profit business organizations which seek to expand the reliance upon ARO ratings in financial products and regulatory processes in order to develop new product lines and increase market share. The largest AROs also compete to obtain business from the issuers of the securities subject to the ARO rating. Reliance on ratings exposes insurance regulatory process to risks arising from competitive pressures on AROs that are beyond state regulators' control and not consistent with regulatory objectives, such as consumer protection.

- a. Ratings are used extensively in insurance regulation. In addition, insurers should be required to use such tools as due diligence reviews of investments, risk management, independent credit analysis, and risk diversification.
- b. Insurance regulators' extensive reliance on ratings, often required by statute, may reduce regulators' independent ability to monitor an insurance company's compliance with prudent investment practices.
- c. Rating agencies' use of corporate bond default history as the basis for analyzing structured securities was based on an underlying assumption that the default rates for the two classes would behave similarly in varying market scenarios. The fundamental differences in the structures of the securities and the cash flows render these types of securities so fundamentally different from one another that the use of corporate bond default history to form an opinion on the probability of particular structured securities' performance was inappropriate.
- d. Rating agencies' rating revisions tend to lag behind market and economic developments. ARO ratings tend to be long-term ratings, meant to be relatively stable over an economic cycle. As a result, ratings may not react fast enough or be sufficiently current to satisfy regulatory needs.
- e. Complex securities, such as Collateralized Debt Obligations consist (in effect) of options on derivatives and contain a great deal of leverage. As a result, the effects of AROs adopting assumptions that would

later prove far different from actual experience were magnified greatly. If the assumptions do not correctly anticipate these securities' actual behavior in a given environment, then the probability that the rating will not reflect the true creditworthiness of that security will increase exponentially.

- f. To verify the accuracy of ratings and the validity of initial assumptions and models for structured securities, it is necessary to monitor the performance of the underlying assets. Rating agencies, however, rarely engage in monitoring sufficient to discover such problems, after having issued the initial rating.
- g. Due to competition and the increasingly complex nature of financial products, the meaning of ratings and the comparability of structured product ratings between NRSROs have changed. These changes require investors to increase their expertise about credit and the NRSROs' rating methodology before ratings can be expected to be adequately understood.
- h. Credit ratings focus on the probability of default, and thus do not capture all investment risks. Credit ratings do not measure recovery given default, and therefore cannot be used to estimate the actual expected losses in insurers' investment portfolios. Rating agencies have, or are in the process of adding separate recovery ratings at least to some fixed income securities, but it remains to be determined how comparable they are.
- i. In order for the NAIC's filing exempt rule to work well, the ARO ratings need to be consistent. Currently, however, the ARO ratings are neither consistent nor uniform for individual securities, nor across different types and classes of securities.
- j. AROs use the same rating scale for municipal and corporate securities indicating that the probability of default for municipal and corporate securities are similar, when in fact, the probability that a municipal security defaults is lower than that of a corporate security with the same rating.
- k. The process by which ARO ratings are transposed into NAIC designations to determine the appropriate surplus levels under RBC assumes the default rates and losses given default assumptions for municipal and corporate securities are similar.
- l. These differences in default probability (and in the possibility of differing losses given default) across asset categories, and the assumption incorporated into the NAIC designations that these differences do not exist, can result in anomalous situations where the capital held against various investments bears less relation to the actual risk presented than is warranted.

2. Reasons for Recent Rating Shortcomings

The RAWG's hearings identified the following factors as contributing to errors when NRSRO ratings alone are used for regulatory purposes.

- a. When rating structured credit or non-standard fixed income products with little or no historical data, AROs have sometimes adopted models incorporating either excessively optimistic assumptions or inadequate probability given to severity of tail risk.
- b. It appears that some AROs have responded to business opportunities by choosing not to reject transactions submitted for ratings. These same pressures appear to have contributed not only to "grade inflation" of credit ratings, but also to a conflation and a decline in the quality of rating standards.
- c. Rating agencies that are compensated primarily for their initial ratings have little incentive to monitor underlying asset performance on structured securities or modify or update their ratings generally.

3. Current and Potential Future Impact of Ratings on Regulation

The NAIC is engaged in several reform measures that will reduce regulators' reliance on credit ratings. First, the NAIC is supporting regulators as risk-focused examinations are implemented by states, and second, the NAIC has amended its treatment of Residential Mortgage Backed Securities ("RMBS"), and is evaluating the merits of expanding a similar type of credit evaluation to other structured securities. Both of these reforms will allow regulators to "drill down" to reveal levels of granularity within a security that are not accessible through credit ratings.

The RMBS proposal replaced ratings with a model (modeling was done by PIMCO Advisory) to establish price ranges for each NAIC designation (1 through 6) for each of the approximately 21,000 different RMBS held by insurance companies. An insurer's carrying value for a particular RMBS was mapped to the price ranges to identify the appropriate NAIC designation for use in RBC. This approach: (1) identifies the actual risks presented by RMBS; (2) quantifies the severity of possible losses; (3) provides a better measure of losses against which surplus must be kept; and (4) when appropriate, frees up capital, in particular for securities held at a discount.

