Conference Call

VALUATION OF SECURITIES (E) TASK FORCE
Thursday, October 31, 2019
4:00 – 5:00 p.m. ET / 3:00 – 4:00 p.m. CT / 2:00 p.m. – 3:00 p.m. MT / 1:00 p.m. – 2:00 p.m. PT

ROLL CALL

Robert H. Muriel, Chair Illinois
James J. Donelon, Vice Chair Louisiana
Lori K. Wing-Heier Alaska
Ricardo Lara California
Andrew N. Mais Connecticut
Trinidad Navarro Delaware
David Altmaier Florida
Dean L. Cameron Idaho
Doug Ommen Iowa
Vicki Schmidt Kansas
Al Redmer Jr. Maryland
Gary Anderson Massachusetts

Chlora Lindley-Myers Missouri
Bruce R. Ramge Nebraska
Marlene Caride New Jersey
John G. Franchini New Mexico
Linda Lacewell New York
Glen Mulready Oklahoma
Jessica Altman Pennsylvania
Kent Sullivan Texas
Todd E. Kiser Utah
Scott A. White Virginia
Mike Kreidler Washington
Mark Afable Wisconsin

NAIC Support Staff: Charles A. Therriault

AGENDA

1. Receive a Non-Substantive Proposed P&P Manual Amendment to Add Instructions for ETFs that Contain a Combination of Preferred Stocks and Bonds
   —Kevin Fry (IL) and Charles Therriault (NAIC)
   (Doc ID: 2019-011-01)
   Attachment A

2. Receive a Non-substantive Proposed P&P Manual Amendment to Rename and Combine the U.S. Direct Obligations/Full Faith and Credit Exempt List and Bond Fund List and Instructions to the U.S. Government Fund List
   —Kevin Fry (IL) and Charles Therriault (NAIC)
   (Doc ID: 2019-012-01)
   Attachment B

3. Receive a Non-Substantive Proposed P&P Manual Amendment to Add Instructions to Limit NAIC Designations to the NAIC Assigned Sovereign Rating
   —Kevin Fry (IL) and Charles Therriault (NAIC)
   (Doc ID: 2019-013-01)
   Attachment C

   —Kevin Fry (IL), Charles Therriault (NAIC), Eric Kolchinsky (NAIC)
   (Doc ID: 2018-014-02)
   Attachment D

5. Receive a Substantive Proposed P&P Manual Amendment to Add Instructions for Ground Lease Transactions
   —Kevin Fry (IL) and Charles Therriault (NAIC)
   (Doc ID: 2019-014-01)
   Attachment E
6. Discuss a Substantive Proposed P&P Manual Amendment for Principal Protected Securities
   —Kevin Fry (IL) and Charles Therriault (NAIC)
   *(Doc ID: 2019-015-01)*

   Attachment G

   Attachment H

   Attachment I

   Attachment J

   Attachment K

   Attachment L

7. Receive a Substantive Proposed P&P Manual Amendment to Remove the Financial Modeling
   Instructions for RMBS/CMBS Securities and Direct IAO Staff to Produce NAIC Designation
   and NAIC Designation Categories for these Securities
   —Kevin Fry (IL) and Charles Therriault (NAIC)
   *(Doc ID: 2019-016-01)*

   Attachment M

8. Receive a Staff Report on the U.S. SEC Adoption of a New Rule to Modernize Regulation of
   Exchange-Traded Funds
   —Kevin Fry (IL) and Charles Therriault (NAIC)

9. Adjournment
MEMORANDUM

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

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

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

RE: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office  
    (P&P Manual) to Add Instructions for ETFs that Contact a Combination of Preferred Stocks and Bonds

DATE: September 30, 2019

1. **Summary** – The P&P Manual authorizes the SVO to review and determine that a fund’s cash flow can be appropriately characterized as fixed income for regulatory purposes, and if so, assign an NAIC Designation to reflect the credit risk associated with the fund’s cash flow and include the name of the fund on the appropriate NAIC List. For inclusion on the SVO-Identified bond or preferred stock ETF list, the ETF must predominantly hold either a portfolio of bonds or preferred stock. This guidance restricts the SVO from reviewing ETFs that hold a portfolio of both bonds and preferred stock. This proposed amendment would provide authorization for the SVO to review ETFs that hold both bonds and preferred stock for possible inclusion on the preferred stock ETF list.

2. **Proposed Amendment** – The text referencing the Investments in Funds is shown below, edits in red-underline, as it will appear in the 2019 P&P Manual format.
The SVO-Identified Bond ETF List and the SVO-Identified Preferred Stock ETF List

255. Description – At this time, ETFs operate under an Exemptive Order granted by the SEC that provides relief from the application of provisions of the Investment Company Act of 1940 that would otherwise apply. ETFs issue creation units to initial investors in exchange for a specified portfolio of bonds. The initial investor can hold the creation units or sell the ETF shares that constitute the creation unit on the exchange on which the ETF is registered. Other investors may purchase ETF shares; including to reconstitute and redeem a creation unit. Shares of ETF are not redeemable to the fund but are traded on registered exchanges at a price set by the market. Shares of ETFs are expected to trade at or near par because of arbitrage related to the value of the portfolio or of the ETF shares. For inclusion on the SVO-Identified bond ETF list, the ETF must hold a portfolio of bonds, preferred stock or a combination of bonds and preferred (or preferred stock) that tracks a specified bond index (a passive investment); or it must a portfolio of bonds, preferred stock or a combination of bonds and preferred (or preferred stock) that it actively manages pursuant to a specified investment objective.

257. An ETF on the SVO-Identified Preferred Stock ETF List is in scope of SSAP No. 32—Preferred Stock and reported on Schedule D, Part 2, Section 1. The SVO may include ETFs that hold a portfolio of bonds and preferred stock on the SVO-Identified Preferred Stock ETF List. These investments are reported at either amortized cost or fair value based on assigned NAIC Designation.
MEMORANDUM

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

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

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


DATE: September 30, 2019

1. Summary – The P&P Manual authorizes the SVO to maintain two special fund lists. The first is the NAIC U.S. Direct Obligations/Full Faith and Credit Exempt Money Market Funds List. This list of Money Market Funds (MMF) gets special treatment because they can be reported as a cash equivalent on Schedule E, Part 2. The SVO proposes simplifying the title of this list to “NAIC U.S. Government Money Market Fund List.” This is only a title change to simplify its description.

The second is the NAIC Bond Fund List, where the SVO reviews that a fund maintains the highest credit quality rating, maintains the highest market risk rating (this rating type that is no longer assigned), and invests 100% of its total assets in U.S. Government securities along with several other restrictive criteria. Only four funds qualify for this list and the four insurers invested in these fund have a combined exposure of $11.8 million BACV in one of the four qualifying funds as of December 31, 2018. With the adoption of the Comprehensive Instructions for Fund Investments on April 7th that provided new instructions for Fixed Income-Like SEC Registered Funds and given the limited number of insurers investing in the funds on the NAIC Bond Fund List, the SVO proposes eliminating this list when the four funds come up for renewal in 2020. The funds on the NAIC Bond Fund List would be eligible for NAIC Fixed Income-Like SEC Registered Funds List and the SVO would be willing to allow these fund issuers to apply to be on this new list at their renewal, if they were so interested. This change would require a referral to the Statutory Accounting Principles (E) Working Group as the NAIC Bond Fund List is referenced in SSAP No. 26R – Bonds.

2. Proposed Amendment – The text referencing these instructions for U.S. Direct Obligations/Full Faith and Credit Exempt Money Market Funds List and NAIC Bond Fund List is shown below, edits in red-underline, as it will appear in the 2019 P&P Manual format.
2019 P&P Manual

Part Three – SVO Procedures and Methodology for Production of NAIC Designations

Investment in Funds

The NAIC U.S. Government Money Market Fund List U.S. Direct Obligations/Full Faith and Credit Exempt Money Market Funds List

247. **Regulatory Treatment of Eligible Funds** – A money market mutual fund on the NAIC U.S. Government Money Market Fund List U.S. Direct Obligations/Full Faith and Credit Exempt List is reported as a cash equivalent on Schedule E, Part 2 on the “Exempt Money Market Mutual Funds – as Identified by the SVO” line. These “exempt” money market mutual funds are reported at fair value and incur a zero percent (0%) risk-based-capital (RBC) charge. Other money market mutual funds are also reported as cash equivalents on Schedule E, Part 2 on the “All Other Money Market Mutual Funds” line. The “all other” money market mutual funds are also reported at fair value but incur an RBC charge similar to other cash equivalents.

248. **Required Documentation** – An insurance company or the sponsor of a money market mutual fund requests an SVO evaluation that a money market mutual fund is eligible to be listed on the NAIC U.S. Government Money Market Fund List U.S. Direct Obligations/Full Faith and Credit Exempt List by submitting the following documentation to the SVO:

- The money market mutual fund application form.
- Authorization letter requesting review of the fund for the purpose of being added to the List.
- The most recent fund:
  - Prospectus;
  - Statement of Additional Information (SAI); and
  - Annual, and if available, the semi-annual report.
- Rating letter from an NAIC CRP dated in the year of the filing.

249. **Eligibility Criteria** – A money market mutual fund is eligible for inclusion on the NAIC U.S. Government Money Market Fund List U.S. Direct Obligations/Full Faith and Credit Exempt List if the fund meets the following conditions:

- The fund maintains a money market mutual fund rating of AAAm from Standard & Poor’s or Aaa-mf from Moody’s Investor Services or an equivalent money market mutual fund rating from any NAIC CRP.
- The fund maintains a stable net asset value per share of $1.00.
- The fund allows a maximum of seven-day redemption of proceeds.
- The fund invests 100% of its total assets in securities that are direct obligations of the U.S. Government and/or in securities that are backed by the full faith and credit of the U.S. Government or collateralized repurchase agreements comprised of such obligations at all times.

  **NOTE:** Please refer to text below for a list of securities considered to be direct obligations of the U.S. Government and entities that are entitled to the full faith and credit of the U.S. Government.

250. **Verification Procedure** – Upon receipt of the documentation, the SVO examines the prospectus, schedule of fund portfolio holdings and related materials to verify that the fund meets the established criteria.
251. **Regulatory Treatment of Eligible Funds** — A bond mutual fund on the NAIC Bond Mutual Fund List is in scope of SSAP No. 26R — Bonds, reported with an NAIC 1 designation on Schedule D, Part 1 — Long Term Bonds on the “SVO Identified Funds — Bond Mutual Funds” line. The insurance company reports an NAIC 1 Designation in accordance with Annual Statement Instructions. These investments are reported at fair value unless the investment qualifies for and the reporting entity elects systematic value.

