Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue: Working Capital Finance Notes**

**Check (applicable entity):**

P/C Life Health

Modification of existing SSAP

New Issue or SSAP

Interpretation

Description of Issue:

The Valuation of Securities (E) Task Force has referred to the Working Group industry-prepared tracked revisions to *SSAP No. 105—Working Capital Finance Investment*s and materials produced by the Securities Valuation Office (SVO) staff on the issues raised. The Task Force recommends that the Working Group consider the amendments, which the Task Force has previously exposed. This agenda item has been drafted to address the referral.

The industry-proposed revisions to SSAP No. 105 detailed in the referral can be grouped into the following categories:

1. Changes to program and or obligor credit quality requirements
2. Changes to program administration and/or documentation
3. Changes to regulatory compliance requirements
4. Changes to statutory reporting requirements.

Existing Authoritative Literature:

*SSAP No. 105—Working Capital Finance Investments* was originally effective on January 1, 2014.

*Purposes and Procedures Manual of the NAIC Investment Analysis Office provides the following on NAIC Designations*

NAIC 1 is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer’s credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An NAIC 1 obligation should be eligible for the most favorable treatment provided under the NAIC Financial Regulation Standards and Accreditation Program.

NAIC 2 is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer’s credit profile is reasonably stable. This means that for the present, the obligation’s protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An NAIC 2 obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

NAIC 3 is assigned to obligations of medium quality. Credit risk is intermediate and the issuer’s credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer’s capacity to make timely payments. An NAIC 3 obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

NAIC 4 is assigned to obligations of low quality. Credit risk is high and the issuer’s credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer’s capacity to make timely payments. An NAIC 4 obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):

SSAP No. 105 permits admittance of Securities Valuation Office (SVO) designated WCFI programs that meet specific requirements. SSAP No. 105 was originally effective in 2014 and was controversial as it was developed at the request of a single life entity. At that time, some Working Group members objected to the development of a new statement of statutory accounting principles (SSAP), reporting changes and specific asset class risk- based capital (RBC) charges at the behest of a single company. The discussion at that time noted that the permitted practice concept was intended to address such situations.

In 2018, the single reporting entity that participates in these programs requested modifications to the adopted program and submitted a proposal for consideration. The Valuation of Securities (E) Task Force held discussion on the industry proposal in the third quarter of 2018, which was exposed for comment. The Task Force approved the referral at the 2019 Spring National Meeting.

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:**

Working Capital Finance Investments (WCFI) reported in the annual statement Schedule BA - Other Invested Assets continues to be limited to investments by the same single life entity that requested the development of SSAP No. 105. This company reported a total of $258 million in a total of seven WCFI programs for 2017 and $224 million in a total of six WCFI programs for 2018. The total of these amounts is immaterial to the reporting entity. No reporting entities disclosed any prescribed or permitted practices varying from SSAP No. 105 in annual statement Note 1 for 2017 or 2018.

**Convergence with International Financial Reporting Standards (IFRS): Not applicable.**

Staff Review Completed by:

Robin Marcotte

**NAIC Staff**

Staff Recommendation:

Staff recommends that the Working Group receive the referral and provide initial direction on the referral, as it is still perceived as primarily impacting a single entity. If consideration of the referral, and revisions to SSAP No. 105 are supported, NAIC staff recommends that the Working Group direct NAIC staff to proceed with drafting revisions to SSAP No. 105, pursuant to the staff recommendations below which include a review of the industry proposed revisions. NAIC staff does support limited revisions to SSAP No. 105, but a few key elements requested by industry are not supported by NAIC staff.

The key industry proposed revisions included in the referral are under the heading “Details for Working Group Discussion.” If consideration of staff recommendations for the revisions to SSAP No. 105 are supported, NAIC staff will prepare updates to the industry proposal for future discussion based on the Working Group direction. Alternatively, the Working Group could choose to hold a separate call on this topic. The industry proposed revisions are substantive, but categorization could change based on the extent of the revisions.