4. The Effect of the Use of ARO Ratings on Public Confidence and Public Perception of the Quality of Regulatory Oversight of Insurance

Congress and the Securities and Exchange Commission have considered increasing the number of entities designated as NRSROs. As the number of AROs increases, so will the competitive pressures. Where issuers pay for AROs for rating services, these competitive pressures may create incentives within the AROs that would be incompatible with prudential supervisory considerations. There is a risk that required checks and balances will be developed only after major ratings failures occur – as has been the clear pattern during the current and prior episodes of inaccuracy of credit ratings.

- a. Ratings have devolved to the point where they can be most appropriately interpreted and applied only by financial professionals who understand the rating agencies' methodologies and the implications that specific circumstances have for those methodologies.

V. Recommendations

1. Referral to the NAIC Capital Adequacy Task Force: The current RBC process should be reviewed to assess the recent performance of ratings for structured securities and how that performance has affected insurers' surplus and reserve holdings.
2. Referral to the NAIC Valuation of Securities Task Force: VOS should study the use of ratings in the financial solvency monitoring of insurance companies to confirm if ratings should differ for municipal, corporate and structured securities as general asset classes. Consideration should also be given to applying ratings differently within segments of these broader categories.
3. Referral to the NAIC Valuation of Securities (E) Task Force: An evaluation should be made to determine whether the difference between the ratings for municipal and other securities is material enough to warrant changing how ARO ratings are converted into the NAIC designations.
4. The NAIC Rating Agency (E) Working Group should evaluate whether states', municipalities' and other public entities' creditworthiness should take into account the unprecedented financial burdens many public sector issuers face from aging populations, public pension liabilities, infrastructure needs, and revenue instability caused by financial and economic dislocations.

- a. The diminished market share of monoline bond insurers (less than 10% of new issues are guaranteed - down from about 50% before the 2008 financial crisis), renders the valuation and credit risk assessment of many municipal bonds more difficult. As a result, the credit quality of insurers' municipal bond portfolio is more opaque, and may require a more frequent and detailed reporting. Heightened reporting levels will enhance transparency and provide regulators information sufficient to assess creditworthiness of the issuer. Many municipal bonds without the guarantee are not actively traded, which also reduces if not eliminates any pricing discovery, and accuracy, the bonds might have had when insured and more liquid. An alternative valuation method may need to be developed, as the NAIC methodology of matrix pricing using comparable bonds may have limitations due to the difficulty of establishing benchmarks, in particular for small municipal issuers.
 - b. Given the impact on municipal finances from the possible protracted equity market downturn, from expected losses in the commercial real estate market, and from the continuing foreclosures in residential real estate market, the credit assessment of municipal bond portfolios should assess the risk of unfunded pension and employee/retiree healthcare liabilities, the growth rate of many government programs (e.g. healthcare, childcare, aged home care) which generally exceeds the growth of government revenues. Continuing municipal fiscal burdens and pressures, and unprecedented burdens resulting from the "baby boomer" generation, may necessitate alternative views and assessments of municipal creditworthiness. Recent municipal defaults in South Carolina, Pennsylvania and Nevada illustrate the sensitivity of this time.
 - c. Regulators should evaluate development of a series of indicators/scales prepared for regulators as warning signs in municipal issues (especially those without strong general obligation support). These indicators could include: i) Liquidity -given the thin secondary market and overall reduced quality of many issues, liquidity is an increasing concern, ii) Sustainability - (as CALPERS and others have raised) on long portfolios given pension, OPEB and social service programs, iii) Municipal Tax Capacity - whether the government has sufficient taxing capacity and authority to satisfy current and prospective obligations, as opposed to neighboring or "competitive" taxing authorities, iv) scrutinize the risk among variant life terms of debt, and v) establishment of thresholds or milestones for reserve adjustments.
5. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should continue to develop independent analytical processes to assess investment risks. These mechanisms can be tailored to address unique regulatory concerns and should be developed for use either as supplements or alternatives to ratings, depending on the specific regulatory process under consideration.
 6. Referral to the NAIC Valuation of Securities (E) Task Force: ARO ratings have a role in regulation; however, since ratings cannot be used to measure all the risks that a single investment or a mix of investments may represent in an insurer's portfolio, NAIC policy on the use of ARO ratings should be highly selective and incorporate both supplemental and alternative risk assessment benchmarks.
 7. Referral to the NAIC's SVO Initiatives (EX) Working Group: NAIC should evaluate whether to expand the use of SVO and increase regulator reliance on the SVO for evaluating credit and other risks of securities.
 8. Referral to the SVO Initiatives (EX) Working Group: Consider whether the NAIC should establish a not-for-profit rating agency where ARO rating coverage is not adequate.
 9. The NAIC Rating Agency (E) Working Group should establish a process to monitor and evaluate ARO activities. A monitoring function would:

- a. Provide information about product offerings and the direction of financial innovation.
 - b. Permit timely regulatory intervention to set regulatory treatment for risky securities differently than that suggested by their credit quality.
 - c. Promote, if not require, rating agency transparency of process, compensation, staff participation, and collateral underlying the security.
 - d. Determine the materiality of risks other than credit to financial solvency.
 - e. Monitor and assess the changes that the rating agencies are implementing, and whether ratings continue to correctly complement regulatory purposes
10. Referral to the SVO Initiatives (EX) Working Group: The SVO does not take part in the structuring of securities transactions for issuers and is not subject to the competitive pressures that can lead to the conflicts of interest discussed throughout this report; therefore, state regulators should evaluate whether to expand the SVO's role.

