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, 2021-035.02) — Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)

3. Discuss the SVO Referral Response to SAPWG on Credit Tenant Loans (Doc. ID 2021-029.04, 2021-029.01, 2021-029.03, 2021-029.02) — 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 issues.

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.

© 2021 National Association of Insurance Commissioners
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

...  

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

...  

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

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

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

---

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.

****

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,

Mike Monahan
American Council of Life Insurers

Tracey Lindsey
NASVA

John Petchler
on behalf of PPIA Board of Directors

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 through 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 difference 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

...
- **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:
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

... 

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:

G:\SECVAL\DATA\Vos-tf\Meetings\2021\May\VOSTF 2021-05-24\02 - Remove CTL and GLF from FE Exclusion\2021-035.01 Task Force 2021 Amend PP To Remove CTL and GLF from FE Exclusion (v2).docx
TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force

FROM: Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group
Carrie Mears, Vice-Chair of the Statutory Accounting Principles (E) Working Group

RE: Proposed VOSTF Attachment B – Filing Exemption for CTLs

DATE: May 21, 2021

After a detailed review of the proposed revisions within Attachment B of the Valuation of Securities (E) Task Force meeting materials for Monday, May 24, it appears that the proposed revisions go beyond providing a filing exemption to allow non-SVO assigned designations. Rather, the edits also appear to modify the structural requirements for credit tenant loans (CTLs), and would thus permit direct mortgage loans, in scope of SSAP No. 37 and reported on Schedule B—Mortgage Loans, to be reclassified from Schedule B to Schedule D—Long-Term Bonds with up to 50% residual risk and a CRP rating, without any SVO structural assessments.

From prior review of the history of the CTL provisions, the original intent was to permit mortgage loans, captured on Schedule B, to be reclassified to Schedule D-1 based on the credit standing of a major tenant, but only if there was very limited residual risk (5%). Over time, the structure of these investments has shifted, but not the name used, and it is believed that most designs now meet the definition of a security and not a mortgage loan. Further, since the scope of SSAP No. 37—Mortgage Loans specifically excludes securities, these revised investment designs would not be captured in scope of SSAP No. 37 and not reported on Schedule B. Rather, under the existing guidance in the Accounting Practices and Procedures Manual, securities that reflect a creditor relationship, whereby there is a fixed schedule for one or more future payments, are captured in scope of SSAP No. 26R—Bonds or SSAP No. 43R—Loan-Backed and Structured Securities and reported on Schedule D-1.

Although the process to assess whether securities with underlying real estate risk shall be subject to filing exempt provisions or be submitted to the NAIC SVO for a credit assessment is a decision of the Task Force, as noted above, the current proposed revisions do not appear to be limited to that aspect. To prevent inadvertent application of the proposed revisions to direct mortgage loans, and to clarify that securities (SSAP No. 26R/SSAP No. 43R) shall be reported in accordance with existing AP&P Manual guidance, it is suggested that the Task Force reconsider the proposed exposure of Attachment B. Instead, it is recommended that the Task Force expose proposed edits to the Purposes and Procedures Manual to clarify that in all instances in which a CTL is defined, it is noted to be a mortgage loan “in scope of SSAP No. 37.” It is noted that this limited edit would clarify that the application of the structural assessment of CTLs is limited to direct mortgage loans and relates to the potential reclassification from Schedule B to Schedule D for those investments. Furthermore, it would clarify that securities are not subject to the CTL structural assessments and
should continue to be reported in accordance with the scope provisions of the guidance within the AP&P Manual. Examples of the proposed recommendations are shown below:

P&P Manual, Page 101 – FE Securities:

Credit Tenant Loan (CTL) – A CTL is a mortgage loan, in scope of SSAP No. 37, 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. A transaction that purports to be a Credit Tenant Loan, including one that is assigned a credit rating by an NAIC CRP, is not eligible for Schedule D reporting unless the SVO confirms that the transaction is eligible for Schedule D reporting and assigns the transaction an NAIC Designation.

P&P Manual, Page 29 – Credit Tenant Loans:

CTL Categories

100. Mortgage loans, in scope of SSAP No. 37, that are 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, are referred to as a Credit Tenant Loan. Four categories of CTLs are recognized as eligible for reporting on Schedule D: Bond Lease Based CTLs; Credit Lease Based CTLs; Acceptable CTL Variants (ACVs); and Multiple Property Transactions (MPTs).

If the limited edits, as shown above, are incorporated, than further revisions to the P&P Manual, particularly to the structural assessment for CTLs and the existing 5% residual risk threshold, are not expected to be needed at this time. It is also believed that this will resolve the current uncertainty and inconsistency with regards to the reporting of securities that have underlying elements of mortgage loan or real estate risk. Although these revisions will clarify the current ability to report securities that represent a creditor relationship under the existing bond definition, it is noted that a current project is underway to establish principles to clarify what should be considered a bond for reporting on Schedule D-1. Once that project is finalized, security structures that do not qualify under those bond principles will be reclassified to a more appropriate schedule.

