AGENDA

1. Discuss Comments Received and Consider for Adoption an Updated Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Require the Filing of Private Rating Letter Rationale Report (Doc. ID 2020-023.05, 2020-023.06) — Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)

2. Receive and Consider for Adoption a Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Permit Filing Exemption for Credit Tenant Loans and Ground Lease Financing Transactions (Doc. ID 2021-035.01) — Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)

3. Discuss the SVO Referral Response to SAPWG on Credit Tenant Loans — Charles Therriault (NAIC), Marc Perlman (NAIC)

4. Any other matters
MEMORANDUM

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

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

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


DATE: April 9, 2021

1. Summary – The IAO staff discussed with the Task Force at its May 14, 2020 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 concerns.

   On Oct. 23, 2020 the Financial Condition (E) Committee directed the Task Force to include a new charge for 2021; specifically, to, “implement policies to oversee the NAIC’s staff administration of rating agency ratings used in NAIC processes, including, staff’s discretion over the applicability of their use in its administration of Filing Exemption.”

   In furtherance of the proposed new Task Force charge and the Task Force’s request for incremental recommendations, the SVO proposes taking a first step towards implementation of some of its recommendations in its memo by increasing SVO scrutiny of PL securities, many of which are bespoke securities.

   At the Task Force meeting on Nov. 14, 2020 the Task Force directed the SVO to make updates to the proposed amendment to have the Private Rating Letter Rationale Reports filed with the SVO but without the SVO’s discretion over evaluating the appropriateness of the rating or methodology utilized, at least at this time. The SVO still recommends that it be granted this oversight authority and will be scheduling a regulator-only call in 2021 to review with the Task Force PLR transactions which appear to be either ineligible for filing exemption, ineligible for Schedule D reporting and/or where there is a material difference in opinion as to the risk.

   At the Task Force meetings on Feb. 18 and Mar. 22, 2021, the Task Force directed the SVO to make additional updates related to transition language to provide an option to companies that cannot provide the ratings rationale due to confidentiality or contractual reasons, and disclosures in NAIC systems as to why something was ineligible. There was also a discussion during the March meeting regarding the expected content of the private rating letter rationale reports. The SVO advised the Task Force at that meeting that rating agencies are in the business of publishing credit analysis opinions and should be very familiar with what they typically publish publicly for a specific asset type. Private ratings are supposed to be determined through the same methodologies as public ratings, the SVO stated that it is expecting a report comparable to what the rating agency would publish in its public reports for that asset type.
2. **Recommendation for oversight of PL Securities** – In its bespoke securities memo the SVO described its concern that its lack of authority to use its judgment in determining whether a CRP rating is useful for NAIC purposes (meaning its rating methodology may not be appropriate for, or consistent with, the assessment of investment risk for statutory purposes) has fed an increase in the use of bespoke securities, many of which are assigned NAIC designations through the Filing Exempt (FE) process, which includes the private letter rating process. To begin to address this lack of meaningful oversight of CRP ratings, the SVO proposes, as it did in its memo, that securities assigned private letter ratings be submitted to it for review. Understanding the many CRP private rating letters include little or no analysis beyond the assigned private rating, the SVO recommends that for a PL security to receive an NAIC Designation the SVO must receive, along with the private rating letter, a related private rating letter rationale report providing more in-depth analysis of the transaction, the methodology used to arrive at the private rating, and, as appropriate, discussion of the transaction’s credit, legal and operational risks and mitigants. With both the private rating letter and the private rating letter rationale report the SVO would be able to determine (i) whether the private credit rating is an Eligible NAIC CRP Rating, meaning the security type is eligible to be reported on Schedule D and that it is appropriate for and NRSRO credit rating to be used to determine the regulatory treatment of the security, and (ii) whether the SVO agrees with the private credit rating.

The SVO still recommends that it have full discretion, based on its reasonable review of the private rating letter and the supporting rationale report, to assign an NAIC designation equivalent to the CRP PLR, to require the security to be filed for review or, to decline to assign any NAIC designation. The Task Force has decided to defer its decision on this aspect of the recommendation.