Modify the Filing Exempt Rule

11. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should consider developing alternative methodologies for assessing structured security risks. Those structured security classes where an alternative method is adopted would be ineligible for filing exemption.
12. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should consider if new investment products should be ineligible for filing exemption and/or instead be subject to regulatory evaluation. Filing exempt status can be granted or withheld on the basis of the regulatory review.
13. Referral to the NAIC Valuation of Securities (E) Task Force: Consideration should be given to modifying the filing exempt rule to adjust for securities with new additional ARO ratings and other measures (such as V Scores and Parameter Sensitivities) when deemed applicable. The need for different RBC and/or some other and additional regulatory processes should be evaluated.² Such processes could include the use of market information on price direction and of yield trends in addition to ARO ratings for some or all filing exempt securities.

Securities highlighted by this process can be reviewed by the SVO with the objective of adjusting the ARO rating to help ensure an accurate RBC charge.

14. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should develop tools to better address market and liquidity risk in structured securities.

² V Scores address the degree of uncertainty around the assumptions that underlie structured ratings (*i.e.* data limitations and modeling assumptions). Parameter Sensitivities address the sensitivity of Moody's ratings to changes in key assumptions, and so measure how the initial rating might differ if key rating input parameters were varied.

Company Specific Action

15. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should consider requiring insurance companies to provide enhanced documentation for their investment policies and procedures to their regulators, to demonstrate they have a sound basis for their investment strategies.
16. Referral to the NAIC Valuation of Securities (E) Task Force: Consider additional company level processes in addition to using ratings. For example, a requirement for a “Structured Security Use Plan” (similar to a Derivative Use Plan) requiring insurers to have an appropriate investment and control environment prior to investing in structured securities.
17. The Rating Agency (E) Working Group will examine the extent to which insurers rely on ratings instead of performing their own due diligence.

Risk Based Capital (RBC)

18. Referral to the NAIC Capital Adequacy (E) Task Force: The NAIC’s Solvency Modernization Initiative (EX) Task Force and the NAIC’s Capital Adequacy (E) Task Force have been discussing reform of the RBC formulae for Life, Property and Casualty, and Health Insurers. The Working Group recommends a comprehensive review of RBC, including a review of whether all RBC formulae should have greater granularity. The focus should be on a total balance sheet approach and have a greater focus on fundamental risk analysis.
19. Referral to the NAIC Capital Adequacy (E) Task Force: Consideration should be given to recalibrate the RBC formulae to require different levels of capital for municipal, corporate and structured securities. Greater quantification of risk in these very different asset classes will permit a more appropriate distribution of capital.
20. Referral to the NAIC Valuation of Securities (E) Task Force: Continue the process of evaluating the merit of an alternative method to determine the NAIC designations to structured securities, in addition to RMBS.

Asset Valuation and Interest Maintenance Reserves

21. Referral to the NAIC Capital Adequacy (E) Task Force & NAIC Blanks (E) Working Group: The Asset Valuation Reserve establishes a reserve to offset potential credit-related investment losses on all invested asset categories. Similar to risk-based capital, greater granularity should be introduced into the AVR mechanism by introducing municipal, corporate and structured asset categories.
22. Referral to the NAIC Statutory Accounting Principles (E) Working Group: The Statutory Accounting Principles (E) Working Group should analyze whether it is appropriate to continue using changes in NAIC designations to determine if realized capital gains or losses are to be classified as interest rate gains or losses. NAIC designations are an indicator of credit quality. They were chosen as a proxy in determining whether gains or losses are interest rate related for administrative simplicity. Regulators should evaluate how well they have served as a proxy in classifying realized capital gains or losses.

References to AROs in Legislation

23. Referral to the NAIC Investment of Insurers Model Act Revision (E) Working Group: Consider encouraging state regulators to identify references to AROs in state insurance laws and to consider proposing modifications that refer to alternative risk assessment methods or providers so as to lessen reliance on AROs.
24. Referral to the NAIC Investment of Insurers Model Act Revision (E) Working Group: Consider whether to propose how references to AROs in NAIC Model investment laws could be retained or changed.
25. Referral to the NAIC Investment of Insurers Model Act Revision (E) Working Group: Consider whether to propose how NAIC Model investment laws could be amended to reflect the filing exempt process.

Assessing Impact of ARO Insight or Action on Insurer Ratings

26. The Rating Agency (E) Working Group should develop information that can be posted on the NAIC website to educate consumers on the limitations of rating agency ratings of insurers.
27. Rating Agency (E) Working Group: Insurers should be required to share the information provided to NRSROs, and regulators should be proactive in considering the implications of these requirements for capital and changes in ratings as a way to safeguard public confidence in regulation. We recommend the development of a model law to accomplish these objectives.
28. Rating Agency (E) Working Group: DBRS analytical process for speculative grade securities, which incorporates both the risk of default and also the likelihood of recovery in default, should be considered to assess whether a different analytical or regulatory approach to speculative grade securities owned by insurers is warranted.
29. Rating Agency (E) Working Group: AM Best indicates that certain components of its rating process related to cash flows and liquidity, risk concentration and correlation, are being enhanced as a way to assess an organization's ability to absorb tail events (i.e., low probability / high severity losses) during adverse financial market conditions. State regulators should meet with AM Best representatives to evaluate the extent to which these adjustments in the methodology signal potential complementary areas of improvement in financial regulation.
30. Rating Agency (E) Working Group: State regulators should also meet with other AROs to evaluate what improvements they have made since the September 2009 hearing on their rating processes.