The following is a summary of the NAIC Staff recommendations on the topics for Working Group discussion:

1. NAIC Staff **does not recommend** lowering the credit quality of the acceptable obligors from NAIC 1 (highest quality) and NAIC 2 (high quality) to allow NAIC designations of 3 (medium quality) and NAIC 4 (low quality) in the WCFI programs. The descriptions of NAIC designations in the *Purposes and Procedures Manual of the Investment Analysis Office note* that both NAIC designations of 3 and 4 have speculative elements (see Authoritative Literature and points for consideration). (paragraphs 6 & 7)
2. NAIC Staff **does not recommend** the proposed credit substitution methodology for unrated subsidiaries as it is overly complex, broad and difficult to apply. SVO staff memos also highlighted the difficulty in applying the industry proposed credit substitution methodology. (paragraph 7)
3. NAIC Staff **recommends the Working Group consider** removing the requirement that the SVO determine if the International Finance Agent is the functional equivalent of the US. Regulator. (paragraph 10.a)
4. NAIC Staff **recommends the Working Group consider** if removing the commingling requirements provide the desired degree of protection. In addition, the Working Group should discuss with the Task Force if the program revisions are functional for analysis purposes. The Working Group should also consider the potential impact of other proposed revisions including lower rated key participants and obligors (points for consideration are in the discussion below). (paragraph 10.b)
5. NAIC Staff **recommends the** **Working Group consider modifying** the finance agent independent review requirements as requested by industry. The industry proposal still provides independent review of the finance agent either by audit or through an internal control report. (paragraph 16)
6. NAIC SAPWG Staff **recommends the Working Group direct staff to prepare minor rewording** to paragraph 11b to improve readability and eliminate redundancy. (paragraph 11.b)
7. NAIC Staff  **does not recommend** removing the statement that the reporting entity mayneed to seek approval from the domestic regulator as this is a statement rather than an explicit requirement and these investments may not fit into the normal investment law categories (points for consideration are in the discussion below). (paragraph 18)
8. NAIC Staff **recommends the Working Group consider modifying the filing certification requirements** and allowing the SVO to determine if a first priority perfected interest has been obtained. (paragraphs 14 & 15)
9. NAIC Staff **recommends the Working Group consider modifying** the default provisions from 15-30 days as it is more practical to have the default date and the cure period be consistent (points for consideration are in the discussion below). (paragraph 28)
10. NAIC Staff **does not recommend** the Working Group change the reporting requirements to move the WCFI investments from Schedule BA – Other Assets, to Schedule DA Short term Investments (points for consideration are in the discussion below). (paragraph 22)

**Details for Working Group Discussion**

1. Changes to program and or obligor credit quality requirements

**SSAP No. 105** – Current provisions:

* Allow admitted asset treatment to receivables from WCFI programs that have high quality NAIC designations from the SVO (NAIC 1 or 2).
* Require the direct obligor to have a designation equivalent of NAIC 1 or 2.
* Nonadmits WCFNs if the program or the obligor falls below either credit threshold.

1. **Admit Obligors and Program with Lower Credit Ratings** – (Reference -SSAP No. 105, paragraph 7)

**Industry proposal** – Expand admitted asset treatment to include receivables from WCFI programs with NAIC SVO designations 3 and 4; and direct obligors with designation equivalents of NAIC 3 and 4.

1. NAIC Staff **does not recommend** lowering the credit quality of the acceptable obligors from NAIC 1 (highest quality) and NAIC 2 (high quality) to allow NAIC designations of 3 (medium quality) and NAIC 4 (low quality) in the WCFI programs. The descriptions of NAIC designations in the *Purposes and Procedures Manual* *of the Investment Analysis Office* note both NAIC designations of 3 and 4 have speculative elements (see Authoritative Literature).

* Assets that reflect “factored receivables” are nonadmitted in statutory accounting. The SAPWG created SSAP No. 105 to allow admission for only high-quality programs, from high quality obligors. Allowing obligors with lower credit assessments would be a fundamental change in program requirements.
* As noted in the P&P Manual:
* NAIC 3 is assigned to obligations of medium quality. Credit risk is intermediate and the issuer’s credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer’s capacity to make timely payments. An NAIC 3 obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
* NAIC 4 is assigned to obligations of low quality. Credit risk is high and the issuer’s credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer’s capacity to make timely payments. An NAIC 4 obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

1. **Unrated subsidiaries –** (Reference - SSAP No. 105, paragraph 7)

**Industry proposal has two aspects:**

1. An unrated subsidiary obligor of a rated obligor - Proposes to attribute the credit strength of the rated parent to the unrated subsidiary obligor without the rated parent being a guarantor of the unrated subsidiary’s WCFI obligations. This proposal envisions the rated entity having some of its own obligations in the program
2. A rated obligor and its unrated subsidiaries which are key transaction participants, but not obligors. The industry proposal is to create criteria to allow the “program” to obtain an acceptable NAIC designation by evaluating if the unrated “key transaction participant” is able to perform its functions.