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 (additions underlined and deletions with strikethrough) shows the proposed Purposes and Procedures Manual revisions and reflects all subsequent updates.
PART ONE
POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE
FILING EXEMPTIONS

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

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

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PL SECURITIES

Effective Date of Verification Procedure for PL Securities

9. Effective January 1, 2022, for each PL security received by the SVO, either through a copy of a private rating letter or in a CRP credit rating feed (except for “deferred submission PLR securities” and “waived submission PLR securities,” each as defined below), 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. For deferred submission PLR securities the effective date for submission of the private rating letter rationale report is January 1, 2024 and for waived submission PLR securities, the private rating letter rationale report need not be submitted to the SVO so long as an insurance company is prevented from doing so due to confidentiality or contractual reasons.

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 developed for this purpose (i.e., a PLGI security).
12. For (a) PL Securities issued from January 1, 2018 to December 31, 2021 subject to a confidentiality agreement executed prior to January 1, 2022, which confidentiality agreement remains in force, for which an insurance company cannot provide a copy of a private rating letter rationale report to the SVO due to confidentiality or other contractual reasons (“waived submission PLR securities”), the insurer may report such securities on such securities’ General Interrogatory (i.e., a PLGI security), and (b) PL Securities issued after January 1, 2022, for which an insurance company cannot provide a copy of a private rating letter rationale report to the SVO due to confidentiality or other contractual reasons (“deferred submission PLR securities”) the insurer may report such securities on such securities’ General Interrogatory (i.e., a PLGI security) until and including December 31, 2023, after which time, if the insurance company still cannot provide a copy of a private rating letter rationale report for whatever reason, the securities can be reported with an NAIC 5GI Designation in accordance with the guidance specified below.

Definitions

13. 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. A private rating letter rationale report should mirror the work product that a CRP would produce for a similar publicly rated security.
Conditions to Filing Exemption for PL Securities Issued on or After January 1, 2018

14. 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 (except for delayed submission PLR securities and waived submission PLR securities), and the SVO deems the privately rated security eligible to receive an NAIC Designation with an NAIC CRP Credit Rating.

15. 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 (except for delayed submission PLR securities and waived submission PLR securities); 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.

16. 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

17. 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

18. 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

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

The PL Process

20. 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

21. 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 (so long as such rationale update would normally be produced by the CRP for a comparable publicly rated security) 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 the SVO deems the privately rated security eligible to receive an NAIC Designation with an NAIC CRP Credit Rating.

In instances where a private letter and private rating letter rationale report is filed, the SVO shall evaluate the private letter and private rating letter rationale report to determine whether the security has been assigned an Eligible NAIC CRP Rating and if the privately rated security is eligible to receive an NAIC Designation with a NAIC CRP Credit Rating. Similar to public securities where a rating is received directly from the CRP via electronic feeds, there is a similar assumption for the PL security, that the rating meets the definition of an Eligible NAIC CRP Rating as a normal part of the CRP rating process, absent evidence to the contrary in the rating letter or private rating letter rationale report (e.g., evidence that the rating applies only to principal or interest, in a deviation from the normal CRP rating process).

If the SVO verifies that the security has been assigned an Eligible NAIC CRP Rating and if the SVO 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.

22. 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
• 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.

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

23. 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 (a) 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, (b) for private letter ratings issued on or after January 1, 2022, an insurance company does not provide a copy of a private rating letter rationale report to the SVO for which there are no confidentiality or contractual limitations or (c) for deferred submission PLR securities, if the insurance company does not submit the private rating letter rationale report to the SVO on or after January 1, 2024.
May 6, 2021

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

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


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 (collectively, the “undersigned”) appreciate the opportunity to comment on the above-referenced proposed amendment to the P&P Manual. We continue to appreciate the SVO’s willingness to meet with industry and have open, meaningful, and collaborative dialogue on complex and important changes, while also being responsive to practical constraints that, if left unaddressed, would potentially needlessly disrupt important markets.

The undersigned support the proposed amendment to the P&P Manual and remain committed to full transparency surrounding securities currently benefiting from private letter ratings. We believe this

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

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

3 The North American Securities Valuation Association (“NASVA”) is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC’s ISIS electronic security filing system, and commenting on year-end processes. Find more information here.
transparency is important and will give regulators greater insight, via the SVO, regarding securities (and the related rating methodologies) with private letter ratings.