VI. Recommendations for Structural Rating Agency Reform

1. Regulators should consider how to support the following reforms for rating agencies :
 - a. Creating committees and processes to identify when new proposed transactions or securities do not warrant a rating. The committees would approve the logic for rating new types of securities. Determinations of such committees and the identified risks that support this determination should be made publicly available;
 - b. Not only applying newer rating models for new securities, but, consistently for all applicable securities, including those in the secondary market;

- c. Creating a real-time automated process that would apply a rating agency's original assumptions to the monthly servicer remittance data;
- d. Disclosing monthly service remittance data or any similar underlying asset performance information publicly;
- e. Creating a data library for planned transactions where details about the proposed collateral could be posted so that investors could “inspect the collateral” before purchasing a transaction;
- f. Develop standards for analyst training;
- g. Monitoring and using monthly servicer performance data to update/correct their initial models and assumptions;
- h. Creating an Office of Chief Statistician and Models reporting to an independent committee of the board of directors;
- i. A third party, who is independent from both the investment banker and the originator, should review the loans proposed for the collateral pool; and
- j. Require the development of standards, greater standardization of definitions and greater consistency in the agreements used for structured securities.

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MEMORANDUM

TO: Director Robert H. Muriel (IL)
Chair of the Valuation of Securities (E) Task Force

FROM: Commissioner Scott A. White (VA) and Superintendent Eric A. Cioppa (ME)
Chair and Vice Chair of the Financial Condition (E) Committee

DATE: Sept. 23, 2020

RE: NAIC Reliance on Rating Agencies

This memorandum is in response to a recent letter the Valuation of Securities (E) Task Force received from the American Council of Life Insurers (ACLI), the Private Placement Investors Association (PPIA), and the North American Securities Valuation Association (NASVA) regarding a Task Force exposed memorandum on “Bespoke Securities” and more generally “Reliance on CRP Ratings.”

As you may know, in February, the Financial Condition (E) Committee met to discuss its 2020 priorities, and at that time, identified the need to reduce reliance on credit ratings as one of its priorities. The Committee specifically discussed its support for the Task Force’s position that reduced reliance on credit ratings was needed in a very targeted way for bespoke securities, which are very individualized. As such, the Committee has some real concerns with the comment letter that states that Securities Valuation Office (SVO) staff should **not** have the authority to determine eligibility for Filing Exemption of an individual credit rating provider (CRP) rating on a deal-by-deal basis.

The Committee appreciates that there may be details that the Task Force needs to work through in order to put a targeted approach in place, but the Committee believes that changes need to be made to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to add this additional authority to the responsibilities of SVO staff. To that end, we are directing the Task Force to add the following to its 2021 charges:

“The Task Force will 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.”

If you have any questions on this matter, please contact either myself, Superintendent Cioppa, or NAIC Staff Support (ddaveline@naic.org).

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August 17, 2020

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, Suite 1500
Kansas City, MO 64106-2197

Re: Issue Paper – IAO Staff Concerns about Bespoke Securities, and Reliance on CRP Ratings

Dear Mr. Fry and Ms. Mears:

The American Council of Life Insurers (“ACLI”)¹, Private Placement Investors Association (“PPiA”)², and North American Securities Valuation Association (“NASVA”)³ appreciate the opportunity to comment on “IAO staff concerns about Bespoke Securities, and Reliance on CRP Ratings” (the “Issue Paper”). The regulatory concerns set out in the paper are important, highlighting the need for: (1) Transparency regarding the information and methodology behind a security rating – whether public or private – to facilitate effective oversight of valuation of securities and enable the Securities Valuation Office (“SVO”) to be the “eyes and ears” of the Valuation of Securities Task Force (“Task Force”); and (2) Effective oversight of the credit rating provider (“CRP”) ratings process at the NAIC to better assess risk for regulatory purposes.

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 44 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](#)

We want to assist the Task Force in addressing these issues in a targeted way, based upon facts, while also taking into account existing regulatory tools. In collaboration with the Task Force and the SVO, we propose to accomplish that goal by developing a set of principles – consistent with the Issue Paper – and beginning to outline a framework addressing the regulatory concerns. The principles we propose include a *commitment to transparency, effective and open regulatory response to concerns, acknowledgment of practical considerations, and avoiding market disruption*. Those principles support an effective potential framework to move forward through:

- Filling the existing information gap surrounding privately rated securities and allowing for the verification of the purpose and process related to the use of private letter ratings through:
 - Insurers providing the SVO with private ratings letters and supporting ratings rationales (on a one-time basis⁴) – both for existing securities and on new purchases;
 - Upon specific request by the SVO, insurers providing other supporting transaction documentation; and
 - Given this is not expected to be a re-underwriting process by the SVO, no fees should be charged for the filings. Industry stands ready to assist the SVO and the Task Force in identifying and refining the population of securities most likely to exhibit characteristics associated with identified analytical concerns.
- Using this information, the SVO can raise thematic concerns regarding certain asset classes or CRPs with the Task Force for regulators' consideration. However, this should not be accompanied by any extension, whether explicit or by implication, of unilateral authority allowing the SVO to overturn individual CRP ratings on a deal by deal basis. Any such authorization would constitute inappropriate comingling of the regulatory authority entrusted to the distinguished members of the Task Force with the prescribed duties of NAIC staff, and attendant concerns as to critical erosion of due process would geometrically amplify the potential for counterproductive and costly market disruption.
- Decisions related to any such thematic concerns being made in a transparent and open manner, affording due process for affected insurers – with all policy decisions, including those pertaining to the procedural framework the SVO is instructed to utilize for the evaluation of ratings on both new and existing transactions, being made by the Task Force.