Thank you for considering this revised proposal. Please contact Dale Bruggeman, or Carrie Mears, SAPWG Chair and Vice Chair, with any questions on this memorandum.
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 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-
leased 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-leased 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>
</tr>
</thead>
<tbody>
<tr>
<td>Balloon &gt;5% and &lt;25%</td>
<td>2</td>
</tr>
<tr>
<td>Balloon &gt;25% and &lt;50%</td>
<td>6</td>
</tr>
<tr>
<td>Balloon &gt;50% and &lt;75%</td>
<td>3</td>
</tr>
<tr>
<td>Balloon &gt;75% and &lt;100%</td>
<td>0</td>
</tr>
<tr>
<td>Balloon &gt;=100%</td>
<td>9</td>
</tr>
<tr>
<td>No casualty or condemnation gap insurance</td>
<td>6</td>
</tr>
<tr>
<td>Transaction involves keep-well agreement</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>27</td>
</tr>
</tbody>
</table>

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.
To: NAIC Securities Valuation Office & NAIC Capital Markets & Investment Analysis Office  
From: Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group  
Date: January 22, 2020  
Re: Residual Risk Threshold for Credit Tenant Loan (CTL) Investments

On Nov. 12, the Working Group continued discussion of agenda item 2020-24: Accounting and Reporting of Credit Tenant Loans and directed that “conforming” CTLs shall remain in scope of SSAP No. 43R—Loan-Backed and Structured Securities with reporting to occur on Schedule D-1. On Dec. 28, the Working Group provided a limited-time provision to permit non-conforming CTLs continued D-1 reporting if they are filed with the SVO by February 15, 2021. With this provision, nonconforming CTLs reported on Schedule D-1 that have not received an SVO-assigned designation shall be disclosed in Note 1 as if a permitted practice.

As you are likely aware, the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) specifies many criteria required for an investment to qualify as a conforming CTL. In addition to a legal and structural analysis, one such standard is a maximum threshold of a 5% residual asset risk. The residual asset risk limit of 5% was established in 1994 from the Invested Asset Working Group. As this committee no longer exists, this memorandum requests your comments on the following:

- Whether it is appropriate to revisit the 5% residual asset risk threshold as a restriction for conforming CTLs.
- If applicable, a recommendation of an appropriate residual risk threshold.
- 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).
- 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.

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 considered as “conforming” due to mitigating factors, and 2) the nature of those factors (i.e. a residual risk insurance policy).

Thank you for considering this request. If you have questions, please contact Julie Gann, NAIC staff of the Statutory Accounting Principles (E) Working Group.

Attachments: SAPWG Agenda Item 2020-24 & INT 20-10

Cc: Julie Gann, Robin Marcotte, Fatima Sediqzad, Jake Stultz, Jim Pinegar, Charles Therriault, Marc Perlman, Eric Kolchinsky
Interpretation of the Statutory Accounting Principles Working Group

INT 20-10: Reporting Nonconforming Credit Tenant Loans

INT 20-10 Dates Discussed
Evote to Expose November 18, 2020; December 18, 2020; Evote to Adopt December 28, 2020

INT 20-04 References
SSAP No. 43R—Loan-Backed and Structured Securities

INT 20-10 Issue

1. During the Statutory Accounting Principles (E) Working Group meeting on November 12, 2020, the Working Group discussed and deferred final decision on inconsistencies in the reporting of “nonconforming” credit tenant loans (CTLs) currently reported on Schedule D-1 and directed reporting exceptions for year-end 2020. Due to subsequent questions, this interpretation has been issued to detail the provisions provided and clarify the reporting of CTLs in the year-end 2020 statutory financial statements.

INT 20-10 Discussion

2. As detailed in agenda item 2020-24, some reporting entities have reported CTLs that do not qualify as “conforming” CTLs per the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) on Schedule D-1: Long-Term Bonds. CTLs that do not qualify under the P&P Manual structural requirements are noted as “nonconforming” CTLs. During the November 12 discussion, the Working Group deferred final guidance on the reporting of nonconforming CTLs. This deferral was supported as the Working Group has a separate project to assess investments that are captured on Schedule D-1. With this project, it was identified that it would be undesirable to require an investment that is currently being reported on Schedule D-1 to be moved to a different schedule if there was potential for that investment to subsequently qualify for Schedule D-1.

3. Although the Working Group deferred final conclusion on the reporting of nonconforming CTLs, it was identified that the long-standing guidance detailed in the P&P Manual only permits CTLs that met certain structural criteria, which is verified by the SVO, to be reported on Schedule D-1. Under this existing guidance, these conforming CTLs are also prohibited from using CRP ratings in determining NAIC designation but are required to utilize SVO-assigned NAIC designations obtained after the SVO verifies compliance with the structural elements. As such, to ensure that nonconforming CTLs are not provided more favorable provisions than conforming CTLs that meet structural requirements, the Working Group confirmed that only CTLs that are filed with the NAIC SVO by February 15, 2021, shall be reported on Schedule D-1. Key aspects noted in this direction:

a. This direction is a limited-time exception to the NAIC Policy Statement on Coordination of the Accounting Practices and Procedures Manual and the Purposes and Procedures Manual of the Investment Analysis Office and shall not be inferred to other investments. Pursuant to the noted Policy Statement, obtaining an NAIC designation does not change an investment’s applicable SSAP, annual or quarterly statement reporting schedule, or override other SSAP guidance required
for the investment to be an admitted asset. Although nonconforming CTLs will be permitted to be reported on Schedule D-1 when filed with the SVO for future receipt of an SVO-assigned NAIC designation (even without meeting structural requirements), this is strictly a limited-time exception to prevent reporting schedule changes while a larger project on the scope of Schedule D-1 is considered.

b. The requirement to file the nonconforming CTL for an SVO-assigned NAIC designation for Schedule D-1 applies to all investments that represent credit tenant loans. It is not permissible for a reporting entity to classify an investment, which meets the characteristics of a credit tenant loan, as a different type of investment (for example, as a form of leased-backed security) for purposes of reporting the investment on Schedule D-1 without filing for an SVO-assigned NAIC designation.

c. The Working Group direction intends to only address nonconforming CTLs that have previously been reported on Schedule D-1 although they did not comply with the requirements of the P&P Manual. This direction is not intended to require, or permit, nonconforming CTLs that have been previously reported as mortgage loans (on Schedule B – Mortgage Loans) or as other invested assets (on Schedule BA – Other Long-Term Invested Assets) to be moved to a different reporting schedule. Nonconforming CTLs that have previously been reported on Schedule B or BA shall remain on that reporting schedule for the duration of this INT.