252. **Required Documentation** — An insurance company or the sponsor of a bond mutual fund requests an SVO evaluation that a bond mutual fund is eligible for inclusion on the Bond Mutual Fund List by submitting the following documentation to the SVO:

- The bond fund application form.
- Authorization letter requesting review of the fund for the purpose of inclusion on the Bond Mutual Fund List.
- The most recent fund:
  - Prospectus;
  - Statement of Additional Information (SAI); and
  - Annual, and if available, the semi-annual report.
- Rating letter from an NAIC CRP dated in the year of the filing.

253. **Eligibility Criteria** — A bond mutual fund is eligible for inclusion on the Bond List if the fund meets the following conditions:

- The fund shall maintain the highest credit quality rating given by an NAIC CRP.
- The fund shall maintain at least the highest market risk rating given by an NAIC CRP to a fund that invests in class 1 bonds that are issued or guaranteed as to payment of principal and interest by agencies and instrumentalities of the U.S. Government, including loan-backed bonds and collateralized mortgage obligations, and collateralized repurchase agreements comprised of those obligations.
- The fund shall allow a maximum of seven-day redemption of proceeds.
- The fund shall invest 100% of its total assets in the U.S. Government securities listed in the section below, class 1 bonds that are issued or guaranteed as to payment of principal and interest by agencies and instrumentalities of the U.S. Government, including loan-backed bonds and collateralized mortgage obligations, and collateralized repurchase agreements comprised of those obligations at all times.
- The fund shall declare a dividend of its net investment income each day prior to calculating its net asset value per share.
- The fund shall not invest in any derivative instruments, as that term is defined in the NAIC Accounting Practices and Procedures Manual.
- The fund shall not invest in any bonds that receive some or all of the interest portion of the underlying collateral and little or no principal, or in any bonds with coupons which reset periodically based on an index and which vary inversely with changes in the index.
- The fund shall not invest in the following types of securities: (a) leveraged or deleveraged notes that pay a multiple or fraction of an index or indices; (b) notes that pay principal or interest linked to foreign currencies, non-U.S. dollar interest rates, equity or commodities indices or any other index that is not composed of U.S. dollar-denominated fixed-income instruments; or (c) notes that pay principal or interest linked to more than one index.
Verification Procedure — Upon receipt of the documentation, the SVO examines the prospectus, schedule of fund portfolio holdings and related materials to verify that the fund meets the established criteria.

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MEMORANDUM

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

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

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

RE: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office
    (P&P Manual) to Clarify That the Sovereign Rating Limitation Applies to Filing Exemption (FE)

DATE: September 30, 2019

1. Summary – The P&P Manual has criteria capping the NAIC Designation that the SVO can assign to a
   foreign security to the sovereign rating of the issuer’s country of origin. This sovereign limitation is not currently
   explicitly addressed when an NAIC Designation is produced through the filing exempt instructions. This
   proposed amendment provides that consistency by limiting all NAIC Designations for foreign securities to the
   NAIC’s Foreign Sovereign Designation Equivalent list published on the SVO’s webpage.

2. Proposed Amendment – The text referencing the NAIC Designation cap for foreign securities is shown
   below, edits in red-underline, as it will appear in the 2019 P&P Manual format.
Part One – Policies of the NAIC Valuation of Securities (E) Task Force

Special Instructions

Sub-paragraph D Company

121. The insurance company must file all foreign securities for which the information required by this Manual is available. For those foreign securities held by a “Sub-paragraph D Company” as defined below, where the required information is not available for the SVO to value the security, the NAIC Designation may be determined by the reporting insurance company. This determination shall carry an F suffix. In no case shall the NAIC Designation exceed the sovereign rating of the issuer’s country of origin as published in the NAIC’s Foreign Sovereign Designation Equivalent list on the SVO’s webpage. The company shall provide its domestic regulator with a description of the procedure it used to evaluate and assign ratings to these foreign securities. In addition, the company shall retain the documentation supporting each designation assigned by it until the next domestic insurance department examination.

Part Three – SVO Procedures and Methodology for Production of NAIC Designations

List of NAIC Credit Rating Providers

LIMITATIONS ON USE OF NAIC CRP RATINGS

NAIC Designation is Capped to NAIC Foreign Sovereign Designation Equivalent

28. The NAIC shall not assign an NAIC Designation for any foreign security which qualifies as a foreign investment as defined in the Annual Statement Instructions published by the NAIC, whether or not eligible for filing exemption, that is greater than the sovereign rating of the issuer's country of origin indicated by the NAIC Foreign Sovereign Designation Equivalent listed on the SVO's webpage.
PART THREE – SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

GENERAL CORPORATE AND MUNICIPAL METHODOLOGY FOR INDEPENDENT CREDIT QUALITY ASSESSMENT

FOREIGN SECURITIES

**Foreign Sovereign Government, and Supranational Entities and Foreign Securities**

28. A reporting insurance company that owns a security issued by a foreign sovereign government, an agency or political subdivision of a foreign sovereign government or a supranational entity (entities with more than one sovereign government as a member), or that is guaranteed directly or indirectly by such an entity must file such security with the SVO accompanied by a prospectus and investment committee memorandum.

29. Insurance companies shall not file issues with the SVO if the issuer of foreign origin does not have a sovereign rating from an NAIC CRP. If the issuer is not rated by an NAIC CRP, proof of a guarantee from an NAIC CRP-rated foreign sovereign government may be submitted. Where a reporting insurance company has filed a foreign security accompanied by an Audited Financial Statement, in English, the SVO will assess the security in accordance with the applicable corporate methodology, but the NAIC Designation it may assign shall be limited capped by the sovereign rating of the issuer's country of origin. This section should not be read as prohibiting the presentation of transactions structured to eliminate foreign sovereign risk.

30. The insurance company must file all foreign securities for which the information required by this Manual is available. For those foreign securities held by a “Sub-paragraph D Company” as defined in Part One, where the required information is not available for the SVO to value the security, the NAIC Designation may be determined by the reporting insurance company. This determination shall carry an F suffix. In no case shall the NAIC Designation exceed the sovereign rating of the issuer’s country of origin. The company shall provide its domestic regulator with a description of the procedure it used to evaluate and assign ratings to these foreign securities. In addition, the company shall retain the documentation supporting each designation assigned by it until the next domestic insurance department examination.

31. The NAIC Designation that can be assigned to a foreign security which qualifies as a foreign investment as defined in the Annual Statement Instructions published by the NAIC, whether or not eligible for filing exemption, shall be capped by the sovereign rating of the issuer's country of origin as published in the NAIC’s Foreign Sovereign Designation Equivalent list on the SVO’s webpage.
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

CC:      Eric Kolchinsky, Director, NAIC Structured Securities Group

DATE:   July 2, 2019


1. **Introduction**  – The SVO proposes a non-substantive amendment to the P&P Manual to update guidance in Part Four under the The NAIC Structured Securities Group, Mortgage Reference Securities. The Structured Securities Group (SSG) is responsible to financially model this group of securities; however, they only review them during their annual surveillance process. Insurers currently do not have instructions to assign an NAIC designation to a newly issued or newly acquired mortgage reference security prior to the publication of the annual surveillance data. This proposal would provide that interim guidance.

2. **Proposed Amendment**  – The proposed amendment is shown below in red-underline.

   **Part Four The NAIC Structured Securities Group**
   
   **MORTGAGE REFERENCED SECURITIES**
   
   **Definition**
   
   ...

   **Quarterly Reporting for Mortgage Reference Securities**

   **To determine the NAIC Designation to be used for quarterly financial statement reporting for a Mortgage Reference Security purchased subsequent to the annual surveillance described in this Part, the insurer uses the prior year-end modeling data for that CUSIP (which can be obtained from the NAIC) until the annual surveillance data is published for the current year. For a Mortgage Reference Security that is not in the prior year-end modeling data for that CUSIP, the insurer may follow the instructions in Part Two of this manual for the assignment of the SVO Administrative Symbol “Z” provided the insurer owned security meets the criteria for a security that is in transition in reporting or filing status.**
September 4, 2019

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

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


Dear Messrs. Fry and Guerin:

ACLI1 and NASVA2 (“the undersigned”) appreciate the opportunity to comment on the Proposal, which has a September 5, 2019 comment period deadline, as exposèd by the Task Force on August 4, 2019.

The undersigned are supportive of the proposal and its adoption.

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

Sincerely,

Tracey Lindsey
Senior Director, Accounting Policy
American Council of Life Insurers

cc: Mr. Charles Therriault, Director, SVO

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

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

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

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO)
Catholic Order of Foresters
CGA Capital
Mesirow Financial, Inc.
CTL Capital
Waterway Capital

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

RE: Joint Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Add Ground Lease Financing Transactions as New Asset Class

DATE: October 17, 2019

1. Introduction – Earlier in 2019 the SVO became aware that certain insurance company filers were submitting credit tenant loan (CTL) transactions and transactions which are herein defined as ground lease financing (GLF) transactions through the Filing Exempt (FE) process. The SVO subsequently explained to the market that (i) all CTL structures must be submitted to the SVO for review pursuant to Part One, Paragraph 106 and Part Three, Paragraph 4 of the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P), (ii) the SVO considered GLF transactions distinct from CTL transactions and (iii) the SVO identified that it would need to study the GLF transactions before they could make a recommendation to the Valuation of Securities (E) Task Force on whether NAIC Designations could be assigned to these structures and if they should be eligible for Schedule D reporting given their credit and legal risks. The SVO has now completed that study and a discussion of the SVO’s evaluation of the GLF asset class, its proposed approach to analyzing GLF transactions, and its recommended related amendments to the P&P follow.