Industry proposes several different ways to attribute the rated entity’s credit rating to the unrated entity including:

* Documented operational control of unrated obligor, or
* An important inter-relationship with unrated obligor, or
* If the unrated key transaction participants are reasonably expected to perform their functions.
* **NAIC Staff does not recommend the proposed credit substitution methodology for unrated subsidiaries** as it is overly complex, broad and difficult to apply. SVO staff memos excerpted below also highlighted the difficulty in applying the industry proposed credit substitution methodology.

**SVO P&P Requirements –** Note that it is possible for the program and the obligor to have different designations. SVO staff, noted that in their analysis key transaction participants could not have a lower designation than the entire program. Essentially their evaluation of a program is downgraded by the “weakest” link.

* Excerpts VOSTF October 2018 memo to the SAPWG:

SVO evaluated whether analytical discretion would enable it to designate WCFI programs with unrated obligors of a rated or designated parent. SVO evaluated whether operational and strategic linkages between a rated parent and unrated obligor can provide a basis to attribute the credit rating of one entity to the other. **It concluded that no principle exists to permit an assumption that a legal entity can be held responsible for the debt of another without having contractually agreed to do so. While WCFI arrangements may be inherently different than the credit situations SVO assesses SVO lacks the experiential basis to opine on the idea that the difference permits attribution.**

The SVO believes that it should be possible to develop performance criteria to evaluate the ability of the unrated entity to perform the functions expected of it. The goal would be to identify performance factors that could be evaluated in the exercise of analytical discretion to determine that the unrated entity could reliably perform the role expected of it.

1. Changes to Program Administration/ Documentation Requirements

**SSAP No. 105** – Current provisions:

* Requires the finance agent (bank, financial institution, financial intermediary or service provider) to fall under the jurisdiction of a financial regulator or that the investor be paid directly (No Commingling).
* If the finance agent is domiciled in another country that is on the SVO list of jurisdictions eligible for netting, it can be regulated by an agency that the SVO determines has a functional equivalent to the Board of Governors of the Federal Reserve System; 2) the Office of the Comptroller of the Currency; or 3) the Federal Deposit Insurance Corporation.
* As an alternative to having a regulated finance agent, SSAP No. 105 allows for the investor to be paid directly without funds flowing through the finance agent. The SSAP program requirements for admission excludes programs which commingle funds of the obligor, supplier, servicers or other investors.

1. **Functionally equivalent regulators of foreign finance agents** – (Reference SSAP No. 105, paragraph 10.a).

**Industry proposal –** Remove the requirement for the SVO to determine functionally equivalent regulators of finance agents in other countries.

**Excerpts from VOSTF October 2018 memo to the SAPWG:**

The SVO either determines that an international finance agent’s regulator is the functional equivalent of specified US federal bank regulators or verifies that payments due to the investor are not commingled. Determining functional equivalence is not an analytical issue. Therefore, programs are evaluated on the commingling standard. However, the prohibition of commingling is a requirement so the SVO verifies that commingling can never occur or fails the program.

* **NAIC Staff recommends the Working Group consider removing the requirement that the SVO determine if the International Finance Agent is the functional equivalent of the US. Regulator.**

1. **Remove finance agent commingling requirements** – (Reference SSAP No. 105, paragraph 10.b.)

**Industry proposal –** As an alternative to having a regulated finance agent, allow the payments to be paid directly to the investor or paid into an account maintained by a regulated financial institution for the benefit of investors without the agent being the beneficiary of the payments. This would require removal of the commingling prohibition.

* **NAIC Staff recommends Working Group consider if removing the commingling requirements** provide the desired degree of protection. In addition, the Working Group should discuss with the Task Force if the program revisions are functional for analysis purposes. The Working Group should also consider the potential impact of other proposed revisions including lower rated key participants and obligors. Points for consideration:
* SVO staff noted in their October 2018 memo that some programs fail the commingling requirement. SVO staff noted if commingling were not a requirement it would consider commingling risk, when present, as a structural deficiency and balance it against the requirement that the Finance Agent be NAIC 1 or NAIC 2.
* Discussions with SVO staff indicated that although the Finance Agent is not required by SSAP No. 105 to be an NAIC 1 or NAIC 2, that as a key participant, the SVO analysis would require it to have an NAIC 1 or NAIC 2 in order for the program to meet the credit quality requirements. Note that if the program requirements were lowered, presumably the key participants could also have lower designations.