**INT 20-10 Consensus**

4. The Working Group reached a consensus to provide a limited time exception allowing nonconforming CTLs to continue to be reported on Schedule D-1 for year-end 2020 provided they have filed for an SVO-assigned NAIC designation. With the issuance of this interpretation, the Working Group confirmed the provisions and limitations detailed in paragraph 3, and summarized the resulting provisions below:

a. CTLs that qualify per the provisions of the P&P Manual are considered to be “conforming” CTLs and shall be reported on Schedule D-1 with the NAIC designation obtained from the SVO.

b. CTLs that do not qualify per the provisions of the P&P Manual to be “conforming” CTLs shall follow the accounting and reporting provisions detailed in the following subparagraphs. These CTLs are noted as “nonconforming CTLs.”

i. Nonconforming CTLs that have previously been reported on Schedule D-1 may continue to be reported on Schedule D-1 for year-end 2020 if they have filed for an SVO-assigned NAIC designation. This provision only requires that an entity file the security with the SVO by February 15, 2021, not that the entity receive the SVO-assigned designation prior to submitting their 2020 annual statutory financial statements. If an entity does not file the security with the SVO by February 15, 2021, the investment shall be reported on Schedule BA. If reporting on Schedule BA, these CTLs shall not be reported with a credit-rating provider (CRP) determined NAIC designation. For nonconforming CTLs that have been filed with the SVO and retained on Schedule D-1, the reporting entity is required to disclose the total amount of nonconforming CTLs reported on Schedule D-1 on Note 1 as if it were a permitted practice. The reporting entity shall complete the permitted practice disclosures required by SSAP No. 1—Accounting Policies, Risks & Uncertainties, and Other Disclosures, with two separate entries that detail the nonconforming CTLs that were reported on D-1 on one line, and the nonconforming CTLs that were not reported on Schedule BA on a separate line within this disclosure. (These lines will likely net to a zero impact to statutory surplus; therefore, the separate line reporting is required.)
ii. Nonconforming CTLs that have been previously reported on a different reporting schedule (e.g., Schedule B or Schedule BA) shall remain on the prior reporting schedule. There is no requirement for reporting entities to pursue SVO-assigned designations for these CTLs or disclose these nonconforming CTLs in Note 1. Furthermore, reporting entities that have previously reported nonconforming CTLs on Schedule D-1 that do not want to file with the SVO or that do not want to disclose in Note 1 pursuant to paragraph 4.b.i. are permitted to reclassify these CTLs to Schedule B or Schedule BA without NAIC designations.

5. The exceptions granted in this interpretation are applicable for the year-end 2020 statutory financial statement only. Nonconforming CTLs that have been filed with the SVO and are reported on Schedule D-1 shall continue the Note 1 reporting for each 2021 quarterly financial statement until an SVO-assigned designation is received. The provisions within this INT, and the ability to continue reporting nonconforming CTLs on Schedule D-1 with an SVO-assigned NAIC designation, are limited time exceptions that extend only to October 1, 2021. The exceptions provided in this INT shall not be interpreted to indicate the likely conclusion of the Working Group in determining the appropriate reporting schedule for nonconforming CTLs. All reporting entities shall be prepared to make adjustments to comply with the reporting schedule utilized for nonconforming CTLs upon final conclusion by the Working Group.

INT 20-10 Status

6. On November 18, 2020, the Statutory Accounting Principles (E) Working Group exposed this interpretation to provide a limited-time exception on the reporting of nonconforming CTLs. On December 18, 2020, the Working Group exposed revisions to this interpretation to allow continued D-1 reporting of nonconforming CTLs if they are filed with the SVO by February 15, 2021. With this provision, nonconforming CTLs reported on Schedule D-1 that have not received an SVO-assigned designation shall be disclosed in Note 1 as if a permitted practice. On December 28, 2020, the Working Group finalized action, via evote, to adopt the interpretation exposed December 18, 2020.

7. No further discussion is planned.
**Statutory Accounting Principles (E) Working Group**  
**Maintenance Agenda Submission Form**  
**Form A**

**Issue:** Accounting and Reporting of Credit Tenant Loans

**Check (applicable entity):**

- Modification of Existing SSAP   
- New Issue or SSAP   
- Interpretation  

<table>
<thead>
<tr>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>☒</td>
<td>☐</td>
<td>☒</td>
</tr>
</tbody>
</table>

**Description of Issue:**
This agenda item intends to clarify the reporting of credit tenant loans (CTL) for statutory accounting. Although this is an investment (that if meeting certain criteria) may have been historically captured in *SSAP No. 43R—Loan-Backed and Structured Securities*, due to recent discussions at the Valuation of Securities (E) Task Force, in order to provide timely guidance, it was identified that this issue needs to be considered separately outside of the substantive SSAP No. 43R project. As the SSAP No. 43R project is a substantive assessment, with various aspects being considered, it is noted that the conclusion of that project may extend beyond the timeframe for which clarity on CTLs is needed.

This agenda item focuses on credit tenant loans. There are other variations of similar investments that should also be specifically named / addressed in the AP&P Manual. These include ground lease financings as well as other lease-backed (non-ABS) securities. NAIC staff recommends that the Working Group first consider CTLs, with separate subsequent consideration of other structures.