2. Analytic Overview –

Credit Tenant Loans – CTLs are loans made to the owner of real property but made primarily in reliance on the credit standing of the tenant on a long-term lease of such property (generally highly rated by an NAIC CRP), structured with an assignment of the rental payments under such lease to the lender with such real property pledged as collateral in the form of a first lien. CTLs are generally structured around the terms of the lease which, in its strongest form, requires the tenant to perform all obligations related to the leased premises thereby obligating the tenant to continue to pay rent regardless of what occurs to the leased premises (e.g. casualty or condemnation). The leases are typically considered, with certain recognized variants in the P&P, to be “hell or high water” or “triple net” in nature. Therefore, the SVO’s analytic focus is on the credit worthiness of the tenant (or its guarantor), and not the...
real property characteristics of the premises. As explained in the CTL section of Part Three of the P&P, the SVO recognizes four categories of CTLs as eligible for reporting on Schedule D (Bond Lease Based CTLs, Credit Lease Based CTLs, Acceptable CTL Variants (ACVs), and Multiple Property Transactions (MPTs)), each with varying degrees of landlord obligation and real estate risk exposure and varying legal and structural complexity. Pursuant to the P&P’s CTL criteria, each enumerated permitted landlord obligation or risk must be explicitly addressed with an enumerated mitigant. (CTLs are explained extensively in the P&P, Part Three, Paragraphs 71 – 91.)

Ground Lease Financings – A GLF transaction typically has two components: (i) 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 (ii) 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.

Both the ground lessor and ground lessee will typically finance their respective estates (i.e., the fee estate of the ground lessor and the leasehold estate of the ground lessee); (i) the ground lessor, typically, with the issuance of debt-like certificates or notes, and (ii) the ground lessee, typically, by borrowing from a financial institution or traditional mortgage lender. To secure the financing, the ground lessor will grant to the lender a mortgage on the fee property such ground lessor owns, and the ground lessee will pledge to the leasehold lender its leasehold estate and its rights under the ground lease and in the improvements which it owns and the space leases if any.

Typically, in a GLF transaction neither the ground lessor nor the ground lessee is an entity either (i) rated by an NAIC CRP or (ii) whose credit worthiness can be evaluated by the SVO. Rather, they are special purpose vehicles (SPVs) intended to be bankruptcy remote.

Comparison of CTLs and GLFs – Due to the “hell or high water” or “triple net” nature of the lease in a CTL transaction or, in the instance where there are variances, their mitigation in accordance with the P&P CTL criteria, the SVO can focus its analysis on the credit worthiness of the credit tenant and not on an analysis of the underlying property. This type of lease eliminates the investor’s exposure to property risk as all payments owed to the investor ultimately come from the tenant.

In a GLF transaction it is often the case that the terms of the ground lease itself (the first leg of the transaction) is structured with the same attributes as a lease in a CTL transaction (e.g. it is “hell or high water” or “triple net”). However, because the ground lessee is an SPV rather than an operating entity, there is no NAIC CRP credit rating or SVO credit analysis to rely on. To determine whether the ground lessee will have sufficient funds to pay its ground lease obligations the SVO must look to the rent payments of the space tenants or the operation of the business being conducted on such property. The SVO, in conjunction with the NAIC Structured Securities Group (SSG) takes the position that the analysis of space leases and space tenants can be more akin to a commercial mortgage backed security (CMBS) analysis than the corporate analysis in a CTL transaction because the space leases may not meet the CTL criteria and can consist of several space tenants of differing credit profiles and each with differing space lease terms. We note that some of the NAIC CRPs which assign ratings to GLF transactions have utilized their CMBS models in their GLF ratings process, but their methodologies and criteria vary widely. The SVO understands that in most GLF transactions the certificate holder, the insurer as the investor, is in a “last loss”, or most senior, position. However, regardless of where they stand in the waterfall, unlike a traditional CTL transaction, ultimate payment on the GLF certificates is dependent not on a single credit tenant, but rather on payments by all the space tenants (which are not necessarily NAIC CRP rated or SVO analyzed entities) pursuant to space leases (which do not necessarily meet the CTL criteria).
Proposal – Recognizing that there are variances in how GLF transactions are structured the SVO proposes amending the P&P to institute a multi-pronged approach to analyzing these transactions. The proposed P&P amendments would include adding GLF transactions as a new asset class and would outline our GLF analytic process as follows:

a. The SVO would analyze the ground lease to determine if it meets the criteria for Bond Lease Based CTLs or Credit Lease Based CTLs in the P&P. We expect most ground leases to meet this test. Ground lease inconsistency with the Bond or Credit Lease Based CTL criteria would result in ineligibility for Schedule D reporting.

b. If the ground lease meets the Bond or Credit Lease Based CTL criteria and if three or fewer space tenants, each of which either (i) are rated by an NAIC CRP or (ii) whose credit worthiness can be evaluated by the SVO, when combined comprise 90% or more of the total space lease payment obligations, the SVO would analyze the space leases to determine if they meet the CTL criteria for one of the four CTL categories in the P&P. If so, the SVO could, in its sole discretion and based on its analytic judgement, analyze the transaction as akin to a CTL, based on the CTL-like nature of both the ground and space leases, the limited number of space leases and the credit profiles of the space tenants. We expect a small fraction of all GLF transactions to fall in this category.

c. If the ground lease meets the Bond or Credit Lease Based CTL criteria and there are four or more space tenants, or the SVO has determined that the transaction does not meet the criteria set forth in clause (b.) above or if there are no space tenants but one operator of a business on the leasehold such as a hotel, warehouse, intermodal facility, etc., the SVO may refer the space leases or the business operation to the SSG for possible financial modeling. If the SSG, in conjunction with its third-party modeling vendor, determines that the space leases or business operation can be modeled, the SSG would analyze the space leases or business operation, as the case may be, to determine whether they will provide sufficient cash flow to pay the ground lease rent payments and any additional costs which the ground lessee would be obligated to cover pursuant to the ground lease terms (e.g. taxes, utilities, maintenance, insurance).

d. If the SSG, in conjunction with its third-party modeling vendor, determines that it is unable to model the space leases or business operation, as the case may be, and if the transaction has been assigned an Eligible NAIC CRP Rating, public or private, the SVO may use the NAIC CRP analysis provided by the filer to assist the SVO in its own analysis. The SVO’s analysis will be entirely at the discretion of the SVO, and the SVO will be under no obligation to accept the NAIC CRP analysis, conclusions or ratings. Furthermore, upon completion of its analysis the SVO can decline to assign an NAIC Designation, in which case the security would be ineligible for Schedule D reporting.

e. Insurers that would like the SVO to review the GLF transactions prior to purchasing them may submit them through the Regulatory Treatment Analysis Service (RTAS) process. The SVO is willing to set up new RTAS processes for each of these three paths, at the request of the submitting investor: 1) SVO credit analysis, 2) SSG modeling and 3) SVO review of NAIC CRP analysis.

f. Additionally, the SVO would look for evidence that (i) the transaction is properly insured because, unlike a credit tenant in a CTL transaction, the ground lessee SPV will not have access to extra funds to cover costs such as repairs in the event of casualty, and (ii) that satisfactory Phase I and, if necessary, Phase II environmental reports have been delivered to provide comfort that there will be no expected environmental liabilities.

3. Recommended Amendment – The recommended changes to the P&P regarding the addition of Ground Lease Financing criteria are shown below in red, showing how it will appear in the 2019 P&P format. The SVO recommends that this amendment also be referred to the Statutory Accounting Principles (E) Working Group for affirmation that these investments are eligible for Schedule D, Part 1 reporting under the criteria proposed.
2019 P&P Manual

Part One – Policies of the NAIC Valuation of Securities (E) Task Force

POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES

...  

GROUND LEASE FINANCING TRANSACTIONS

GLF Overview

107. A ground lease financing transaction (GLF) typically has two components: (i) 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 (ii) 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.

108. The ground lease itself typically meets the Credit Tenant Loan (CTL) criteria for Bond Lease Based or Credit Lease Based CTLs in this Manual. Additionally, there can be one or several space tenants or business operators (which (i) may or may not be NAIC CRP rated entities or (ii) whose credit worthiness can or cannot be evaluated by the SVO) making lease payments under separate space leases (which may or may not meet the CTL criteria) or a business operation. As such, the SVO cannot rely solely on the CTL criteria for its analysis of GLF transactions and instead must rely on a combination, as necessary and available, of the CTL criteria, the CMBS criteria, the documented analysis of NAIC CRPs, and the SVOs own analytic judgement.

109. A GLF transaction reported as a CTL on transaction on Schedule D, acquired prior to January 1, 2020, and reported with an NAIC Designation produced under filing exemption, can continue to be reported on the basis of that Eligible NAIC CRP Rating until sold or disposed of.

NOTE: See “Ground Lease Financing Transactions” in Part Three for filing instructions, documentation requirements and methodology applicable to GLFs.

Part Three – SVO Procedures and Methodology for Production of NAIC Designations

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

...  

FE SECURITIES

Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:

...  

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• **Ground Lease Financing Transactions** – A Ground Lease Financing (GLF) transaction typically has two components: (i) 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 (ii) 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 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.

**Part Three – SVO Procedures and Methodology for Production of NAIC Designations**

. . .

**Ground Lease Financing Transactions**

**NOTE:** See “Policies Applicable to Specific Asset Classes” in Part One for policies governing this activity, as well as “Specific Populations of Securities Not Eligible for Filing Exemption” in “Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities” above.

**Initial Filing Requirements**

305. For ground lease financing (GLF) transactions, the reporting insurance company shall submit a complete GLF Evaluation Form together with the documentation described in the GLF Evaluation Form and, if available, evidence of a current Eligible NAIC CRP Rating and related NAIC CRP analysis for (i) the GLF Transaction (including, but not limited to rating methodology used, model assumptions and stress test results) and (ii) each space lessee or its guarantor or business operator in the case of a hotel, warehouse, intermodal facility, etc. or other business operation.

**Subsequent Filing Requirements**

306. For GLF Transactions, the reporting insurance company shall submit evidence, if available, of a current Eligible NAIC CRP Rating and related NAIC CRP analysis for (i) the GLF Transaction (including, but not limited to rating methodology used, model assumptions and stress test results) and (ii) each space lessee or its guarantor or business operator. For purposes of this section, a current Eligible NAIC CRP Rating is defined as one issued or reviewed within the past 12 calendar months. If the GLF Transaction is modeled by the NAIC’s third-party modeling vendor, the reporting insurance company will submit the data required by the vendor in the form such vendor specifies. In the event a space lessee or its guarantor or business operator, as the case may be, is not rated by an NAIC CRP and a space lease or business operation is not modeled, the reporting insurance company shall file the Audited Financial Statements and other relevant credit information of the space lessee or its guarantor or business operator, as the case may require, consistent with all corporate bond filing requirements.

**SVO Procedure**
307. Upon receipt of a GLF Evaluation Form, the SVO analyst shall review the form and all documentation submitted with it and shall proceed with analysis in accordance with section “SVO Approach to GLF Transactions” below.