The approach taken, as laid out in the exposure, is also accommodating to practical constraints on immediately obtaining all rating rationale reports, and therefore will minimize disruption to the private placement market. The private placement market is extremely important to insurance companies, and therefore, both policyowners and regulators, as private placement bonds consistently outperform the public market.

We continue to look forward to working with the SVO and regulators on this very important topic and continue to be fully committed to transparency, as it pertains to both industry and the SVO, regarding the securities deemed appropriate for Schedule D bond treatment as well as the ratings and designations applied.

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We thank the SVO, and regulators, for their continued dialogue on these and other important issues. We continue to stand ready and offer our assistance and input as needed.

Sincerely,

Tracey Lindsey

John Petchler

Mike Monahan
American Council of Life Insurer

cc: Charles Therriault, Director, Securities Valuation Office
TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

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

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

RE: Filing Exemption for Credit Tenant Loan and Ground Lease Financing Transactions

DATE: May 1, 2021

Summary – The SVO staff was requested to draft the attached amendment to permit Credit Tenant Loan and Ground Lease Financing Transactions to use NAIC Credit Rating Provider ratings in the Filing Exemption process and update the residual asset exposure from the current 5% limitation to 50%. If these transactions have greater than a 50% residual asset exposure they would be ineligible for Filing Exemption.

Analytical Considerations – CTLs are a type of commercial real estate financing secured by one or more properties leased to a credit tenant. Traditional CTL structures are unique in that the credit risk is based solely upon the lessee’s credit worthiness instead of the value of the real estate collateral. Pursuant to the lease terms of a CTL, the credit tenant is obligated to make rent payments regardless of casualty or condemnation and assumes responsibility for all operating, maintenance, and insurance expenses and real estate taxes with no lease "outs" (ways to avoid making lease or associated payments). Any obligations retained by the landlord, such as payment of maintenance, must be addressed though insurance or another acceptable mitigant. These traditional CTLs are structured so that lease payments are available to timely pay the debt service, including the full amortization of the principal, along with all other costs related to the property. The investors benefit from a security interest in the real estate collateral but this protection only serves to benefit the noteholders if the lessee defaults on rent leading to a default on note payments.

The current Purposes and Procedures Manual of the Investment Analysis Office (the P&P) guidance permits balloon payments in CTL transactions of up to 5% of the original loan balance which do not correspond to a lease payment. This balloon amount can be greater so long as the risk is appropriately mitigated through residual value insurance or another mitigant. Since the final lease payment will not cover the balloon payment owed under the note, balloon payments are dependent on the proceeds from the landlord’s re-financing of the property or, failing that, its sale. Balloon payments therefore expose the noteholder to the residual value of the property and the risk that it might not be sufficient to cover the remaining balance of the note.
The value ascribed to real estate collateral is often called its “dark value.” Dark value is estimated from the possible future re-leasing of the commercial property and includes lump-sum charges for lost rent, re-tenanting costs, brokerage costs, brokerage fees, unreimbursed maintenance, and other holding-period or re-leasing expenses. However, with each percent increase in balloon payment size there is a lockstep increase in the residual exposure to the property’s dark value and the ability to re-lease the asset at a sufficient rate.

The SVO can assess the risk of, and assign NAIC Designations to, transactions with any level of residual exposure that the Task Force approves, from 0% to 100%. The shift in risk from the lessee’s credit worthiness to the collateral asset’s value can apply to any security backed by leased assets if repayment of the loan is dependent in part on the future re-leasing or sale of the asset. 50% residual exposure to the underlying collateral means that at maturity the noteholder’s risk of repayment of the remaining outstanding half of its principal is directly tied to the value of the underlying real estate and the ability to re-finance and re-lease it at a sufficient rate. (If held directly, a mortgage loan on real estate is reported on Schedule B.) The SVO staff believes there is substantially less risk to investors when the residual asset exposure is limited. It has been stated that the performance of CTLs through times of economic distress has been strong. However, until now all CTLs filed with the SVO have been conforming CTLs with minimal residual exposure. We do not know how a CTL with a larger residual exposure would perform should the balloon payment come due and the property need to be re-leased or sold in a year when commercial real estate values are suppressed.