Pursuant to guidance in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*:

Mortgage loans that are 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, are referred to as a Credit Tenant Loan. *(Staff Note – This overall definition also matches the NAIC Model 280: Investments of Insurers Model Act (Defined Limits Version).*

**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. A transaction that purports to be a Credit Tenant Loan, including one that is assigned a credit rating by an NAIC CRP, is not eligible for Schedule D reporting unless the SVO confirms that the transaction is eligible for Schedule D reporting and assigns the transaction an NAIC Designation.

It has been long-standing practice for CTLs to be filed with the NAIC SVO for review and assessment. If the SVO identified that the CTL qualifies under the SVO’s legal and structural analysis (which reflects bond characteristics) and meets certain other criteria (such as minimal residual real-estate risk), then it has been granted special treatment and reported in scope of SSAP No. 43R on schedule D. If the CTL did not qualify under the SVO provisions or if it was not filed with the SVO, it would not qualify to be reported as a bond. These CTLs are often referred to as “non-conforming CTLs.” It has been presumed that a non-conforming CTL would be considered a mortgage loan and reported in scope of *SSAP No. 37—Mortgage Loans.*
The Valuation of Securities (E) Task Force has recently been discussing CTLs as it was identified that CTLs that were not submitted to the SVO and/or did not qualify under the SVO’s structural and legal analysis were being reported on Schedule D with filing exempt designations. Although this identification resulted with discussion at the Task Force on the existing process, it was also noted that the overall statutory accounting guidance is not clear. The following elements have been identified as potential accounting and reporting issues:

1. There is no clear guidance in the Accounting Practices & Procedures Manual that SVO-identified conforming CTLs are in scope of SSAP No. 43R. It is noted that the CTL structure does not qualify within the SSAP No. 43R definition of a loan-backed and structured security (LBSS), and all that is currently included in SSAP No. 43R is a generic reference to “credit-tenant loans” as an example of an “all other” loan-backed and structured security. This reference is in paragraph 27.b of SSAP No. 43 in the section that addresses “designation guidance.”

2. It is presumed that non-SVO-identified CTLs would have historically been reported as mortgage loans. However, SSAP No. 37 explicitly excludes “securities” from the scope of the standard. Due to the structure of CTLs, and as they have CUSIPs, there is a question whether they are a “security” which would then specifically exclude CTL’s from the mortgage loan guidance.

3. It has been identified that if non-conforming CTLs are reported as mortgage loans, the RBC calculation may be considered punitive for these specific designs. This is because the assessment of a CTL is based on the credit quality of the major tenant, whereas the RBC calculation factors for mortgage loans is a loan-to-value (LTV) assessment. As the RBC calculation does not have an alternative process for CTL structures, under the LTV process, these loans receive high RBC charges.

4. If the non-conforming CTLs are not reported on schedule D and not reported as mortgage loans, they would be captured on Schedule BA – Other Long-Term Invested Assets. Although there are certain classes of assets that could be reported with NAIC designations on Schedule BA, assets with underlying characteristics of mortgage loans do not currently have this capability. As such, if reported under this Schedule BA category under current provisions, these items would receive a 20% RBC for property/casualty and health filers and would receive a 30% charge for life filers. Even if provisions were incorporated to permit NAIC designations for this class of asset (or direct reporting within a different reporting line), this would only allow life insurers to receive a reduction in RBC. There would be no benefit for property/casualty and health filers under existing RBC provisions.

In order to fully assess the proper accounting and reporting, this agenda item presents the following key characteristics of CTLs:

- A CTL generally is long-term in nature in comparison to a commercial mortgage. So, whereas a commercial mortgage loan may be between 5-10 years, a CTL could be between 15-40 years of fixed payments that correspond to the term of the lease and the loan.

- The CTL is structured based on the credit-quality of the corporate tenant which is obligated to pay rent regardless of property casualty, condemnation or obsolescence and to pay all expenses associated with the property, such as taxes, maintenance and utilities. The investment, however, is secured with collateral through a mortgage on the property. With this structure, the reporting entity receives a steady cash flow stream with the additional protection of real estate collateral.

- Conforming CTLs are generally structured to be fully amortized over the term of the loan and lease; however, they are illiquid investments. This principal amortizing component is a key element of the
requirements in determining whether a CTL meets the SVO requirements in support of bond classification / NAIC designation. (Technically, if the structure is not substantively amortized over the term, then it is not a Schedule D eligible CTL, per the P&P Manual. However, the phrase “non-conforming CTL” is used to describe the general structure of the transaction.) To provide simple examples (ignoring investment returns or interest payments):

- **Example 1**: If a CTL investment reflected $1,500,000, with the investor receiving $100,000 in annual cash payments over a 15-year lease/loan term, at conclusion of the investment, the principal balance would have been returned to the investor. Although the underlying property would have been provided as collateral as part of the CTL agreement, with the structure of the investment, there is little risk that the property would be transferred to the reporting entity at maturity to satisfy a remaining principal amount due. This is referred to as “residual risk.” The SVO parameters permit a slight amount of residual risk (e.g., 5%) in conforming CTLs. If the investment retains a greater amount of residual risk, then additional mitigation elements must be included in the structure for an SVO “conforming CTL” designation.

- **Example 2**: If a CTL investment reflected $1,500,000, with the investor receiving $600,000 in total cash payments over a 15-year lease/loan term, at conclusion of the investment, the reporting entity investor would be due $900,000. If the structure was not renewed or refinanced with the tenant (or a new tenant), then the reporting entity investor would receive ownership of the building in lieu of the remaining principal amount owed. The reporting entity investor would then have to sell the building to recoup their investment. This structure reflects a level of residual risk that has been historically deemed unacceptable for bond reporting under the SVO parameters. Rather, this structure has been historically considered to reflect a mortgage loan at inception, with recategorization as real estate if the reporting entity received the property at the conclusion of the investment maturity.