Of course, the principles and information sharing framework will need to be developed, refined, and exposed for industry review and comment. We look forward to working with the Task Force and the SVO to develop such principles and framework to address the regulatory issues raised in the Issue Paper. As a starting point to that dialogue, this letter (1) frames the issues, so that the Task Force and Interested Parties are using common and neutral language; (2) analyzes each “red flag” as described in the Issue Paper, to show that those characteristics by themselves do not indicate a questionable rating; and (3) proposes principles for how to practically achieve the goals outlined in the Issue Paper.

⁴ Ratings rationales, as available, would be filed on a one-time basis both for existing securities and on new purchases, but private ratings letters would continue to be filed annually for those securities whose ratings are not already included on an electronic feed, as required by the P&P Manual.

Framing the Issues

A key concern set forth in the Issue Paper is certain financial instruments that are believed to be “constructed by or for a small group of investors, which, due to their private nature, are perceived as not subject to or constrained by market forces and competition.” The Issue Paper further states that the visible characteristics of the financial instrument may substantially underrepresent actual risks.⁵ As the observations and proposal are considered, it is important to frame these issues so as to ensure neutrality of the discussions, and to recognize the legitimate role of CRPs and the Filing Exempt process.

Neutrality

We encourage the Task Force to begin this discussion from a position of neutrality – i.e., avoid a presumption that all securities identified by the SVO as “bespoke” are guilty until proven innocent. The business goals associated with many of the securities identified by the SVO as “bespoke” are legitimate and related to insurance company and market needs, rather than an industry-wide attempt to achieve advantageous risk-based capital treatment inconsistent with securities’ true risks. Each insurance company is ultimately unique, with different products and risks. Working with asset managers to design investment products that meet insurance company asset-liability matching, cash flow matching, and risk appetites is a positive, appropriate, and necessary goal for industry. Additionally, effective asset-liability matching contributes to keeping insurers resilient under stress. Furthermore, in many cases, a security characterized as “bespoke” may be negotiated with a counterparty in order to provide that counterparty with a desired financing option and to provide the insurance company with an appropriately structured asset and a suitable risk-based return. Even if a single insurance company purchases the entire issue, such a security is subject to market requirements and demands resulting from arm’s length negotiations.

Similarly, we would ask the Task Force to discuss security characteristics not as “red flags,” but rather as “review factors” or “investment characteristics.” This more neutral terminology emphasizes that regulatory review can include examination of those features, without implying an automatic conclusion that any particular investment feature is per se problematic.

Recognizing the Legitimate Role of CRPs, Filing Exemptions, and Private Letter Ratings

While acknowledging the identified regulatory concerns, it should also be acknowledged that the Filing Exempt process is critical to insurers, and to the capital markets more broadly, for a variety of reasons:

- A) Industry estimates that there are thousands of privately rated securities currently held by insurers.⁶ The SVO does not currently have the resources necessary to review each of these securities in a timely fashion.

⁵ The Issue Paper suggests the following reasons for why these securities may underrepresent risk: a) These securities are usually not broadly syndicated (i.e. not owned by many parties); (b) They are created by or for one or a few related insurance companies as an investment; (c) They are assigned a credit rating by only one NAIC CRP, often via a private rating; and (d) Participants often deliberately keep the terms and structure private.

⁶ A sampling of six ACLI member companies yielded over 1,900 unique privately rated securities.

B) In certain industries or asset classes, CRP analysts have specialized expertise to underwrite difficult or unique structures or credit risks as a result of larger staffing models and access to resources such as conferences and industry specialists. The regulatory objectives of the Task Force would be more effectively and efficiently served by directing SVO efforts toward enhancing insights to better leverage CRP expertise, as opposed to expanding the scope of the SVO's authority or resources - which would result in duplication of CRP services recognized as legitimate by the broader capital markets and various regulatory oversight bodies.

C) External ratings and filing exemption provide insurers with reasonable certainty into how a security will be treated under RBC. Insurers can look to the rating assigned by a CRP and estimate how much capital they would typically be required to hold, per the pre-defined rules for translating from a CRP rating to an equivalent NAIC designation. This ability to reasonably rely on a CRP rating provides critical clarity for insurers in evaluating potential transactions, serving as a mechanism for pricing in target levels of capital efficiency (e.g. an NAIC 1 or 2 designation) with reasonable assurance. It is critical to acknowledge the meaningful implications for the economics of holding a given security; including the real cost to holding capital, future investment decisions, value in the secondary market, and disruption in the broader capital markets.