The SVO staff has observed very different treatment by rating agencies of the valuation and refinancing or liquidation risk presented by exposure to the residual asset. Some rating agencies notch downward significantly from the rating of the lessee when there is substantial lease renewal and refinancing risk associated with the repayment of principal, while others notch up based on the property valuation. These methodology differences have led to valuation difference of greater than 30-40%, which significantly impact loan-to-values ratios, one metric of the residual asset’s risk, and rating assignment differences can be as large as of 5 or more notches. It is the SVO staff’s opinion that these rating methodology inconsistencies should be addressed.

**Proposed Amendment** - The text impacting Credit Tenant Loan and Ground Lease Financing Transactions is shown below, addition edits in red underline and deletions in red strikethrough, as it would appear in the 2020 P&P Manual format.
PART ONE

POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE
Credit Tenant Loans

... Presumption of Eligibility

106. Transactions that meet the definition and legal and structural characteristics for one of the four CTL categories may shall be submitted to the SVO for evaluation on the appropriate CTL Evaluation Form if the outstanding principal balance at the end of the lease term does not exceed 50% of the original CTL loan balance and shall be presumed eligible for Filing Exemption if assigned an Eligible NAIC CRP Rating. Transactions that meet the definition and legal and structural characteristics for one of the four CTL categories but with an outstanding principal balance at the end of the lease term exceeding 50% of the original loan balance must be filed with the SVO with all required documentation. From the perspective of an insurance company lender, a transaction that on its face meets the criteria of a particular CTL category is entitled to a presumption of Schedule D eligibility, subject to a determination by the SVO that the transaction is not appropriate for Schedule D reporting.

NOTE: See “Credit Tenant Loans” in Part Three for filing instructions, documentation requirements and methodology applicable to CTLs.

...
PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS
Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:

- **Credit Tenant Loan (CTL)** – A CTL is a mortgage loan made primarily in reliance on the credit standing of a major tenant, structured with an assignment of the rental payments to the lender with real property pledged as collateral in the form of a first lien. This Manual identifies four categories of CTLs as eligible for reporting on Schedule D conditioned on an SVO determination that the transaction meets the criteria specified by the VOS/TF for Schedule D treatment in this Manual to receive an NAIC Designation. A transaction that purports to be a Credit Tenant Loan but for an outstanding principal balance at the end of the lease term that exceeds 50% of the original loan balance, including one that is assigned a credit rating by an NAIC CRP, is not eligible for filing exemption for Schedule D reporting unless the SVO confirms that the transaction is eligible for Schedule D reporting and assigns the transaction an NAIC Designation. The CTL section in this Part provides further guidance on how the SVO analyzes CTL transactions for purposes of determining whether the SVO can assign an NAIC Designation.
- **Ground Lease Financing Transactions** – A Ground Lease Financing (GLF) transaction typically has two components: (a) a ground lease for a long period (e.g., 99 years) between a ground lessor who owns the land and a ground lessee who attains a leasehold for the purpose of developing the land; and (b) the subleasing of space or operation of a business such as a hotel, warehouse, intermodal facility, etc., in an existing or to-be-constructed building to one or more tenants (space tenants) under shorter (e.g., 5–15 year) leases (space leases) or to the operator of a business such as a hotel, warehouse, intermodal facility, etc., under a franchise agreement or other arrangement. GLF transactions with an outstanding principal balance at the end of the ground lease term that exceeds 50% of the original loan balance, including those that are assigned a credit rating by an NAIC CRP, are not eligible for filing exemption. The GLF section in this Part provides further guidance on how the SVO analyzes GLF transactions for purposes of determining Schedule D eligibility and whether the SVO can assign an NAIC Designation.

...
CREDIT TENANT LOANS

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● **Loan Term Exceeds Initial Lease Term** – (a) Difference shall not exceed six months; and (b) Remaining principal shall not exceed 50% of original loan balance.