The focus of this agenda item is to inquire whether the conforming CTLs (such as example 1) should be captured in scope of SSAP No. 43R or whether these investments should be captured in SSAP No. 21R—Other Admitted Assets. This agenda item is not proposing that structures that do not conform to current requirements (such as example 2) be considered in scope of SSAP No. 43R. This agenda item also inquires whether structures that are not conforming CTLs (such as example 2) should be reported as mortgage loans or whether these structures should be captured in SSAP No. 21R. This agenda item is not proposing to reconsider the existing SVO guidelines in determining whether a CTL is “conforming” and in determining what is considered to be a suitable amount of “residual risk.” If there is a desire to reassess these provisions, NAIC staff would recommend a separate project with the Task Force, after concluding on desired reporting location and governing SSAP, to review these parameters.

Although it is understood that historical practice has permitted certain SVO verified CTLs that meet legal and structural analyses to be reported on Schedule D, there is a question whether these investments reflect bonds or securitized assets that should be included on the bond schedule. If preferred by the Working Group, revisions can be considered to remove these items from potential Schedule D reporting and instead capture these investments in scope of SSAP No. 21R. Some elements to consider in determining whether SSAP No. 21R would be more appropriate:

- If captured in scope of SSAP No. 21R, all CTLs will be reported in the same schedule, regardless of whether they are considered “conforming” or “non-conforming” CTLs. (In other words, the same reporting schedule would occur regardless of the NAIC SVO assessment.) This reporting process would likely result with improved identification and assessment of CTL investments in the financial statements. Under the current
process, since CTLs are bifurcated across reporting schedules, it is not possible to identify the full extent an insurer is invested in CTLs (regardless if confirming or non-conforming).

- If captured in scope of SSAP No. 21R, CTLs could still be filed with the NAIC SVO for the legal and structural analysis and, if qualifying, to obtain an NAIC designation. For these “conforming” CTLs, revisions could be incorporated to permit the NAIC designation to be reported on Schedule BA. This NAIC designation could be used by life insurers to obtain an improved RBC designation. (Although the improved RBC is not an option under the current RBC formula for non-life entities, from information gathered, most CTL holders are life insurers.)

- Reporting CTLs in scope of SSAP No. 21R would be consistent with previous decisions of the SAPWG to not report non-bond items as bonds simply for RBC purposes. It would also be consistent with the policy statement that obtaining an NAIC designation does not direct statutory accounting or reporting. Pursuant to this policy statement, obtaining an NAIC designation does not change an investment’s applicable SSAP, annual or quarterly reporting schedule or override other SSAP guidance required for the investment to be an admitted asset. This policy statement does identify that there are limited situations in which an SVO-listing could be used for classification purposes that focuses on the underlying structure of the investment. If conforming CTL investments are retained in SSAP No. 43R (and not moved to SSAP No. 21R), it would be recommended that CTLs that meet the SVO structural analysis be captured on a listing that could be referred to in the scope section of SSAP No. 43R. It is noted that the recent issues involving non-conforming CTLs seem to originate from an interpretation that obtaining a CRP rating would allow entities to report these structures as bonds on Schedule D through the filing exemption process. This assessment is incorrect under existing statutory accounting guidance and the existing policy statement.

- Reporting CTLs in scope of SSAP No. 21R would seemingly be consistent with the decision made for structured settlements in 2018. Although structured settlements and CTLs are vastly different investments, they both represent an investment, that is not a bond, but reflects an investment in a cash flow stream that is subject to the underlying credit quality of the payer.

On May 29, 2020, the Valuation of Securities (E) Task Force submitted a referral to the Working Group to permit non-conforming CTLs that receive an NAIC designation from the SVO to be considered in scope of SSAP No. 43R. Excerpts of this referral have been provided below:

The Task Force is referring this memo and proposed amendment to the Statutory Accounting Principles (E) Working Group and requesting the Working Group affirm that they would consider these Non-conforming CTLs to have the characteristics of a bond if assigned an NAIC Designation by the SVO staff. Like the referral from earlier this year on GLFs, these Non-conforming Credit Tennant Loan (CTL) Transactions have historically been reported under the Accounting Practices & Procedures Manual's SSAP No. 43R – Loan-Backed and Structured Securities under Paragraph 27, b as a type of CTL. The SVO staff recommends affirming that treatment only if the SVO staff can assign an NAIC Designation.

The edits noted in the Task Force referral are revisions to the Purposes and Procedures Manual (P&P) to affirm the Task Force’s role in making all decisions on the use of CRP ratings and provides guidance to insurance company filers on what to do if they are uncertain about the filing procedure for a particular security or class of securities.

NAIC staff highlights that it would be inconsistent with the Policy Statement on Coordination of the AP&P Manual and the P&P Manual of the NAIC IAO to permit CTLs to be classified as a bond simply in accordance with an NAIC designation / CRP rating. However, the provisions in the Policy Statement does identify that such classifications can occur based on an SVO structural assessment of an investment. NAIC SAPWG staff has
confirmed with the SVO staff that the review and assignment of an NAIC designation for CTLs requires a structural assessment, and they only receive an NAIC designation if the CTL possess bond characteristics.

Existing Authoritative Literature:

**SSAP No. 37—Mortgage Loans**

2. **A mortgage loan is defined as a debt obligation that is not a security, which is secured by a mortgage on real estate.** In addition to mortgage loans directly originated, a mortgage loan also includes mortgage loans acquired or obtained through assignment, syndication or participation. Investments that reflect “participating mortgages,” “mortgage loan fund,” “bundled mortgage loans” or the “securitization of assets” are not considered mortgage loans within scope of this SSAP.

   a. A security is a share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

      i. It is either represented by an instrument issued in bearer or registered form, or if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.

      ii. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.