Ground Lease Financing Transaction – Definition and Overview

308. A ground lease financing (GLF) transaction typically has two components: (i) 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 (ii) 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.

309. Both the ground lessor and ground lessee will typically finance their respective estates (i.e., the fee estate of the ground lessor and the leasehold estate of the ground lessee); (i) the ground lessor, typically, with the issuance of debt-like certificates or notes, and (ii) the ground lessee, typically, by borrowing from a financial institution or traditional mortgage lender. To secure the financing, the ground lessor will grant to the lender a mortgage on the fee property such ground lessor owns, and the ground lessee will pledge to the leasehold lender its leasehold estate and its rights under the ground lease and in the improvements which it owns and the space leases if any.

310. Typically, in a GLF transaction neither the ground lessor nor the ground lessee is an entity either (i) rated by an NAIC CRP or (ii) whose credit worthiness can be evaluated by the SVO. Rather, they are special purpose vehicles (SPVs) intended to be bankruptcy remote.

311. In a GLF transaction it is often the case that the ground lease (the first leg of the transaction) is structured with the same attributes as a lease in a CTL transaction (e.g. it is “hell or high water” or “triple net”). However, because the ground lessee is an SPV rather than a corporate entity, there is no NAIC CRP corporate credit rating or SVO corporate analysis to rely on. To determine whether the ground lessee will have sufficient funds to pay its ground lease obligations the SVO must look to the rent payments of the space tenants or the operation of the business conducted in such improvements (such as a hotel, warehouse, intermodal facility, etc.). Depending on the specifics of a GLF transaction, analysis of space leases and space tenants and business operations and business operators could be more akin to a commercial mortgage backed security (CMBS) analysis than the corporate analysis in a CTL transaction because (i) the space leases may not meet the CTL criteria and can consist of one or several space tenants of differing credit profiles and each with differing space lease terms and ultimate payment on the GLF is dependent on the space tenants making their rent payment on the space leases or (ii) in the event there is a business operation, ultimate payment on the GLF is dependent on the operation of such business to generate cashflow for ground rent and other expenses. For this reason, the SVO may refer certain GLF transaction space lease or business operations analyses to the NAIC Structured Securities Group (SSG) because of the SSG’s financial modeling capabilities and because, in accordance with this Manual, it analyzes and assigns NAIC Designations to CMBS transaction.

SVO Approach to GLF Transactions

312. All GLF transactions are ineligible for filing exemption and must be submitted to the SVO. The SVO will conduct GLF transaction review in the following manner:
a. The SVO will analyze the GLF transaction structure and determine whether the ground lease meets the CTL criteria for Bond Lease Based or Credit Lease Based CTLs, except for not having a credit tenant. If the SVO, in its sole discretion, determines the ground lease does not meet the Bond Lease Based or Credit Lease Based CTL criteria, except for a credit tenant, the security would be ineligible for Schedule D reporting.

b. If the ground lease meets the CTL criteria, except for a credit tenant, and if three or fewer space tenants, each of which (i) are rated by an NAIC CRP or (ii) whose credit worthiness can be evaluated by the SVO, when combined comprise ninety percent (90%) or more of the total space tenant lease obligations, the SVO will analyze the space leases to determine if they meet the CTL criteria for one of the four CTL categories in this Manual. If so, the SVO can, in its sole discretion and based on its analytical judgment, analyze the transaction as akin to a CTL, based on the CTL-like nature (e.g. “hell or high water” or “triple net” features) of both the ground and space leases, the limited number of space leases and the corporate credit profiles of the space tenants.

c. If the ground lease meets the criteria for Bond Lease Based or Credit Lease Based CTLs and there are four or more space tenants, or the SVO has determined that it cannot apply the approach in (b.) above or the transaction does not meet the criteria set forth in clause (b) above, the SVO will refer the space leases or the business operation, as the case may be, to the SSG for possible financial modeling. If the SSG, in conjunction with its third-party modeling vendor, and in its sole discretion and analytical judgment based on factors including, but not limited to, availability of data, transaction structure and other transaction specific risks, determines that the space leases or business operation can be modeled, it will analyze the space leases or business operation, as the case may be, to determine whether they will provide sufficient cash flow to pay the ground lease rent payments and any additional costs which the ground lessee is required to cover pursuant to the ground lease terms (e.g. taxes, utilities, maintenance, insurance).

d. If the SSG, in conjunction with its third-party modeling vendor, and in its sole discretion and analytical judgment, determines that it is unable to model the space leases or business operation, as the case may be, and if the transaction has been assigned a public or private Eligible NAIC CRP Rating the SVO shall proceed with an analysis of the transaction guided by the available analyses of all NAIC CRPs that provided an Eligible NAIC CRP Rating on the transaction. For the avoidance of doubt, the SVO’s analysis will be entirely at the discretion of the SVO and the SVO is not obligated to accept or follow the rating methodology of any NAIC CRP and can, in its sole discretion and based on its analytical judgement, assign an NAIC Designation which differs from the correlated Eligible NAIC CRP Rating or choose not to assign any NAIC Designation. The SVO may, in its sole discretion, upon written request from the submitting investor, disclose its rationale as to why such transaction was not given a Designation correlated to the Eligible NAIC CRP Rating.

e. Should the SVO or, if applicable, SSG determine that it cannot assign an NAIC Designation to the GLF, the GLF would be ineligible for Schedule D reporting.

GLF Specific Considerations

313. The space lease payments or business operation, as the case may be, should be sufficient to cover any recurring costs the ground lessee is obligated to pay (e.g. taxes, utilities, maintenance, insurance) pursuant to the terms of the ground lease. All such ground lessee obligations will be factored into the SSG’s financial model of the space leases or business operations, if applicable.

314. To provide comfort that there will be no environmental liabilities, the filing documents shall include a Phase I environmental report showing no environmental problems and, if the Phase I report shows a
problem or the nature and prior used of the land indicates a substantial likelihood of preexisting environmental contamination, a Phase II environmental report.

315. Typically, a ground lease will require the ground lessee to hold the following insurance to protect the ground lease payments from potential shortfall due to the termination or abatement of space lease payments or reduction or termination of business operation upon the occurrence of condemnation or casualty or other insurable condition. Any of the insurable risks below that are not insured should be otherwise mitigated and evidence of such mitigant should be included in the filing documents.

   a. Casualty insurance in an amount of coverage equal to 100% of the replacement value of the improvements with the fee lender named as the loss payee.
   b. Rent loss insurance in an amount of coverage equal to at least 12 months of ground rent with the fee lender named as loss payee.
   c. General liability insurance. The amount of coverage shall be sized appropriately, depending on the size and type of building (e.g. office, hotel, warehouse, intermodal facility, etc.).
   d. Ground Lessor would be required to purchase special risk condemnation insurance in an amount of coverage equal to the principal amount of the GLF. This policy shall be prepaid and remain in place for the entire term of the GLF secured by the fee mortgage.

Note: All insurance must be issued by a carrier with an NAIC Designation equivalent rating of 1.G or better.

Part Four – The NAIC Structured Securities Group

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Ground Lease Financing Transactions

Definition

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

SSG Role and Process

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

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group

DATE: July 2, 2019

RE: Proposed Amendment to the *Purpose and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Update the Definition and Instructions for Principal Protected Notes

1. **Introduction** – The SVO proposes a substantive amendment to the P&P Manual to update guidance in Part Three under the Procedure Application to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities, Specific Populations of Securities Not Eligible for Filing Exemption. The SVO has become aware of a class of structured securities, known as Principal Protected Notes, that mixes a traditional bond or bonds with additional assets that may possess any characteristic. These additional assets are intended to generate an excess return, we call them the “performance assets;” such as, derivatives, common stock, commodities, equity indices, etc. … essentially any asset. The performance assets may include undisclosed assets and are typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond.

2. **Analytical Concern** – The SVO has reviewed a dozen or more of these securities. They share a consistent theme; the external credit rating provider (CRP) rating is based solely on the component dedicated to the repayment of principal and ignores the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1. There are many potential variants of this structure, for simplicity I have included examples of two common forms below. While the transactions details have been changed to maintain confidentiality the examples accurately reflect the risks and assets embedded within these structures.

a. In this initial example there are only two components: 1) a $10 MM par UST zero-coupon bond sold at discount (ex. $70) from par ($100) that will pay par ($100) at maturity and 2) a return linked to any positive performance of call options on the S&P 500 Index (if the S&P 500 Index has a negative performance, investors will only receive an amount equal to their initial investment). The external rating would be AAA, based solely on the risk of the UST security.
b. In the second example there are multiple components: 1) a $22MM corporate bond paying a fixed coupon (ex. 4.50%) with a stated maturity date (ex 9/30/2049), 2) the corporate bond has two NRSRO ratings (Moody’s Baa2, S&P BBB+), 3) the SPV invests $25MM in additional undisclosed and unrated assets, 4) the SPV pays a semi-annual coupon of 0.80%, 5) the excess coupon difference (4.50% - 0.80% = 3.70%) is used to accumulate into the required principal to pay at maturity and 6) a different NRSRO rated the PPN a BBB, again based solely on the corporate bonds that represent less than 50% of the total investment in this example.

In both examples, assets that would otherwise be ineligible for reporting on Schedule D are making their way onto that schedule through financial structuring. Significant risks are being obscured by focusing only risk associated with the repayment of principal. The source of the assets being transferred into this structured security and their relationship to the insurer is also not transparent. In addition, assets affiliated with the insurance company may be included in the additional asset tranche.

3. **Recommendation** – The SVO proposes removing this class of securities from eligibility for Filing Exemption. The SVO has existing methodologies that can applied to assess the overall risk of these structures and, to the extent that the SVO identifies possible affiliated assets, the SVO would alert regulators. The SVO also recommends referring this memorandum to the Statutory Accounting Principles (E) Working Group to consider the treatment of the asset transformations described above.

4. **Proposed Amendment** – The proposed amendment is shown below in red-underline.