Empirical evidence suggests the NAIC's Regulatory Treatment Analysis Service ("RTAS") process cannot be expected to sufficiently meet insurers' and capital markets' needs on a broad scale. The process has not historically exhibited the speed, agility or predictability necessitated by market dynamics. Once a potential issuer decides to bring a debt private placement to market there is a natural urgency to move as efficiently as possible, with the entire process from green light to commitment typically completed within 5 to 6 weeks. Rating agencies have developed the agility to accommodate these expediciencies, whereas the RTAS process - which is of uncertain length and often takes months to complete - simply has not. As a result, the RTAS process is largely perceived as incongruent with the efficient functioning of the market as its use might reasonably be expected to inhibit the ability of issuers or investors to seize opportunities near their apogee. Furthermore, many investment bankers and insurers find the \$15,750 - \$25,000 fee associated with an RTAS request to be a material impediment, especially knowing that an RTAS designation represents only a preliminary indication of how the SVO might assign a designation. For these reasons, the current RTAS process is likely to be used only rarely. However, insurers still need a process that can provide ratings and capital charge certainty around a variety of securities that, historically, the SVO has not had deep experience in underwriting; making it difficult to imagine a scenario where the filing exempt process or the role of CRPs could feasibly be supplanted.

While the SVO should understand and review the CRPs' ratings processes in order to ensure that the CRPs' assessments of risk are robust and thoughtful, the process should not discount a material subset of CRP ratings altogether (e.g. securities with private letter ratings or single-CRP ratings) or point toward the SVO assuming those risk assessment responsibilities in-house. CRPs serve a critical function in providing independent ratings analysis and risk assessment in an efficient way to the insurance industry and the broader capital markets.

Analysis of the Issue Paper's "Red Flags"

The Issue Paper's identification of "red flags" does not acknowledge the volume of securities that would trigger these review factors but are not inherently suspect investments carrying greater, let alone mischaracterized, risk. There are thousands of securities with single CRP ratings; many of which are "plain-vanilla" securities not exhibiting any risks related to how they are rated by a CRP other than those typical of any debt security. Practically speaking, as most insurers do not subscribe to all rating agencies, it is unknown to most insurers which securities are truly rated by only one CRP, and the SVO is already in the optimal position to leverage their systems in establishing the population of such positions in order to more efficiently drill down into the subset thereof with greater potential for representing legitimate analytical concerns. As outlined later in this letter, under our proposed next steps, the SVO would be granted authority to obtain additional information regarding securities rated by a single CRP. The information transparency and consistency created by our principles will put all securities on a level playing field.

With regard to instances where *"assets backing the security were primarily owned by the insurer or affiliates before the transaction and reported differently (i.e. regulatory arbitrage⁷)"* or *"assets backing the security do not generate bond-like cash flows (i.e. contractual requirements to pay periodic principal and interest)"*, the assessment of accounting classification and measurement – including consideration of whether sale accounting was achieved in compliance with SSAP No. 103R, whether a transaction is compliant with economic substance and arm's length conventions under SSAP No. 25, or the structural characteristics that establish statutory classification as a bond or otherwise – should be deliberated and arbitrated by the Statutory Accounting Principles Working Group ("SAPWG") in accordance with NAIC policy⁸. With regard to the assignment of valid NAIC designations, neither of these characteristics, by themselves, should be presumed indicative of CRP ratings that mischaracterize or understate credit or other non-payment risk. The SAPWG and NAIC staff continue to work with industry on comprehensive revisions to SSAP 43R – *Loan-backed and Structured Securities*. This work-stream acknowledges that securities not generating bond-like cash flows present a regulatory consideration with regard to classification and is comprehensively addressing regulator concerns. The effort is progressing toward outcomes that will provide valuable direction and access to information which will help focus SVO efforts to identify and assess specific areas of concern regarding assessment of credit risk and propose regulatory responses to the Task Force, and also to raise perceived classification issues for referral to SAPWG.

In instances where the *"insurer or affiliated group are sole investors in a security"*, if the borrower is an unrelated third party, the transaction is subject to normal competitive and market forces including arm's length negotiations between willing and objectively incentivized counterparties aware of the relevant facts and circumstances; albeit that the investing insurer(s) may be in a better position to directly negotiate covenants and/or protections that further mitigate risks in a contractual and transparent manner. Again, this characteristic by itself does not incentivize or facilitate CRP ratings that mischaracterize or understate credit or other non-payment risk. Note: if the borrower qualifies as a

⁷ In this instance, our use of the term "regulatory arbitrage" is intended to apply solely to instances where a company applies sale accounting to a transfer of assets that does not meet the criteria established under statutory accounting guidance.

⁸ The NAIC Policy Statement on Coordination of the Accounting Practices and Procedures Manual and the Purposes and Procedures Manual of the NAIC Investment Analysis Office emphasize the separate roles of classification and assessment of credit risk and the position of the AP&P Manual as the "highest level of authoritative guidance."

subsidiary, controlled or affiliated (“SCA”) entity, existing guidance in the P&P Manual already stipulates the transaction is ineligible for filing exemption and can only be assigned an NAIC designation by the SVO.

Regarding transactions where an “*affiliate of the company is underwriter or sponsor of the security*”, there are numerous legitimate and appropriate reasons for insurers to participate, and again, this characteristic by itself should not be cast as an unequivocal indication of a CRP rating mischaracterizing or understating credit or other non-payment risk. Competitive and market forces remain relevant, as is particularly self-evident in instances where there are other third-party investors. Additionally, the insurer is in a better position to negotiate from an affiliate, covenants or protections that might not be fully achievable with a third party – allowing for further assurances that these investments are prudent and appropriate for backing policyholder obligations. Affiliated party securitizations may also provide a real benefit to the insurer that has nothing to do with regulatory capital requirements (e.g., certain securitizations require assets to be warehoused prior to the securitization being effectuated, or can materially improve the liquidity of such assets, or owning a percentage of the tranches issued in a securitization may fulfill the 5% risk retention requirement that is required of certain sponsors of securitizations).