1 Examples of agreements intended to be captured within this statement:

   a. Reporting entity is a “co-lender” in a single mortgage loan agreement that identifies more than one lender (which includes the reporting entity) with the real estate collateral securing all lenders identified in the agreement. For these single-mortgage loan agreements, each lender is incorporated directly into the loan documents. The key differentiating characteristic of a mortgage loan provided under a group “mortgage loan co-lending agreement” rather than a solely owned mortgage loan is that no one lender of the lending group may unilaterally foreclose on the mortgage. With these agreements, the lenders must foreclose on the mortgage loan as a group.

   b. Reporting entity has a “participation agreement” to invest in a single-mortgage loan. The reporting entity is not the lender of record named as a payee on the mortgage loan, but the lender of record sells a portion of the mortgage loan to the reporting entity through an assignment or participation interest under the participation agreement. Under a participation agreement, the reporting entity acquires an undivided interest in the single mortgage loan proceeds to be received by the lender of record. Under a participation agreement, single mortgage loan proceeds include the periodic mortgage loan principal and interest payments received by the lender of record, and all rights and proceeds received in the foreclosure of a mortgage, deed of trust, deed in lieu of foreclosure, or other similar proceeding by the lender of record. The amount of the proceeds to be received by the reporting entity is based on the ratio of its participation interest to the then-outstanding single mortgage loan balance. To qualify as a mortgage loan under the scope of this statement, the reporting entity must have a signed participation agreement with the lender of record named in the mortgage loan, the financial rights and obligations of the reporting entity under the participation agreement are the same as the lender of record, the reporting entity’s participation interest in the single mortgage loan proceeds must be pari-passu with the lender of record named on the mortgage loan agreement, and the participation agreement must be properly and promptly recorded on the lender or record’s books and records.

2 The scope of this SSAP is limited to single mortgage loan agreements. Although single mortgage loan agreements can potentially have more than one lender (e.g., co-lenders/participations) and more than one borrower (such as in a tenancy-in-common arrangement), the concept of a “single mortgage loan” does not include arrangements in which a reporting entity acquires more than one mortgage loan in a sole transaction. (For example, if a reporting entity was to acquire an interest in a “bundle” of mortgage loans with various unrelated borrowers and collateral, this agreement would be outside of the scope of this SSAP. However, a bundle of mortgage loans does not include a “bulk purchase” where the reporting entity’s interest in each mortgage loan is legally separate and divisible and the purchase just facilitates the acquisitions of multiple single mortgage loan agreements.)
iii. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

**SSAP No. 43R—Loan-Backed and Structured Securities**

(Excerpts from scope guidance)

2. Loan-backed securities are defined as securitized assets not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the payments received by the issuer from the underlying assets, including but not limited to pass-through securities, lease-backed securities, and equipment trust certificates.

3. Structured securities are defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to payments received by the issuer from the underlying assets.

4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer’s obligation has been fully satisfied. The investor only has direct recourse to the issuer’s assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

   a. In determining whether a loan-backed structure is a related party investment, consideration shall be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security. For example, although a loan-backed security may be acquired from a non-related issuer, if the assets held in trust predominantly reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction shall be considered an affiliated investment, and the transaction shall also subject to the accounting and reporting provisions in SSAP No. 25—Affiliates and Other Related Parties.

5. Mortgage-referenced securities do not meet the definition of a loan-backed or structured security but are explicitly captured in scope of this statement. In order to qualify as a mortgage-referenced security, the security must be issued by a government sponsored enterprise in the form of a “credit risk transfer” in which the issued security is tied to a referenced pool of mortgages. These securities do not qualify as “loan-backed securities” as the pool of mortgages are not held in trust and the amounts due under the investment are not backed or secured by the mortgage loans. Rather, these items reflect instruments in which the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders

---

3 In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which related party transactions (particularly those involving affiliates) is knowingly captured in a SSAP No. 43R structure and not identified as a related party transaction (or not reported as an affiliated investment on the investment schedule) because of the involvement of a non-related trustee or SSAP No. 43R security issuer. As identified in SSAP No. 25—Affiliates and Other Related Parties, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

4 Currently, only Fannie Mae and Freddie Mac are the government sponsored entities that issue qualifying mortgage-referenced securities. However, this guidance would apply to mortgage-referenced securities issued by any other government sponsored entity that subsequently engages in the transfer of residential mortgage credit risk.
may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages. Unless specifically noted, the provisions for loan-backed securities within this standard apply to mortgage-referenced securities.

6. Investments within the scope of this statement are also subject to the provisions and disclosure requirements of SSAP No. 25 if the SSAP No. 43R transaction is a related party arrangement. Loan-backed and structured securities meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement and SSAP No. 25.

7. The scope of this statement encompasses all types of loan-backed and structured securities, including, but not limited to, the following:
   a. Loan-backed and structured securities acquired at origination,
   b. Loan-backed and structured securities acquired subsequent to origination for which it is probable, at acquisition, that the reporting entity will be able to collect all contractually required payments receivable, and are accounted for at acquisition under SSAP No. 103R,
   c. Loan-backed and structured securities for which it is probable, either known at acquisition or identified during the holding period, that the reporting entity will be unable to collect all contractually required payments receivable, and
   d. Transferor’s beneficial interests in securitization transactions that are accounted for as sales under SSAP No. 103R and purchased beneficial interests in securitized financial assets.