**Part Three SVO Procedures and Methodology for Production of NAIC Designations**

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

... Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:

   - Principal Protected Notes (PPN) – PPN (sometime called “Principal Protected Securities,” “Principal Protected Loans,” or “Combo Notes”) are a type of structured security where a portion of the underlying assets are dedicated to ensure the repayment of principal at maturity or a third party may guarantee the repayment of principal at maturity. The remaining assets in the structure, the performance assets, are intended to generate additional returns and may be of a type (ex. derivatives, equities, commodities, non-CRP rated debt, loans, funds, private equity, real estate, affiliated, undisclosed, etc.) that would not be eligible for reporting on Schedule D. Investments in PPNs must be submitted to the SVO for analysis.
September 20, 2019

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

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

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to update the Definition and Instructions for Principal Protected Notes

Dear Messrs. Fry and Guerin:

ACLI\(^1\) and NASVA\(^2\) (“the undersigned”) appreciate the opportunity to provide feedback on the Valuation of Securities Task Force (“the Task Force”) exposure regarding ‘Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to update the Definition and Instructions for Principal Protected Notes’ (“the exposure”). Although we agree with the Analytical Concern stated in the exposure, as it relates to the example securities provided, we have three potential concerns: Securities Valuation Office (“SVO”) Capacity to Designate, Unintended Scope Expansion and Prospective Application. We will address each of these concerns below in greater detail.

**SVO Capacity to Designate**

We note the SVO has taken on various additional designation responsibilities and we have some concerns on whether the SVO has the capacity to designate further securities. There are also concerns that the SVO may not yet have an established and vetted rating methodology developed for the unique Analytical Concern presented by Principal Protected Notes (“PPNs”). Furthermore, given the nuances of existing standards regarding SVO authority to evaluate different types of structured securities, not to mention

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

\(^2\) The **North American Securities Valuation Association** (NASVA) is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Security 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.
additional possible components of PPNs (commodities, derivatives, equities, etc.), the absence of greater elaboration on the proposed methodology for PPNs concerns some of our membership. Our ask is that these issues are thoroughly vetted prior to adopting any further guidance related to PPNs.

It would be helpful if the major tenets of the rating methodology that will be used (or developed) to designate such securities could be shared with industry, including the extent to which approved credit rating provider (CRP) ratings will be considered. Structured finance assets provide insurance companies access to solid risk adjusted returns at a time when higher yields are scarce, and to cash flows streams that are often well suited to our asset/liability matching (“ALM”) needs. Given the potential implications for insurance companies weighing risk adjusted return opportunities that will support the ability to meet future policy holder obligations, we believe additional insight into the designation process will help provide clarity for insurers and minimize market uncertainty.

Unintended Scope Expansion

The exposure states:

These additional assets are intended to generate an excess return, we call them the “performance assets;” such as, derivatives, common stock, commodities, equity indices, etc. ... essentially any asset. The performance assets may include undisclosed assets and are typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond.

The SVO has reviewed a dozen or more of these securities. They share a consistent theme; the external credit rating provider (CRP) rating is based solely on the component dedicated to the repayment of principal and ignores the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1.

In both examples, assets that would otherwise be ineligible for reporting on Schedule D are making their way onto that schedule through financial structuring. Significant risks are being obscured by focusing only risk associated with the repayment of principal.

The exposure appears focused on the primary concern that external CRP ratings do not always fully depict the risks inherent to PPN investments. In such instances, the concern may arise that use of such CRP ratings under the Filing Exempt process would allow the investments to appear on Schedule D, Part 1 as structured securities, providing the impression to financial statement users that the investment risks are confined to the credit risk implied by the CRP rating. Absent contractual overlays that transform the risks to invested basis into solely those relating to the capacity of the obligor to make contractually promised payments, a portion of the carry value presented as a fixed-income like investment with a particular credit profile in the statutory financial statements could be exposed to the types of risks that would garner different classification and measurement/valuation under the applicable statutory guidance (e.g., risks associated with non-Schedule D, Part 1 eligible asset classes such as derivatives, equities, commodities, etc.). Viewed through this lens, we do not take issue with the elaborative language identifying concern that, in such instances, the CRP rating’s focus on only one of several inherent risks could fail to meet the regulatory objective.

However, the literal language drafted as the proposed amendment appears to expand beyond the objective of gaining additional visibility into the risks inherent to PPN investments. Mindful of unintended scope expansion, we feel the definition of PPNs within the proposed amendments should be updated to focus on characteristics indicating heightened risk that the security’s CRP rating is based solely on the underlying asset component dedicated to the repayment of principal and interest, and ignores the risk associated with the underlying performance assets. This appears to be a primary concern targeted by the exposure. We would like to offer a revised definition to dispel potential ambiguities as to the scope of the proposed amendments and facilitate consistent application across reporting entities:
Principal Protected Notes (PPNs) – are a type of structured security where payment of contractually promised fixed cash flows (principal and interest thereon) is satisfied by an underlying approved CRP rated bond(s), but additional potential returns are generated by additional assets in the structure which do not contribute to the contractually promised fixed cash flows. Investments in PPNs must be submitted to the SVO for analysis.

The type of performance asset underlying a PPN (as defined above) may vary, as the distinguishing characteristic of a PPN is that only a portion of the underlying assets are dedicated to the satisfaction of contractually promised fixed cash flows – indicating heightened risk that the security’s CRP rating fails to fully depict risks inherent to the structure as a whole. The above definition would capture both examples provided in the body of the exposure and achieve the regulatory objective with reduced potential for unintended expansion of scope or inconsistent application across reporting entities. If there are analytical concerns which do not meet the above definition, we request dialogue with the SVO to address each concern, on an iterative basis, to ensure the definition is not overly broad while still meeting regulatory objectives. In that same spirit, we would like additional dialogue to ensure that structures not containing the above defined characteristics – e.g., structures containing derivatives only hedging foreign exchange risk, tranches in CLO structures, etc. – are not captured within the scope of the PPN definition.

Prospective Application

We believe the new filing requirements for PPNs should be applied prospectively. While industry is sympathetic to the Analytical Concern related to PPNs, we are concerned about establishing a precedent of retroactive rule changes, particularly as it relates to filing requirements. Investments by insurance companies prior to the implementation of this change were made under a reasonable belief that then existing filing instructions were representative of statutory standards applicable for PPNs.

We look forward to continuing work with the SVO and the Task Force to right-size this proposal to help achieve regulatory objectives but also to ensure it does not portend any unnecessary burdens for reporting companies or unintended consequences. Further, the filing exempt process has served both industry and regulators well over the past decades. We want to ensure this process is utilized to the best extent possible, understanding that the SVO does not have the capacity to assign designations for the entire population of Schedule D, Part 1 eligible securities.

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

Sincerely,

[Signature]
Senior Director, Accounting Policy
American Council of Life Insurers

[Signature]
Tracey Lindsey
President
North American Securities Valuation Association

cc: Mr. Charles Therriault, Director, SVO
September 19, 2019

VIA EMAIL
Mr. Kevin Fry
Chairman, Valuation of Securities (E) Task Force,
National Association of Insurance Commissioners
and
Chief Operating Officer
Illinois Department of Insurance
320 West Washington Street, Fourth Floor
Springfield, IL 62767

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the “P&P Manual”) to update the Definition and Instructions for Principal Protected Notes (“PPNs”)

Dear Chairman Fry and Members of the Valuation of Securities (E) Task Force:

Kroll Bond Rating Agency, Inc. (“KBRA”) thanks you for the opportunity to submit this letter during the open comment period concerning the proposal to amend the P&P Manual’s definition of PPNs and the instructions for reporting PPNs (the “Proposal”). KBRA generally supports the Task Force’s objective of properly understanding and evaluating the risk of securities that are held by regulated insurance companies. KBRA also has reviewed the Securities Valuation Office’s July 2, 2019 memorandum regarding the Proposal (the “Memo”). Given that KBRA and the Task Force share the goal of accurately assessing risk, KBRA’s purpose in submitting this letter is to clarify KBRA’s understanding as to certain matters of fact set forth in the Memo.

KBRA believes that a security is not necessarily more or less risky solely because the security features a PPN in its structure. The main question should be: are the cash flows generated by the collateral supporting a debt instrument capable of meeting the principal and interest payment obligations of the transaction? For example, there may be transactions structured with PPNs where the collateral consists solely of AAA rated U.S. Treasury Bonds. Instead of evaluating the actual risk associated with the collateral, the Proposal would treat such a transaction the same way it would treat one that incorporates a PPN secured solely by non-investment grade securities. Conversely, a debt transaction that is secured by those same non-investment grade securities, but which does not include a PPN in its structure, would not be excluded by the PPN prohibition articulated in the Proposal. Whether a structure includes a PPN is important, but it should be a secondary consideration that should be incorporated into an
Mr. Kevin Fry  
Chairman, Valuation of Securities (E) Task Force,  
National Association of Insurance Commissioners  
September 19, 2019  
Page 2 of 3

analysis of the structural risks of any transaction. In short, KBRA does not believe that PPNs are inherently risky.

KBRA believes that analyzing risk must include, but should not be limited to, a transaction’s structural features. More importantly, KBRA believes that all risks, including collateral and structural features, should be analyzed together in order to properly assess risk. KBRA welcomes the opportunity to participate in more conversations around these issues.

Sincerely,

Jim Nadler  
Chief Executive Officer and President  
Kroll Bond Rating Agency, Inc.

Patrick Welch  
Chief Credit Officer  
Kroll Bond Rating Agency, Inc.

cc: Mr. Charles Therriault  
Director, Securities Valuation Office  
National Association of Insurance Commissioners (via email)

Ms. Denise Genao-Rosado  
Senior Administrative Assistant  
National Association of Insurance Commissioners (via email)
September 20, 2019
Submitted electronically to etheriault@naic.org and dgenaorosado@naic.org

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

Dear Mr. Fry:

We appreciate the opportunity to comment on the Valuation of Securities Task Force (the “Task Force”) exposure regarding the ‘Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Update the Definition and Instructions for Principal Protected Notes’ (the “Exposure”). We support the Task Force’s and SVO’s objective to provide solutions to investment-related regulatory issues for existing or anticipated investments. We recommend however, that:

- the proposed definition of PPNs be made more clear and less encompassing;
- the Task Force consider the accounting treatment’s impact to capital as well as the proposed changes’ impact on required capital;
- the Task Force provide more transparency into the process that would be utilized to assign ratings for PPN;
- the Task Force consider potential materiality of exposure to the change and the timing of implementation.

Commentary in the Introduction Section

The Exposure states:

These additional assets are intended to generate an excess return, we call them the “performance assets;” such as, derivatives, common stock, commodities, equity indices, etc. … essentially any asset. The performance assets may include undisclosed assets and are typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond.

The SVO has reviewed a dozen or more of these securities. They share a consistent theme; the external credit rating provider (CRP) rating is based solely on the component dedicated to the repayment of principal and ignores the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1.