Practical Approach to Addressing the Information Gap

The fundamental stated concern is an information gap surrounding certain securities and the ability of the SVO to act on identified issues. We want to contribute to eliminating such gap and establish a path for regulatory response to identified concerns. We believe those goals can be achieved by centering the discussion on four principles: *Transparency; Effective Regulatory Response; Practical Implementation; and Avoiding Market Disruption*.

Transparency

Insurers could file CRP private ratings letters for existing securities on a one-time basis, and annually thereafter for securities not already included on an electronic feed. Going forward, private rating letters could be filed at acquisition for new purchases of privately rated securities. Insurers could also file supporting CRP ratings rationales (if separate from the private ratings letters), to the extent available, for existing and newly acquired privately rated securities on a one-time basis.⁹

The SVO would also be authorized to request that an insurer file the underlying legal agreements, other supporting transaction documentation, and financial statements for such privately rated securities. Furthermore, most CRPs publish their ratings methodologies, so some transparency into how ratings are determined already exists.

Following the above principles would make available to the SVO, and to the Task Force, consistent information across all privately rated and publicly rated securities. The SVO, one way or another, would have access to additional ratings information regarding securities that display the characteristics outlined in the Issue Paper, which will enhance the SVO’s ability to verify (but not re-underwrite) the purpose and process related to industry’s use of ratings from CRPs. The resulting transparency will

⁹ Since the SVO already has meaningful access to a variety of information on publicly rated securities, no additional filings for public bonds and 144A securities would be contemplated.

also augment the SVO's efficacy as the "eyes and ears" of the Task Force regarding oversight of credit risk depictions in statutory filings, and equip the SVO to elevate perceived classification issues for referral to SAPWG.

Effective regulatory response

Based on this information, the SVO would analyze trends and bring thematic concerns¹⁰ to the Task Force regarding CRP ratings, or any other concerns with a class of securities as a result of its review of the information. The SVO could then request insurers provide any additional information needed to the SVO and the Task Force for analysis.

The Task Force would provide transparent procedures with appropriate due process in fulfilling its mission of establishing and maintaining all aspects of the NAIC's credit assessment process for insurer-owned securities.¹¹ The Task Force would retain the authority to make policy decisions regarding the assessment of risk of a given class of securities, with the SVO as its advisor, and the SVO would then implement those decisions. Any changes to NAIC designation methodology, after vetting with the Task Force, would be applied prospectively, with sufficient transition measures, so as to not penalize companies that have complied with the existing rules, and to avoid market disruption. The SVO would not be granted analytical discretion with regard to the existing NAIC designations on any previously filed or filing exempt security beyond that already afforded by the documentation in the P&P Manual, as approved by the Task Force.

To be clear, the purpose of this initiative is to provide sufficient transparency so that the SVO can review the CRPs' ratings processes and rationale and raise items of thematic concern to the Task Force, but it would not grant the SVO the power to overturn individual CRP ratings. These principles also would continue to recognize the SVO's existing authority to communicate any perceived abuses or transactions created solely for risk-based capital arbitrage to the Task Force or SAPWG, and to a filer's applicable domestic regulator for prompt resolution.

Implementation that is practical

We encourage the Task Force to focus on logistics, achievability, and ensuring that existing tools are fully utilized. As outlined above, the literal application of the framework in the Issue Paper would require thousands of securities to be filed, reviewed, and potentially re-rated by the SVO. This sweeping exercise would be costly to industry, put significant strain on resources, and in the case of most of those securities, not meet any of the areas of concern identified. Further, this framework would significantly supplant the CRPs' current role, negating their existing essential resources, specialization, and modeling.

¹⁰ Thematic concerns address regulatory issues of general applicability, rather than individualized determinations on a particular security.

¹¹ Task Force's ongoing charges include "[c]onsider[ing] whether improvements should be suggested to the measurement, reporting and evaluation of invested assets by the NAIC as the result of: 1) newly identified types of invested assets; 2) newly identified investment risks within existing invested asset types; or 3) elevated concerns regarding previously identified investment risks."

Given the number of private letter ratings in the market, the Task Force may want to consider limiting the scope of privately rated securities that are required to be filed. We would encourage the Task Force to take into consideration the cost of making those filings and the means by which true regulatory concerns can be most efficiently addressed during what are already trying times for insurance entities. Given the value to the SVO and the Task Force of gaining additional insight via access to the private letter rating information outlined above, we propose that all such filings, as well as any review and analysis on the part of the SVO, should be done with no associated fees charged to the filing insurance companies. This agreement will help calibrate our joint efforts to refine the population of securities subjected to additional scrutiny to only those most likely to exhibit vulnerability to mischaracterization of risk in CRP ratings. One way to refine the population would be to require insurers to file only those private letter ratings that also trigger one of the other “red flags” from the Issue Paper (excluding the single CRP rating flag, which is redundant in this instance). Industry stands ready to assist the SVO and the Task Force in identifying and refining this population.