### ACCEPTABLE CTL VARIANTS

#### Guidelines for Acceptable CTL Variants

97. Transactions that exhibit the following variations from the definitions of Bond Lease or Credit Lease Based CTL contained above will nevertheless be eligible for assignment of an NAIC Designation Schedule D treatment in accordance with these guidelines and the definitions if the following standards are met:

- Transactions where lease payments are insufficient to cover required debt service. The shortfall would be covered fully by credit enhancement, cash escrow, excess rent set-asides, or sufficient property value.
- Transactions with balloon payments in excess of 50% for Credit Lease Based CTLs if lease payments or credit enhancement fund the balloon. The SVO will assess the extent to which the payment stream, whether provided by the lease or credit enhancement, covers the balloon payment.
- Transactions where the tenant may terminate the lease despite the fact that the amount due under the lease is greater than 5% of the original loan amount, less the balloon payment due at maturity, if applicable. The tenant shall not terminate the lease without first paying off the loan amount, less, if applicable, the balloon payment due at maturity, or extending the term of the lease to a term sufficient to amortize the remaining balance of debt.

### MULTIPLE PROPERTY TRANSACTIONS (MPTs)

#### Acceptable CTL Variants Eligible for MPT Treatment

101. The following Acceptable CTL Variants will be acceptable for Credit Lease Based MPT CTLs:

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 Transactions where the tenant may terminate the lease, despite the fact that the amount due under the lease is greater than 5% of the original loan amount, less the balloon payment due at maturity, if applicable. The tenant may not terminate the lease without first paying off the loan amount, less, if applicable, the balloon payment due at maturity, or extending the term of the lease to a term sufficient to amortize the remaining balance of debt.
GROUND LEASE FINANCING TRANSACTIONS

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ANALYSIS AND SPECIFIC CONSIDERATIONS

SVO Approach to GLF Transactions

110. All GLF transactions with an outstanding principal balance at the end of the ground lease term that exceeds 50% of the original loan balance, including those that are assigned a credit rating by an NAIC CRP, are ineligible for filing exemption and must be submitted to the SVO. The SVO will conduct GLF transaction review in the following manner:

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

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

CC: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force
Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Credit Tenant Loan referral from the Statutory Accounting Principles (E) Working Group

DATE: May 1, 2021

In this memorandum and the subsequent responses to the questions from the Working Group in its communication of Jan. 22, 2021, the SVO would like to reflect its continued strong support for this asset class and the re-assessment of the current 5% cap on balloon payments in credit tenant loan (CTL) transactions. We thought it was important to highlight some of the unique characteristics of these investments and the potential risks posed by greater reliance on the residual value of the underlying property and increased reliance on rating agencies.

Credit Tenant Loan Overview
CTLs are a type of commercial real estate financing secured by one or more properties leased to a credit tenant. CTL structures are unique in that the credit risk is based solely upon the lessee's credit worthiness instead of the value of the real estate collateral. Pursuant to the lease terms of a CTL, the credit tenant is obligated to make rent payments regardless of casualty or condemnation and assumes responsibility for all operating, maintenance, and insurance expenses and real estate taxes with no lease "outs" (ways to avoid making lease or associated payments). Any obligations retained by the landlord, such as payment of maintenance, must be addressed though insurance or another acceptable mitigant. Additionally, CTLs are structured so that lease payments are available to timely pay the debt service, including the full amortization of the principal, along with all other costs related to the property. The investors benefit from a security interest in the real estate collateral but this protection only serves to benefit the noteholders if the lessee defaults on rent leading to a default on note payments.

Balloon Payments
The current Purposes and Procedures Manual of the Investment Analysis Office (the P&P) guidance permits balloon payments in CTL transactions of up to 5% of the original loan balance which do not correspond to a lease payment. This balloon amount can be greater so long as the risk is appropriately mitigated through residual value insurance or another mitigant. Since the final lease payment will not cover the balloon payment owed under the note, balloon payments are dependent on the proceeds from
the landlord’s re-leasing of the property necessary for refinancing the debt or, failing that, its sale. Balloon payments therefore expose the noteholder to the residual value of the property and the risk that it might not be sufficient to cover the remaining balance of the note.