Designation Guidance

27. For RMBS/CMBS securities within the scope of this statement, the initial NAIC designation used to determine the carrying value method and the final NAIC designation for reporting purposes is determined using a multi-step process. The Purposes and Procedures Manual of the NAIC Investment Analysis Office provides detailed guidance. A general description of the processes is as follows:

   a. Financial Modeling: The NAIC identifies securities where financial modeling must be used to determine the NAIC designation. NAIC designation based on financial modeling incorporates the insurers’ carrying value for the security. For those securities that are financially modeled, the insurer must use NAIC CUSIP specific modeled breakpoints provided by the modelers in determining initial and final designation for these identified securities. Securities where modeling results in zero expected loss in all scenarios are automatically considered to have a final NAIC designation of NAIC 1, regardless of the carrying value. The three-step process for modeled securities is as follows:

---

5 As discussed in paragraph 4.a. of this statement, a SSAP No. 43R security may still be considered a related party transaction even if the asset trustee or security issuer is a non-related party.

6 Securities classified within the type of paragraph 7.a. or 7.b. may be required to change classification to type 6.c. when it becomes probable that the reporting entity will be unable to collect all contractually required payments receivable.

7 The accounting requirements related to these types of securities included in paragraphs 22-25 shall be determined at acquisition or initial transfer.
i. Step 1: Determine Initial Designation – The current amortized cost (divided by remaining par amount) of a loan-backed or structured security is compared to the modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP to establish the initial NAIC designation.

ii. Step 2: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then determined as described in paragraph 26 based upon the initial NAIC designation from Step 1.

iii. Step 3: Determine Final Designation – The final NAIC designation that shall be used for investment schedule reporting is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 27.a.ii.) to the NAIC CUSIP specific modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP. This final NAIC designation shall be applicable for statutory accounting and reporting purposes (including establishing the AVR charges). The final designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 27.a.ii.).

b. All Other Loan-Backed and Structured Securities: For loan-backed and structured securities not subject to paragraphs 27.a. (financial modeling) follow the established designation procedures according to the appropriate section of the Purposes and Procedures Manual of the NAIC Investment Analysis Office. The NAIC designation shall be applicable for statutory accounting and reporting purposes (including determining the carrying value method and establishing the AVR charges). The carrying value method is established as described in paragraph 26. **Examples of these securities include, but are not limited to**, mortgage-referenced securities, equipment trust certificates, credit tenant loans (CTL), 5*/6* securities, interest only (IO) securities, securities with CRP ratings (excluding RMBS/CMBS), and loan-backed and structured securities with SVO assigned NAIC designations.

**Note: This is the only reference to credit tenant loans in the AP&P Manual.**

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): The following items are noted as recent actions / projects by the Working Group:

- In agenda items 2018-22 and 2016-39, the Working Group clarified the scope guidance in SSAP No. 37. With these revisions (reflected in the cited guidance), the Working Group has clarified that the focus of SSAP No. 37 is on direct, single mortgage loan agreements that are not securities. These revisions have clarified that the scope of the SSAP does not include funds, securitizations, or “bundles” of mortgage loans.

- The Working Group has a current project to substantively review and revise SSAP No. 43R. Pursuant to agenda item 2019-21, the original focus was on “equity” related items (such as collateralized fund obligations), but the scope of the project has been expanded to include a complete review of SSAP No. 43R. The initial discussion draft issue paper was exposed in March 2020 with a comment period ending July 31, 2020. This initial exposure focused initial review of broad groupings of assets and did not address investments addressed in the Purposes and Procedures Manual. The issue paper noted that these VOSTF-related items were pending development and would be addressed in subsequent exposures.

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None

Staff Recommendation:
NAIC Staff recommends that the Working Group move this item to the active listing, initially categorized as nonsubstantive and expose the agenda item to solicit comment before directing NAIC staff on the desired guidance for CTLs. There are two general options:

- **Option 1: SSAP No. 43R for Conforming CTLs (this includes CTLs With SVO-Identified Bond Characteristics Acquired Prior to Jan. 1, 2020 as detailed in the P&P Manual)** – With this option, statutory accounting will continue with historical application and keep CTLs that are identified to have bond characteristics, after review by the SVO, in scope of SSAP No. 43R and reported on Schedule D as bonds. If selecting this option, the Working Group should also advise if they would prefer for the nonqualifying CTLs to be in scope of SSAP No. 37—Mortgage Loans and reported on Schedule B, or if they want these investments to be considered an “other invested asset” under SSAP No. 21 and reported on Schedule BA. (Note: The SVO will only review non-conforming CTLs held prior to Jan. 1, 2020 for bond characteristics. As such all non-conforming CTLs acquired after Jan. 1, 2020 will not be in scope of SSAP No. 43R.)

  If selecting this option, NAIC staff will propose edits to SSAP No. 43R to explicitly include in scope CTLs that are included on an SVO-identified listing based on a structural analysis. Furthermore, revisions will be proposed to either SSAP No. 37 or SSAP No. 21R—Other Invested Assets to capture CTL type structures that are not on the SVO identified listing.

- **Option 2: SSAP No. 21 for All CTLs** – With this option, statutory accounting revisions will be proposed to capture all CTLs in scope of SSAP No. 21—Other Invested Assets and reported on Schedule BA. With this approach, all CTLs will be reported on the same schedule, and revisions will be proposed to allow CTLs that are reviewed and approved by the NAIC SVO to be reported with an NAIC designation. This process will be similar to the existing approach for other non-bond items reported on Schedule BA that have underlying characteristics of fixed income instruments. With this approach, there will be no need to reference an SVO-identified listing of qualifying CTLs in SSAP No. 21R. Pursuant to the Purposes and Procedures Manual, CTLs will not qualify as filing exempt, and a CTL would need an SVO-provided NAIC designation if there was a desire to obtain a more favorable RBC. (Only CTLs the SVO determines qualify to receive an NAIC designation will be assigned one and will be identified on a separate listing maintained and published by the SVO.) (Under existing RBC parameters, the ability for a more favorable RBC on Schedule BA based on NAIC designation is only permitted for life entities.)