Additional opportunity for right sizing the scope of private letter ratings to be filed could be gained by further consideration (through the lens of the Task Force’s objectives) of how many years back to reach on previously rated securities. While some set of past information will be helpful to the initial analysis, given the practical realities that documents may be difficult to obtain for investments already in the market for several years, and that the passage of time disproportionately decreases the likelihood that practices employed in the past remain representative of themes potentially meriting Task Force consideration today (or on a forward-looking basis), a common sense “look back” cut-off would facilitate more effective deployment of resources for both for the SVO and insurers. Practical issues, including resource strain, with identifying relevant themes and gathering relevant information in the absence of such a cut-off should be scrutinized carefully for potentially diminishing alignment with the present priorities of the Task Force.

Over time, as industry, the SVO and the Task Force collaborate in examining populations of potential heightened risk, we anticipate that collective perspectives on risk-indicative characteristics, and therefore the attendant requirements for filing, will evolve and assist in further refinements to ensure information captured is responsive to the identified regulatory concerns. After the SVO has received the private letter rating information outlined above, we would suggest additional dialogue among the Task Force, the SVO and industry to narrow what information is filed with the SVO on an ongoing basis.

Industry recognizes (and asks the NAIC to recognize) certain challenges in producing ratings analyses from the CRPs, including potentially revising confidentiality provisions in CRP engagement letters and working with CRPs to prepare detailed ratings reports for deals for which such reports have not previously been commissioned. It may take time to alter CRP confidentiality arrangements to permit insurers to share their full ratings rationales with the SVO. Additionally, obtaining detailed ratings reports may require a significant investment of insurer time and money. However, industry commits to work in good faith with the SVO and the CRPs, encouraging CRPs to make the changes necessary to share full ratings rationales going forward in order to facilitate transparency and to help fill the information gap. We would just note that we expect this process to take time. For example, it took almost two years for all CRPs to amend their confidentiality agreements with borrowers in order to allow sharing of the private ratings letters themselves and to submit private ratings electronically via ratings feeds.

An approach that avoids market disruption

Market stability and certainty also matter and should be part of the evaluation of any proposal to change the valuation process, as well as considered in designing the implementation of those changes. Insurers have been relying on CRP ratings for many years, as those ratings are key in obtaining clarity on reserving the appropriate level of capital for an insurance company, and therefore, form a critical part of an insurer's investment decision making process. We therefore urge the Task Force to exercise its usual careful and deliberate process when making decisions regarding the Filing Exempt process. If there are questions or concerns regarding ratings on a specific investment type after a process is finalized, those concerns need to be discussed in an open forum, allowing industry the opportunity to provide information on such investments and support for why the ratings are reasonable. Any changes to ratings need to be done very carefully, so markets are not disrupted, and insurers have enough time to react and make decisions in the best interest of policyholders.

When coupled with other recent and ongoing regulatory initiatives, developing these principles into a regulatory framework will provide the SVO with the information needed to address the regulatory concerns outlined in the Issue Paper, without causing a significant disruption to the markets, adding significant transactional costs to the industry, or creating an undue administrative burden on NAIC resources.

We look forward to working with the Task Force and the SVO to refine and implement a solution that achieves those goals.

Sincerely,



Mike Monahan
American Council of Life Insurer

Tracey Lindsey

Tracey Lindsey
NASVA

John Petchler

John Petchler
on behalf of PPIA Board of Directors

cc: Charles Therriault, Director, Securities Valuation Office



Stephen W. Broadie
Vice President, Financial & Counsel

August 17, 2020

Mr. Kevin Fry
Chair, NAIC Valuation of Securities (E) Task Force
Illinois Department of Insurance
320 W. Washington St., 4th Floor
Springfield, IL 62767-0001

Re: IAO Staff Concerns about Bespoke Securities, and Reliance on CRP Ratings

Dear Mr. Fry:

The American Property Casualty Insurance Association (APCIA) appreciates the opportunity to comment to the Valuation of Securities (E) Task Force on the exposed Issue Paper regarding IAO staff concerns about bespoke securities and reliance on CRP ratings. APCIA is the primary national trade association for home, auto, and business insurers. The association promotes and protects the viability of private competition for the benefit of consumers and insurers, with a legacy dating back 150 years. APCIA members represent all sizes, structures, and regions—protecting families, communities, and businesses in the U.S. and across the globe.

APCIA urges the Task Force to consider this far-reaching proposal very carefully, and in so doing we strongly endorse the joint comments of the American Council of Life Insurers, the Private Placement Investors Association, and the North American Securities Valuation Association. We are particularly concerned with the Issue Paper's proposed limitations on the "filing exempt" (FE) process for securities rated by an NAIC Credit Rating Provider (CRP). Regulators and industry alike have benefitted greatly over the years from the ability to leverage the far-greater resources of CRPs for credit analysis of most securities. The Issue Paper's proposal that "at least two independent CRP ratings would be required for any NAIC designation to be derived from CRP ratings" (emphasis added) would, in our opinion, fatally damage the FE process.

We look forward to working with the Task Force and Securities Valuation Office staff as the Task Force considers the issues raised in the Issue Paper.

Sincerely,

A handwritten signature in black ink, appearing to read "Step W Broadie", is written over a light blue horizontal line.

Stephen W. Broadie



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

DATE: 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.

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 judgement 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 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

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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, 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.

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**

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| PL SECURITIES |
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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 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 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 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.
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 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 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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