Based upon the language above, it appears the Task Force has two primary concerns:

- **Concern 1**: Schedule D structured securities whose return is supported by assets not eligible for Schedule D reporting; and
- **Concern 2**: Ratings that reflect the risk of loss of principal and a small coupon, but do not reflect the risk of loss of potential additional returns.
Concern 1

An investment is reported on schedule D, Part 1 through: SSAP No. 26R - Bonds (“26R”) or SSAP No. 43R - Loan-Backed and Structured Securities (“43R”).

- 26R exists for investments that have a creditor relationship, whereby there is a fixed schedule for one or more future payments. Essentially, 26R investments have 1) principal amount due and 2) interest amount due.
- 43R exists for investments that have payment of interest and/or principal based upon payments received by the issuer from underlying assets.

Neither 43R, nor to our knowledge, state investment laws or the NAIC model investment law, require the underlying assets to be a 26R eligible asset. Otherwise stated, 43R does not prohibit underlying assets that would otherwise be ineligible for schedule D reporting under 26R. If such a requirement existed, we believe 43R would have less relevance. 43R allows for income generating investments that support insurance company liabilities and asset liability matching (“ALM”) core to an insurance company’s operations.

Additionally, we believe concerns with certain investments under 43R are already actively addressed by the Statutory Accounting Principles Working Group (“SAPWG”) through the following:

- adoption of changes to SSAPs 2R, 26R, 43R, and 86 that require structured notes to be accounted for as derivatives; and
- exposure of changes to 43R to exclude structures with underlying equity interests from the scope of the statement.

Concern 2

We agree with the Exposure that the CRP rating of a PPN is typically directionally consistent (e.g., typically equivalent to +/- 1 notch) with the rating of the component dedicated to the repayment of principal and coupon (e.g., the rating on the underlying corporate bond), and largely ignores the risk and return of the performance asset.

The reason for the rating equivalence is very important, but not mentioned in the Exposure. The reason the ratings are equivalent is that the contractual terms of the PPN (typically repayment of principal plus a small coupon, say 1%) are fully satisfied by the component dedicated to the repayment of principal and coupon. It is logical and definitionally consistent that since 100% of the contractual terms of the PPN are satisfied by, say a BBB-rated corporate bond, that the rating of the PPN would be BBB. Indeed, the risk asset(s) can immediately go to zero and as long as the BBB-rated corporate asset satisfies its principal and interest payments, the insurance company will get all of its investment back plus the small coupon. Additionally, and very importantly, an accounting impairment, which is an immediate reduction to surplus, would likely occur in this situation.1

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1 In 2006, the Task Force raised concern that the carry value of a PPN would not represent the amount available to meet current and future obligations of the insurance company if the underlying risk asset(s) was not performing, as the market value of such investment would likely be less than the principal amount. This was because 43R, at that time, only required the use of undiscounted cash flows for assessment of impairment. Accordingly, as long as the “safe” asset(s) was
A separate Task Force presentation delivered to the Task Force at the NAIC’s 2019 Summer National Meeting entitled “Bespoke Securities” stated the SVO would rate a NAIC 1 PPN as a NAIC 5.2 At an 800% ACL RBC level (representative of the level of capital that many insurers hold and before covariance, taxes, or concentration), an insurance company holds 1.6% capital for a NAIC 1 investment and 89.24% capital for a NAIC 5 investment. The proposed change in rating represents a 5,600% increase in required capital for an investment whose contractual terms are 100% satisfied by an A-rated or better asset. This appears very punitive as to an asset on which an insurer is still expected to recover principal and coupon in an adverse business, financial, or economic condition, doubly so considering an impairment through surplus would typically be recognized when the additional asset(s) is not performing.

In short, we believe that the ability of PPNs to satisfy current and future obligations is appropriately managed through the combination of 1) the CRP rating and 2) use of discounted cash flows to assess impairment.

**Commentary in the Analytical Section**

The Exposure states:

> In both examples, assets that would otherwise be ineligible for reporting on Schedule D are making their way onto that schedule through financial structuring. Significant risks are being obscured by focusing only risk associated with the repayment of principal. The source of the assets being transferred into this structured security and their relationship to the insurer is also not transparent. In addition, assets affiliated with the insurance company may be included in the additional asset tranche.

Regarding “**Significant risks are being obscured by focusing only risk associated with the repayment of principal,**” we believe the return of principal is a significant risk in and of itself. We acknowledge that the potential for additional return above the stated coupon may not be rated; however, as noted above, statutory accounting principles exist to regulate income recognition and carry value. Furthermore, we would note that 10-year Investment Grade Public Corporate Bonds were issued in September 2019 with coupons as low as 2.20%, with no potential for additional income. An investor could also purchase a NAIC 1 PPN with a 1% contractual coupon, but have the potential and expectation for meaningful additional returns. The NRSRO ratings suggest that both investments have the same likelihood to return contractual payments; however, the PPN could provide additional returns, potentially well above the 2.20% coupon. Additionally, statutory accounting would typically require the PPN to be impaired when the investor is not expected to recover the originally projected cash flows performing, future undiscounted cash flows would always support the principal amount, and there would be no impairment even though the risk asset(s) was not performing.

The Task Force referred its concern to the SAPWG, which resulted in substantive revisions to 43R that required the use of discounted cash flows using the original book yield to assess impairment. Accordingly, if the risk asset(s) is (are) not performing, there are less future cash flows, which typically results in impairment. This revision resulted in close alignment of the carry value of PPNs with the amount that would be available to meet current and future obligations.

2 The analytical details behind the rating were not disclosed; however, an NAIC 5 is equivalent to a S&P CCC rating. S&P defines a CCC rating as one that is “currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitments on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitments on the obligation.”
(1% plus estimate of additional returns); however, the corporate bond would only be impaired when the investor does not expect to recover principal and coupon (2.20% in this example).

Regarding “The source of the assets being transferred into this structured security and their relationship to the insurer is also not transparent. In addition, assets affiliated with the insurance company may be included in the additional asset tranche,” we believe statutory accounting principles governing affiliated transactions ameliorate these concerns, particularly with the principle application of SSAP No. 25—Affiliates and Other Related Parties. As such, a PPN would have to be designated as affiliated if the return of the PPN is predominately provided by affiliated investments. Additionally, SSAP No. 25 requires that affiliated investments be arm’s-length, fair, reasonable, and economic.

**Proposed Amendment**

The proposed amendment is as follows:

Principal Protected Notes (PPN) – PPN (sometime called “Principal Protected Securities,” “Principal Protected Loans,” or “Combo Notes”) are a type of structured security where a portion of the underlying assets are dedicated to ensure the repayment of principal at maturity or a third party may guarantee the repayment of principal at maturity. The remaining assets in the structure, the performance assets, are intended to generate additional returns and may be of a type (ex. derivatives, equities, commodities, non-CRP rated debt, loans, funds, private equity, real estate, affiliated, undisclosed, etc.) that would not be eligible for reporting on Schedule D.

We would urge you to consider revisions to the following proposed amendment defining PPN and have provided suggested language below. We believe this revised definition would provide the industry with the clarity and specificity which will result in consistent implementation of the exposure while at the same time capturing both examples provided in the body of the exposure.

*Principal Protected Notes (PPN) – are a type of investment where payment of contractually promised fixed cash flows (principal and interest thereon) is satisfied by an underlying bond(s), but additional potential returns are generated by non-fixed-income assets in the structure which, if held directly, would be reported on Schedule D – Part 2 – Section 2 – common stock, Schedule A – real estate, Schedule DB – derivatives, or Schedule BA – private equity funds, hedge funds, other equity funds in the form of LP/LLC structures or characteristics of common stock. Investments in PPNs must be submitted to the SVO for analysis.*

**Summary**

In summary, we suggest the following steps be considered as the exposure proposal moves forward:

1. consider the revised language we have provided above which we believe creates a clear and specific definition of what constitutes a PPN so any amendment can be consistently implemented;
2. consider how existing accounting treatment’s impact to capital (i.e., impairments) would align with proposed changes to required capital;
3. provide more transparency into the process which would be utilized to assign NAIC ratings for PPN investments;
4. request feedback from the industry on potential materiality of exposure given the definition and rating process for PPNs; and
5. use the feedback from #4 above to gauge the impact on the industry and the associated timing of implementation.

We hope you find our comments to be constructive and helpful as the Task Force considers solutions to address PPNs.

Sincerely,

[Signature]

Joseph W. Wittrock, CFA
Senior Vice President and Chief Investment Officer
Mr. Kevin Fry, Chair  
NAIC Valuation of Securities (E) Task Force  
1100 Walnut Street, Suite 150  
Kansas City, MO 64106  

Dear Mr. Fry,  

We appreciate the opportunity to comment on the proposed amendment to the Purposes & Procedures Manual of the Investment Analysis Office (P&P Manual) to update the definition and instructions for Principal Protected Notes (PPN) and Combo Notes, and removing these classes of securities from eligibility for Filing Exemption (FE).  

We strongly support the stated objective of the NAIC Securities Valuation Office to improve asset risk transparency, capital treatment, and proper scheduling for Principal Protected Notes (as defined), Combo Notes, and other structured securities. However, we are concerned that the broad based application of the proposed amendment, as currently contemplated, will result in significant unintended consequences, particularly with respect to structured notes or securitized assets generally. The issues posed should be given proper consideration and analysis. The NAIC should allow for industry comment and involvement in crafting a new rule, which should be appropriately scoped and implemented.  

PPN Comment:  

The recent proposal from the SVO recommending elimination of the the filing exemption for Principal Protected Notes and to adjust capital requirements due to the perceived riskiness of these securities conflates various forms of structured credit that exist in the market into one overly broad category. The description used by the NAIC is broad and has been interpreted differently by industry participants. As a result, the definition does not draw a clear distinction between the intended target and other structured financings eligible for schedule D reporting such as LBASS securities under SSAP 43R. The industry needs more clarity on how these particular notes are defined as opposed to other structured finance vehicles.  

The SVO bases its position on several elements: (i) the notes at issue may include assets that would not otherwise be permitted on Schedule D; (ii) the assets being transferred into the structure are not transparent and may be affiliated with the insurer, and (iii) the SVO’s capacity to designate these assets.  