“Dark Value”
The value ascribed to real estate collateral is often called its “dark value.” Dark value is estimated from the possible future re-leasing of the commercial property and includes lump-sum charges for lost rent, re-tenanting costs, brokerage costs, brokerage fees, unreimbursed maintenance, and other holding-period or re-leasing expenses. The existing 5% limit of on balloon payments in the CTL guidelines minimizes the exposure to the real estate collateral’s dark value. However, with each percent increase in balloon payment size there is a lockstep increase in the residual exposure to the property’s dark value and the ability to re-lease the asset at a sufficient rate.

The SVO’s Opinion
The Working Group has asked the SVO whether it thinks it appropriate to revisit the 5% residual threshold in the CTL guidelines and, if so, to recommend an appropriate residual threshold. The SVO thinks the residual threshold should be revisited but we do not have a specific threshold to recommend. The SVO can assess the risk of, and assign NAIC Designations to, transactions with any level of residual exposure that the Working Group and Task Force approves, from 0% to 100%. The debt markets are awash in securities with repayment contingent on the re-leasing or liquidation of an asset and residual exposures at all levels, including greater than 100%. This shift in risk from the lessee's credit worthiness to the collateral asset's value can apply to any security backed by leased assets, whether they be railcars, aircraft, aircraft engines, vessels, shipping containers, etc., if repayment of the loan is dependent in part on the future re-leasing or sale of the asset. The appropriate residual threshold is really a question of what constitutes a bond for financial solvency, regulatory and statutory accounting purposes and, more specifically, what amount of residual exposure (i.e. direct exposure to an underlying asset at the end of an investment) should be permitted in insurance companies' debt investments. The SVO is not well positioned to answer with a specific threshold because its primary responsibility is credit assessment, which can performed on any level of residual risk, but would suggest the Working Group consider the financial effect to the investor of having to rely upon the future re-leasing of the property in order to refinance the debt or the sale of the asset for payment at maturity.

“Asset-Backed Securities” pursuant to Regulation AB
There have been recommendations for a 50% residual threshold based on the definition of “Asset-Backed Security” under the U.S. Securities and Exchange Commission’s (SEC) Regulation AB (17 CFR § 220.1101). Regulation AB dictates the disclosure and reporting requirements for publicly offered asset backed securities which, as defined in the regulation, includes non-auto lease backed securities with residual exposures up to, but not including, 50%, by dollar amount, of the securitized pool balance. The residual threshold drops to 20% if the securities are offered as part of a shelf registration. The regulation was intended to provide for better disclosure of asset level information and, by providing investors with timely and sufficient information, to reduce the likelihood of undue reliance on credit ratings. A security
with greater than 50% residual exposure could also be registered with the SEC but with different disclosure and reporting requirements. Likewise, a security with 49% residual exposure which meets the Regulation AB definition of “Asset-Backed Security” could be privately placed. Neither security would be subject to Regulation AB, but we would assert both are “asset-backed” securities. We make this point to demonstrate that the Regulation AB definition of Asset-Backed Security, while convenient, is not necessarily a compelling basis for determining a level of residual exposure compatible with NAIC’s regulatory objectives. According to the SEC’s 2004 proposing release for Regulation AB (SEC Release Nos. 33-8419; 34-49644) the SEC arrived at the 50% threshold “after reviewing residual value percentages for typical lease-backed securitizations.” The SEC’s disclosure regulations and regulatory objectives should not necessarily influence the NAIC’s regulatory financial solvency objective; one clear lesson from the Great Recession of 2007-2008 was that market convention and acceptance should not drive NAIC regulatory policy.

Rating Agencies
Markets will create any security an investor is willing to buy. Likewise, there is no limitation or restriction on what can be assigned a credit rating and one should never assume that because a security has a credit rating it is an appropriate investment for NAIC regulatory purposes. The SVO staff believes there is substantially less risk to investors when the residual asset exposure is limited. This is true for all securities that may have a residual asset exposure because there is far less transparency and consistency in assessing the risk of the residual asset, especially for small pools of non-commoditized assets like real estate. (We intentionally make the distinction between small pools of non-commoditized assets and large pools of commoditized assets, such as auto lease ABS, because it is possible to more accurately estimate cashflows for traditional asset backed securities, including the proceeds from the sale of the assets at the end of each lease, thereby more accurately mitigating residual asset risk.) The next few examples highlight the increase in variability and inconsistency in assessment of risk, even among rating agencies, for securities with large residual exposures.