In addition to exposing a direction, NAIC staff recommends notifying the Valuation of Securities (E) Task Force of this agenda item in response to their referral. With this notification, NAIC staff will request further confirmation that an SVO-Listing could be developed to capture the CTLs that meet the SVO’s structural and legal analysis and possess bond characteristics.

Staff Review Completed by:
Julie Gann - NAIC Staff
June 2020

Status:
On July 30, 2020, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed this agenda item with a request for comments on the two general options
for the accounting treatment of credit tenant loans (CTL). Notification will also be sent to the Valuation of Securities (E) Task Force of this agenda item in response to their referral. With this notification, NAIC staff will request further confirmation that a SVO-Listing could be developed to capture the CTLs that meet the SVO’s structural and legal analysis and possess bond characteristics.

**Proposed Language – October 2020**
The following proposed edits intend to reflect guidance if the Working Group directs for Option 1, with conforming CTLs in SSAP No. 43R. Language is proposed to show the edits that could occur if non-conforming CTLs are directed for Schedule BA or in scope of SSAP No. 37. If the Working Group directs Option 1 with an exposure, only the edits that correspond to the Working Group direction will be exposed. (For example, if the Working Group directs Option 1 with non-conforming in BA, then the edits drafted for SSAP No. 37 will not be exposed.)

**Proposed Revisions to SSAP No. 43R—Loan-Backed and Structured Securities:**

**SCOPE OF STATEMENT**

1. This statement establishes statutory accounting principles for investments in loan-backed and structured securities. Items captured in scope of this statement are collectively referred to as loan-backed securities. The scope of this statement includes:
   
   a. Loan-backed and structured securities defined in paragraphs 2-4 and 7.
   
   b. Mortgage-referenced securities defined in paragraph 4.
   
   c. Retained beneficial interests from the sale of loan-backed and structured securities in accordance with SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.
   
   d. Credit tenant loans (CTLs), which qualify for bond treatment, pursuant to a structural analysis as identified in Part 3 of the Purposes and Procedures Manual of the NAIC Investment Analysis Office. CTLs that do not qualify are referred to as “non-conforming” CTLs and shall be reported on Schedule BA. Other Long-Term Invested Assets. With this classification, certain reporting entities can file the instrument with the NAIC SVO for a credit analysis and report the non-conforming CTL with the SVO-assigned NAIC designation. Although the structure of CTL does not permit reporting in scope of SSAP No. 43R (on Schedule D-1), the credit assessment reported on Schedule BA can be used to influence risk-based capital charges.
   
   Staff Note: If the Working Group directs mortgage loans reporting for non-conforming CTLs instead of Schedule BA, the following replacement paragraph for 1.d. would be utilized:

   Credit tenant loans (CTLs), which qualify for bond treatment, pursuant to a structural analysis as identified in Part 3 of the Purposes and Procedures Manual of the NAIC Investment Analysis Office. CTLs that do not qualify are referred to as “non-conforming” CTLs and are captured in scope of SSAP No. 37—Mortgage Loans.
   
   e. Ground lease financing (GLF) transactions, which qualify for bond treatment, pursuant to a structural analysis as identified in Part 3, of the Purposes and Procedures Manual of the NAIC Investment Analysis Office.

Although the recommendation is for Schedule BA, if the Working Group directs non-conforming CTLs to SSAP No. 37—Mortgage Loans, the following language has been drafted for consideration: *(This language will be removed if the Working Group proceeds with the Schedule BA reporting proposal.)*
SCOPE OF STATEMENT
1. This statement establishes statutory accounting principles for the accounting and reporting of mortgage loans and related fees. The scope of this statement includes:

   a. Mortgage loans defined in paragraph 2.

   b. Credit tenant loans (CTLs) which do not qualify for bond treatment, pursuant to a structural analysis as identified in Part 3 of the Purposes and Procedures Manual of the NAIC Investment Analysis Office. CTLs that qualify for bond reporting are published on (add SVO website reference). (CTLs are captured in scope of this statement although they may meet the “security” definition reflected in paragraph 2 unless they qualify for bond reporting under the SVO structural analysis. By definition, a credit tenant loan is a mortgage loan.)

Status:
On November 12, 2020, the Statutory Accounting Principles (E) Working Group took the following actions:
1. Confirmed that conforming CTLs will remain in scope of SSAP No. 43R and reported on D-1;
2. Directed a referral to the SVO to request information on the residual risk percentage permitted to be considered a conforming CTL; and
3. Permit nonconforming CTLs filed with the SVO that receive an SVO-assigned NAIC designation to be reported on Schedule D-1. If the nonconforming CTLs are not filed or have not received a NAIC SVO designation before the March 1, 2021, filing date, the securities shall be reported on Schedule BA.

On December 4, 2020, due to the number of questions requesting clarification on the motion, the Working exposed INT 20-10: Reporting Nonconforming Credit Tenant Loans.

On December 28, 2020, the Statutory Accounting Principles (E) Working Group adopted INT 20-10: Reporting Nonconforming Credit Tenant Loans, temporarily allowing continued D-1 reporting of nonconforming CTLs if they are filed with the SVO by February 15, 2021. With this provision, nonconforming CTLs reported on Schedule D-1 that have not received an SVO-assigned designation shall be disclosed in Note 1 as if a permitted practice.