Schedule D: The concern with respect to proper scheduling is inconsistent with current practice across asset classes. Reporting structured notes with underlying assets that are technically ineligible for schedule D, occurs regularly. For example, CMBS, RMBS, ABS, are all examples of common general account investments that appear on Schedule D but contain underlying assets that would otherwise appear on other schedules. An NRSRO rated note or bond with bond-like cash flows and bond characteristics is properly scheduled on Schedule D. We recommend that the proposed amendment be limited to require SVO filings only in those cases where the underlying assets are not schedule D eligible assets or are assets without
bond or bond-like cash flows. This is consistent with the SVO’s presentation on bespoke securities dated 8/4/2019.

Transparency/Affiliation: We are in favor of improved transparency and disclosure requirements around any affiliated transactions. Concern regarding affiliated investments is also being addressed by SAPWG 2019-03 changes to SSAP 25 regarding affiliated investments, which requires disclosure and additional look-through analysis to identify related parties. Requiring a filing based on a look-through analysis is inconsistent with existing practice as Statutory Accounting Principles do not allow for the consolidation of assets. Potential issues of transparency, specifically with respect to statutory affiliation, are addressed by SSAP 25.

SVO Capacity to Designate: Recently, the SVO has taken on additional responsibilities as it relates to privately rated assets with the adoption of rules that require filing rating letters. Prior to taking on even more responsibilities, the SVO should establish clear methodologies that address the concerns of the SVO as well as demonstrates the SVO’s ability to designate these assets prior to eliminating the reliance of Nationally Recognized Statistical Rating Organizations (NRSRO). Based on the letter from the SVO to the VOSTF, it is not clear if the SVO is aware of the number, size and complexity of the PPN assets currently held by insurers.

Combo Note Comment:

Combo Notes are mentioned but not defined or analyzed in the 8/4/19 memo to the VOSTF, and are also referenced in a recent LCD article as a targeted investment.

Combo notes are distinctly different from the type of asset the NAIC is describing when discussing PPNs. Contrasting features include the following: i) the underlying assets are all schedule D assets; ii) the manager or 3rd party equity shares the first loss risk; iii) the subordinated note is not disregarded for the rating, but rather sensitized and modeled out by an NRSRO; and iv) the notes include many different investors and are marketed broadly.

Combo Notes also do not meet the definition of “bespoke security”, which was also raised as an area of concern. The NAIC broadly defines a “bespoke security” as one that is: i) not broadly syndicated (i.e. owned by many parties); ii) created by or for one or a few related insurance companies as an investment and; iii) assigned a credit rating by only one NAIC CRP, often via a private rating. Combo Notes do not meet this criteria.

Combo notes play an important role in the issuance of CLO liabilities. Accounting changes will impact the broader bank loan and CLO market, including the estimated >$120bn of CLO assets held by insurers. Historical loss rates on CLO assets are extremely low, provide diversity to insurer’s portfolios, and can be an important asset class for insurers and their policyholders. The white paper issued by the NAIC Capital Markets Bureau on 8/5/19 on leveraged loans provides additional statistical support for the exceptional stability of this asset class. Given the previous filing exempt status and existing guidance under SSAP 43R, a change to require filing of all Combo Notes should be considered a substantive change. Combo Notes meet the definition of a loan backed security as defined under SSAP 43R, and do not meet the definition of a Principal Protected Note as defined in the proposed modification to the P&P manual and should therefore be scoped out.

Conclusion:

Given the issues posed above, the many open questions, and the potential unintended consequences of the proposed changes, this matter should not be fast-tracked through committee without first affording the industry meaningful opportunity to comment and provide analysis to better define scope and to define and
distinguish the risks the NAIC is looking to address. Additionally, insight into the factors and models that the SVO will use to derive a rating designation for previously FE securities would be helpful.

Thank you so much for your consideration.

Michael K. Moran
SVP & Chief Accounting Officer
September 20, 2019

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

Dear Mr. Fry,

We appreciate the opportunity to provide feedback on the Valuation of Securities Task Force exposure regarding ‘Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office to update the Definition and Instructions for Principal Protected Notes’ ("PPNs").

As disclosed in Part One, Section 4, paragraph c) (ii) (C) of the Purposes and Procedures Manual of the NAIC Investment Analysis Office ("P&P Manual"), the NAIC has authority to determine whether it is appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of a particular asset class. While this is the case, we respectfully request clarification on the definition of the investments required to be filed under this proposal, visibility into the analysis to be conducted by the SVO, an outline for the expected time required by the SVO to produce designations on individual impacted investments and an outline for timing in which this proposal is to be applied to the preparation of Statutory Statements.

Issue background: The memorandum summarizing the issue and the SVO proposal included two examples of investments considered to be PPNs:

1. Zero coupon Treasury bond with notional equal to face amount of the PPN coupled with a call option on the S&P 500.
2. Fixed coupon corporate bond having fixed coupon that covers stated interest on the PPN with excess interest plus the principal on the corporate bond covering the face amount of the PPN. Plus additional undisclosed and unrated assets that may provide additional return.

Regarding these examples, the SVO concluded with three statements that serve as organizing principles for our response letter:

- **Asset transformations:** Assets that would otherwise be ineligible for reporting on Schedule D are making their way onto that Schedule through financial structuring.
- **Affiliate/related party transactions:** The source of the assets being transferred into this structured security and their relationship to the insurer is also not transparent. In addition, assets affiliated with the insurance company may be included in the additional asset tranche.
- **SVO stated analytical concern:** Significant risks are being obscured by focusing only (on) risk associated with the repayment of principal.

**Asset transformations:** Addressing the statement made in the proposal that both examples include assets that would otherwise be ineligible for reporting on Schedule D, the SVO recommended referring this topic to SAPWG to consider the treatment of the asset transformations described. While it should be generally understood that, most often, securitizations result in transforming many types of
underlying investments—including those not reported on Schedule D—into fixed income securities, we are supportive of such a referral should that create clarity for the industry. In fact, a topic with a similar theme (Collateralized Fund Obligations) is currently being addressed by the SAPWG and we suggest that topic is substantive and should be expanded to include the recommended referral from the SVO.

**Affiliate/related party transactions:** The SVO indicated that the source of the assets being transferred into principal protected notes and their relationship to the insurer is not transparent. As part of the recommendation, the SVO would alert regulators to the extent that the SVO identified possible affiliated assets. SSAP 25 and SSAP 103R both have measurement and disclosure requirements. We are supportive of improved quality of disclosures providing transparency into affiliated and related party transactions and ongoing exposures to the same. We expect this could be accomplished through other regulatory clarifications that do not require the SVO to assign designations.

**SVO stated analytical concern:** We appreciate the analytical concern that there may be risks being obscured in these structures. However, we do not fully understand how this concern is addressed by the SVO recommendation. Mostly, this stems from a lack of clear definition of the assets to which the proposal would be applied. We are concerned that the definition laid out in the SVO proposal differs from industry standard definitions found on Bloomberg or other reputable sources. The result may be inconsistent application across the industry.

**Implementation and timing:** We are concerned about the pace in which it appears this topic is to be implemented. In addition to the potential impact to RBC, a shift in the rules may impact surplus due to an adverse change to market pricing on impacted investments should companies desire to transact in order to exit positions. In the past, substantive changes to the regulatory framework have been studied to understand their impact prior to adoption of any recommended change. We request similar application in this matter, being mindful of unintended scope expansion to additional investments. In order to complete such a study effectively, we assert that the SVO must clearly articulate the nature of the analysis and the expected outcome on the affected investments.

We understand the SVO has no interest in grandfathering current investments. We agree that such grandfathering would be inappropriate. Instead, we suggest that the SVO provide transparency on how they would assign designations to affected investments and allow a reasonable transition period for affected companies to manage the potential impacts to investments that were acquired in accordance with and under a previous set of regulatory standards.

What seems imperative to a healthy regulatory environment and the financial stability of individual companies is a more deliberative and transparent approach to this issue. We look forward to continuing work with the SVO and the Task Force to achieve regulatory objectives in support of a healthy insurance industry.

Best regards,

Ellyn M. Nettleton  
Controller and Treasurer

Bradley Anderson  
Investment Valuation and Analysis
MEMORANDUM

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

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

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

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

DATE: September 30, 2019

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

The IAO staff reported to the Task Force at the Summer National Meeting that at some point the NAIC should align the RMBS/CMBS modeling to provide a single NAIC Designation for modeled RMBS/CMBS. This would be a change from the current practice of providing a series of book adjusted carrying value price breakpoints to companies to determine the NAIC designation. Staff also reported that with the upcoming implementation of NAIC designation categories, the new 20 additional granular delineations of credit risk, the complexity and expense to the NAIC and insurers to produce and incorporate the needed 19 price breakpoints would be high.

2. **Recommendation** – The IAO staff recommends that the NAIC move to a single NAIC designation and NAIC designation category modeled assessment of credit risk for RMBS/CMBS. This is a good time to make such a change prior to the NAIC and insurance companies making modifications to their systems for the NAIC designation categories. Such a change will produce a uniform and consistent credit risk assessment for these securities permitting insurers to report the same SSG determined NAIC designation. Given the impact of this change to SSAP 43R - Loan-Backed and Structured Securities, staff recommends a referral to the Statutory Accounting Principles (E) Working Group for a simultaneous exposure.

3. **Proposed Amendment** – The following text shows the revisions in Part Four that would appear in the 2019 P&P Manual format.
PART FOUR
THE NAIC STRUCTURED SECURITIES GROUP
DEFINITIONS

1. The following terms used in this Part Four have the meaning ascribed to them below.

- **ABS** stands for asset-backed securities and means structured securities backed by consumer obligations originated in the United States.

- **CMBS** stands for commercial mortgage-backed securities and means structured securities backed by commercial real estate mortgage loans originated in the United States. The definition of CMBS may refer to securitizations backed by commercial mortgages, respectively, originated outside of the United States if and to the extent that the vendor selected by the NAIC to conduct the financial modeling: (a) has the necessary information about the commercial mortgage and commercial mortgage loans originated outside of the United States to fully model the resulting securities; and (b) can adapt the modeling process to account for any structural peculiarities associated with the jurisdiction in which the mortgage was originated.

- **Initial Information** means the documentation required to be filed with an Initial Filing of an RMBS or a CMBS CUSIP, pursuant to the section below and pertaining to Loan Information, Reps and Warranty Information and Structure and Formation Information for the transaction, where:
  - **Loan Information** means a review of the loan files by a third party to assess the sufficiency of legal title and other related issues.
  - **Reps and Warranty Information** means the actual representation and warranties in effect for the securitization given by the mortgage originator(s) to the Trust pertaining to loan origination processes and standards, compliance with applicable law, loan documentation and the process governing put backs of defective mortgages back to the originator(s).
  - **Structure and Formation Information** means the waterfall, as described in the definition of Ongoing Information, information and documentation in the form of legal opinions and documentation governing the formation of the securitization and its entities relative to issues such as bankruptcy remoteness, true sale characterization, the legal standards and procedures governing the securitization and other similar issues.