The SVO staff has observed very different treatment by rating agencies of the valuation and refinancing or liquidation risk presented by exposure to the residual asset. Some rating agencies notch downward significantly from the rating of the lessee when there is substantial lease renewal and refinancing risk associated with the repayment of principal, while others notch up based on the property valuation. The assumptions and bases for property valuations, the biggest driver of risk when there is a large residual exposure, can vary significantly across the rating agencies. Some using capitalization rates, a key component of the valuation, in the 6.50-16.50% range depending upon the property type and location. Others do not provide stated capitalization rates in their methodology but apply rates in a lower narrower range of 6.00-7.50% in reports that we have seen leading to substantially higher valuations. These methodology difference have led to valuation difference of greater than 30-40% which significantly impact loan-to-values ratios.

One recent publicly rated (Nov. 2020) real estate lease backed transaction had a 76% residual exposure at maturity in 2035 for a facility leased by a U.S. government entity. The rating on the security was
notched downward five times to "A2" from the U.S. government's "AAA" rating and is now under ratings review for possible downgrade (Dec. 2020). Other rating agencies have taken the opposite approach and notched upward above the lessee's credit rating based on the collateral and the loan-to-value ratio, in some cases raising the transaction's credit rating two to five notches above the lessee's credit rating. For example, a non-conforming CTL transaction with a "BBB" rated large international company as tenant and a 37% residual exposure was rated "A+". In another transaction, the lessee was rated "BBB-" but the non-conforming CTL was rated "AA-" despite a 100% residual exposure. While these are only a few examples, they reflect the varied and highly inconsistent treatment of the risk of residual asset exposure and valuation across rating agency methodologies. It is the SVO staff's opinion that these methodology inconsistencies should be addressed if these securities are to be considered eligible for Filing Exemption. The ratings on other lease-backed securities may have similarly varied and inconsistent treatment but the SVO has not yet reviewed those security types in detail. We note that in the adopting release for revisions to Regulation AB in 2014 (Release Nos. 33-9638; 34-72982), the SEC, in referring to the financial crisis of 2007-2008, wrote, “The failures of credit ratings to accurately measure and account for the risks associated with certain asset-backed securities have been well documented,” and, “The collapse of these ‘investment-grade’ rated securities was a major contributor to the financial crisis, and demonstrated the risks to investors of unduly relying on these securities’ credit ratings without engaging in independent due diligence.”

Specifically, responding to the Working Group's questions, the SVO staff's responses are below:

• **Whether it is appropriate to revisit the 5% residual asset risk threshold as a restriction for conforming CTLs.**

The Task Force's adoption of the 5% residual asset risk threshold was generous under the CTL guidelines since it permits some exposure to the underlying real estate collateral in transactions assessed based on the credit worthiness of the lessee and allows them to be reported as a bond with comparable accounting and risk-based capital (RBC) treatment. Since the P&P guidance was adopted in the early 1990s, additional investment structures have been created to securitize lease payments for many types of assets well beyond the commercial real estate financing of CTLs and with residual asset exposure far in excess of 5%. In acknowledgment of the changes to the lease backed securities market since the CTL guidelines were adopted, the SVO recommends that the Working Group and Task Force re-consider the current 5% residual exposure threshold for CTLs and possibly for other lease-backed securities. As noted in several industry comments, CTLs have consistently performed well for insurers under the existing standards and the SVO believes that historical performance is directly related to the current structural framework, required mitigants and review process.