- **Legacy Security**, for the purposes of this section shall mean any RMBS and any CMBS that closed prior to January 1, 2013.
• **Official Price Grids** means and refers to those generated by the SSG and provided to an insurance company or insurance companies that own the security for regulatory reporting purposes.

• **Ongoing Information** consists of: (a) tranche level data; such as principal balance, factors, principal and interest due and paid, interest shortfalls, allocated realized losses, appraisal reductions and other similar information for the specific tranche; (b) trust level data, such as aggregate interest and principal and other payments received, balances and payments to non-tranche accounts, aggregate pool performance data and other similar information; (c) loan level performance information; and (d) a computerized model of rules that govern the order and priority of the distribution of cash from the collateral pool (i.e., the “waterfall”) to the holders of the certificates/securities—provided in the format and modeling package used by the NAIC financial modeling vendor.

• **Original Source**, with respect to a specific set of data, means the Trustee, Servicer or similar entity that is contractually obligated under the agreement governing the RMBS or CMBS to generate and maintain the relevant data and information in accordance with standards specified in applicable agreements or an authorized re-distributor of the same.

• **Price Grids** means and refers to CUSIP-specific price matrices containing six price breakpoints; i.e., each price corresponding to a specific NAIC Designation category. Each breakpoint on a Price Grid is the price point that tips the NAIC Designation for the RMBS CUSIP into the next NAIC Designation (credit quality/credit risk) category. The plural is used because two Price Grids are generated for any CUSIP. This reflects the difference in RBC for those insurance companies that maintain an asset valuation reserve and for those insurance companies that do not.

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

- **Underlying Security** means the RMBS or CMBS backing a Re-REMIC. A Re-REMIC cannot be an Underlying Security.

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

- It is possible that the scope of the RMBS and CMBS definitions may be broadened because the financial modeling vendors indicate other collateral or waterfall structures can be modeled.
- NAIC CRPs may adopt different internal conventions with respect to what market or asset segments are within their rated populations of RMBS, CMBS or ABS. This could affect the application of the adopted NAIC methodology or require the NAIC to select which naming process it wishes to adopt.

- It is possible that the SSG will acquire analytical assessment capabilities that permit the assessment of existing, additional or different structured securities that cannot now be modeled or that are not currently rated.
ADMINISTRATIVE AND OPERATIONAL MATTERS

Certain Administrative Symbols

2. The following SVO administrative symbols are used in the Valuation of Securities (VOS) Products to identify RMBS and CMBS that the NAIC vendor has confirmed will be subject to the financial modeling methodology described in this Part.

- **FMR** – Indicates that the specific CUSIP identifies an RMBS that is subject to the financial modeling methodology.

- **FMC** – Indicates that the specific CUSIP identifies a CMBS that is subject to the financial modeling methodology.

The use of these SVO administrative symbols in the VOS Product and published in the AVS+ Products compiled by the SVO and SSG as the SVO List of Investment Securities means the insurer should not use the filing exempt process for the security so identified.

**NOTE:** The administrative symbols **FMR** and **FMC** are related to symbols that insurers are required to use in the financial statement reporting process. Under applicable financial statement reporting rules, an insurer uses the symbol **FM** as a suffix to identify modeled RMBS and CMBS CUSIPs. The symbol **FM** is inserted by the insurer in the financial statement as a suffix in front of the NAIC Designation category, i.e., **2FM**.

Quarterly Reporting of RMBS and CMBS

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

4. **RMBS and CMBS that can be Financially Modeled** – RMBS and CMBS that can be financially modeled are exempt from filing with the SVO. NAIC Designations and NAIC Designation Categories for RMBS and CMBS that can be financially modeled are assigned by SSG determined by application of the methodology discussed in this Part, not by the use of credit ratings of CRPs.

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

**Filing Exemption for ABS**

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

**Review of Decisions of the SSG**

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

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

Documentation Standards

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

Initial Information Requirements

10. An RMBS or CMBS meets the Initial Information Requirements if the security meets one of the following three conditions:

- **RTAS** – The RMBS or CMBS was assigned a preliminary price grid or designation as described in this Part;
- **Initial Sufficiency Filing** – The RMBS or CMBS was reviewed by SSG through an Initial Sufficiency Filing; or
- **Safe Harbor** – The RMBS or CMBS meets the Safe Harbor requirements.

**Initial Sufficiency Information Filing**

11. An insurance company may file Initial Sufficiency Information with the SSG for the purpose of obtaining a determination that an RMBS or CMBS CUSIP is eligible for financial modeling under the annual surveillance process discussed below. Initial Sufficiency Information is only filed once for any given RMBS or CMBS. Reporting insurance companies are solely responsible for providing the SSG with Initial Information. A determination by the SSG that a given RMBS or CMBS CUSIP is eligible for financial modeling after an Initial Sufficiency Filing assessment is subject to the further and continuing obligation that the SSG obtain or the insurer provide the SSG with updated Ongoing Information close to the date of the annual surveillance.

12. **Required Documents for Initial Sufficiency Filing** – An insurer that owns an RMBS or a CMBS for which Initial Information is not publicly available shall provide the SSG with the following documentation.

13. **RMBS** – Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for an RMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:
   - Pooling and Servicing Agreement or similar
   - Prospectus, Offering Memorandum or similar; Accountant’s comfort letter
   - If applicable, ISDA Schedules and Confirmations or similar
   - Legal opinions given in connection with the transaction
   - Any other documents referenced by the above
   - Third-Party Due diligence scope document and raw results. If less than 100% due diligence, detailed description of the loan selection process
   - If applicable, loan purchase agreements or similar. Loan Tape

14. **CMBS** – Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for a CMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:
   - Pooling and Servicing Agreement or similar
- Prospectus, Offering Memorandum or similar; Accountant’s comfort letter
- If applicable, ISDA Schedules and Confirmations or similar
- Legal opinion given in connection with the transaction
- Any other documents referenced in the above
- Asset Summaries
- Loan Tape
- Loan documents, including reliable information about the terms of the transaction; including, but not limited to, financial covenants, events of default, legal remedies and other information about financial, contractual or legal aspects of the transaction in form and substance consistent with industry best practices for CMBS issuance.
- In certain cases, additional documents below will enable the SSG to verify and validate initial underwriting information of the property securing the CMBS. These documents may be required in form and substance consistent with best practices for typical CMBS issuance.
- Historical operating statements and borrower’s budget
- Underwriter’s analysis of stabilized cash flow with footnotes of assumptions used
- Property type specific, rent roll information
- Appraisals and other data from recognized industry market sources
- Independent engineering report (Property Condition Assessment)
- Environmental Site Assessment (ESA) – Phase I/Phase II
- Documentation related to seismic, flood and windstorm risks
- Franchise agreements and ground leases, if applicable
- Management agreements
SSG Modeling Alerts

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

Safe Harbor

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

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

Ongoing Information Requirements

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

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

Scope

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

Important Limitation on the Definitions of RMBS and CMBS

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

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

Analytical Procedures Applicable to RMBS and CMBS Securitizations Subject to Financial Modeling Methodology

Filing Exemption Status of RMBS and CMBS

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

22. Beginning with year-end 2009–2020 for RMBS and 2010–2020 for CMBS, NAIC Designations and NAIC Designation Categories probability weighted net present values will be assigned by SSG produced under NAIC staff supervision by utilizing the NAIC-selected vendor’s using its financial model output with defined analytical inputs selected by the SSG. The vendor will provide the SSG with a range of net present values with a risk profile for each RMBS or CMBS sufficient for SSG to assess the credit risk of these securities and assign an NAIC Designation and NAIC Designation Category corresponding to each NAIC Designation category. The NAIC Designation for a specific RMBS or CMBS is determined by the insurance company, based on book/adjusted carrying value ranges.

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

Analytical Procedures for RMBS and CMBS

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

RMBS and CMBS Subject to Financial Modeling

Setting Microeconomic Assumptions and Stress Scenarios

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

The Financial Modeling Process

25. Information about the financial modeling process can be found at www.naic.org/structured_securities/index_structured_securities.htm.
Cashflow and Expected Losses: Use of Net Present Value and Carrying Value for Financially Modeled RMBS and CMBS

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

<table>
<thead>
<tr>
<th>RBC charge / NAIC designation (pre-tax)</th>
<th>P&amp;C</th>
<th>Midpoint</th>
<th></th>
<th>Life</th>
<th>Midpoint</th>
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<tr>
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<td>RBC</td>
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<td></td>
<td>6</td>
<td>30.0%</td>
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</table>
27. The NAIC Designation for a given modeled RMBS or CMBS CUSIP owned by a given insurance company depends on the insurer’s book/adjusted carrying value of each RMBS or CMBS, whether that carrying value, in accordance with SSAP No. 43R—Loan-Backed and Structured Securities, paragraphs 25 through 26a, is the amortized cost or fair value, and where the book/adjusted carrying value matches the price ranges provided in the model output for each NAIC Designation; except that an RMBS or CMBS tranche that has no expected loss under any of the selected modeling scenarios and that would be equivalent to an NAIC 1 Designation if the filing exempt process were used, would be assigned an NAIC 1 Designation regardless of the insurer’s book/adjusted carrying value.

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

Securities Not Modeled by the SSG and Not Rated by an NAIC CRP or Designated by the SVO

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

Definition

29.28. A Mortgage Referenced Security is a category of a Structured Note, as defined in Part Three of this Manual. In addition to the Structured Note definition, the following are characteristics of a Mortgage Referenced Security: A Mortgage Referenced Security’s coupon and/or principal payments are linked, in whole or in part, to prices of, or payment streams from, real estate, index or indices related to real estate, or assets deriving their value from instruments related to real estate, including, but not limited to, mortgage loans.

Quarterly Reporting for Mortgage Reference Securities (pending adoption)

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

Not Filing Exempt

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

NAIC Risk Assessment

32.31. In determining the NAIC Designation of a Mortgage Referenced Security, the SSG may use the financial modeling methodology discussed in this Part, adjusted to the specific reporting and accounting requirements applicable to Mortgage Referenced Securities.
THE RTAS – EMERGING INVESTMENT VEHICLE

Purpose

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

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

Extension of Authority

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

Interpretation

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

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