• **If applicable, a recommendation of an appropriate residual risk threshold.**
The SVO suggests limiting the residual asset risk exposure for CTLs and, possibly, for other lease-backed securities as well. As mentioned previously, as residual asset exposure increases, the security develops risk characteristics more like that of the underlying asset than that of an investment security making periodic payments of interest and principal. There are also separate reporting, statutory accounting, RBC, and investment limitations that would be applicable to the underlying assets were they to be held directly as an investment. Furthermore, the exposure is residual, meaning only determinable at or near maturity when the asset needs to be either re-released or sold to satisfy note payment obligations. The P&P defines CTLs as being, "mortgage loans that are made primarily in reliance on the credit standing of a major tenant." Therefore, at a minimum, a “primarily” standard would be appropriate, meaning no residual exposure should be 50% or greater. The SVO staff believes that even 50% is a very high exposure to the underlying collateral asset's re-leasing or salability risk, meaning that at maturity the noteholder’s risk of repayment of the remaining outstanding half of its principal is directly tied to the value of the underlying real estate and the ability to re-lease the asset at a sufficient rate. (If held directly, a mortgage loan on real estate is reported on Schedule B.) A lower residual threshold would lessen that risk. Industry has often pointed to the strong performance of CTLs through times of economic distress. However, until now all CTLs filed with the SVO have been conforming CTLs with minimal residual exposure. We do not know how a CTL with a larger residual exposure would perform should the balloon payment come due and the property need to be re-released or sold in a year when commercial real estate values are suppressed. Ultimately, the Working Group and the Task Force will need to decide, from a regulatory risk and reporting perspective, how much exposure to any small pools (including single asset pools) of non-commoditized assets is appropriate to still be reported on the bond schedule with an NAIC Designation and receive commensurate RBC treatment. The SVO will be able to assign an NAIC Designation to whatever residual threshold, 0% to 100%, the Working Group and Task Force ultimately decide upon.

- **Whether other mechanisms or compensating controls (beyond a residual risk insurance policy) could be incorporated as a mitigating factor for CTLs that exceed the 5% residual risk threshold (or a threshold as recommended).**

Yes. Residual risk insurance is the most common mitigant to residual risk, but the SVO would accept other mitigants including, but not limited to, non-cancellable guarantees, cash escrows and reserves, excess rent set asides and recourse to the lessee. We would propose that a list of mitigants not be limiting but rather examples, so that we can assess and make a determination on any proposes mitigant.

- **A listing of the nonconforming CTLs that were filed with the SVO in accordance with the direction of Interpretation (INT) 20-10. Please include high level details including outstanding principal and NAIC designation assigned by the SVO.**
The SVO has received 61 CTLs from when the INT 20-10 was issued through Apr. 21, 2021. There were 16 conforming CTLs ($0.406 billion), 27 non-conforming CTLs ($0.789 billion) and 18 transactions still pending documentation and review ($0.414 billion). The typical outstanding documentation included: primary legal agreement, CTL evaluation form, mortgage, residual value insurance, lease agreement, condemnation insurance, appraisal, and assignment of lease and rents. The list of security IDs and descriptions for non-conforming CTLs has been included in a regulator-only addendum. After reviewing the data for existing CTLs filed in 2020, we thought it was important to highlight that there is no universal issue description for these investments, making them difficult to identify. For the 1,018 CTLs filed with the SVO in 2020, 130 were identified as a CTL, 113 were identified as lease related, 326 were trust certificates, 160 were pass-thru certificates, 61 had no security type description, and the remaining 228 were various types of notes or certificates. Without reviewing the actual legal agreements and their terms, it will be very difficult to identify these securities without an insurer providing them to the SVO and the SVO identifying them in NAIC systems for all regulators.

In addition, the Working Group is also requesting information, to the extent possible, using best efforts, on (1) how many CTLs originally exceeded the residual risk threshold but were later deemed “conforming” due to mitigating factors, and (2) the nature of those factors (e.g. a residual risk insurance policy).

<table>
<thead>
<tr>
<th>Primary Non-Conforming Issue</th>
<th>Count</th>
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<tbody>
<tr>
<td>Balloon &gt;5% and &lt;25%</td>
<td>2</td>
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<tr>
<td>Balloon &gt;25% and &lt;50%</td>
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</tr>
<tr>
<td>Balloon &gt;50% and &lt;75%</td>
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<td>No casualty or condemnation gap insurance</td>
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<td>Transaction involves keep-well agreement</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>27</strong></td>
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To put these numbers into perspective, the SVO staff reviews over 1,000 CTL transactions each year. During the three-year period from 2018 to 2020, the yearly filing average was 1,203 CTL filings comprising: 86 initial filings, 1,112 annual update filings, and 2 material change filings. The SVO has developed extensive experience reviewing CTL transactions.

We hope that the Task Force and Working Group find this report useful as they deliberate this important issue.