1. **Finance agent validation requirements** – (Reference SSAP No. 105, paragraph 16)

**SSAP No. 105 –** Requires that the annual program filing to the SVO include an annual audit which is unqualified related to servicing. In addition, it requires either an independent report on the controls of the finance agent related to the administration of the investment (SSAE 16 report) or an annual audit of the internal controls. Consolidated reports which include the finance agent are acceptable. SSAP No. 105 allows for materiality judgment of the SVO relative to the report findings.

**Industry proposal –** Make the annual audit requirement one of two options, with either a SSAE 16 report (or its functional equivalent), or an annual audit of the financial statements which includes internal controls. Retain the requirement to only permit reports which do not contain qualifications related to servicing of WCFI.

* **NAIC Staff recommends the Working Group consider modifying the finance agent independent review requirements as requested by industry.** The industry proposal still provides independent review of the finance agent either by audit or through an internal control report.

1. **Confirmed Supplier Receivable** – (Reference SSAP No. 105, paragraph 11b)

**SSAP No. 105 –** Requires that the ability of the investor to exercise its creditor rights not be subject to the discretion of the finance agent, other lenders or investors. A separate sentence notes the same requirements but allows an exception that a cure period not to exceed 30 days is permissible.

**Industry proposal –** Remove the sentence “shall not be subject to the discretion of the finance agent other lenders or investors” but keep the subsequent sentence.

* **NAIC SAPWG Staff recommends that the Working Group direct staff to prepare minor rewording to paragraph 11b to improve readability and eliminate redundancy.**

1. Regulatory Compliance Requirements

**SSAP No. 105 – paragraph 18 provides the following:**

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

1. **Domestic Regulator Approval –** (Reference SSAP No. 105, paragraph 18)

**Industry proposal –** Remove reference to the possibility for the need of insurers to seek prior approval from their domestic regulator.

* NAIC Staff  **does not recommend** removing the statement that the reporting entity mayneed to seek approval from the domestic regulator as this is a statement rather than an explicit requirement. **NAIC Staff provides the following points for consideration:** 
  + Issue Paper No. 147 documents that requiring domestic regulator approval was an intentional decision because of concerns regarding the ability of smaller entities to monitor the investments in such programs on an ongoing basis.
  + The current guidance in SSAP No. 105 is not an explicit requirement, but only identifies that a domiciliary commissioner **may** require a company to receive initial permission before investing in WCFI.
  + These investments may not fit into the normal investment law categories.
  + The Industry proposal agrees that the asset class is not for most insurers as it requires relationships with finance agents beyond the traditional dealer insurer.
  + The Industry proposal notes that the investor needs specialized knowledge, asset management operations and the ability to book and supervise the assets.
  + The Industry proposal notes that the filing fees require sizable commitments to justify the costs, which would make it cost prohibitive for smaller players.

1. **Filing certification –** (Reference SSAP No. 105, paragraphs 14 and 15)

**SSAP No. 105** – Program requirements for a confirmed supplier receivable require the investor to certify that they have the commercially reasonable belief that their participation in the WCFI program results in a first priority perfected interest and required meeting Uniform Commercial Code (UCC) requirements in a legalistic manner. Annual filings require the investor to certify that the they have a commercially reasonable belief that they have met the standard for creating a first priority security interest. There is also a requirement that the SVO deems the investor’s belief reasonable.

**Industry proposal –** Remove requirement for legal officer to certify compliance in a obtained a first priority perfected interest in accordance with UCC requirements for each annual submission and related SVO requirements.

* SVO staff has indicated that the criteria in paragraphs 14 and 15 are typically determined when contracting a program and similar objectives can be accomplished in more ways than the UCC lien process. Requiring the UCC lien process is overly prescriptive.
* The definition in SSAP No. 105 of a confirmed supplier receivable requires a first priority perfected interest and, SVO analytical staff should be able to determine if first priority interest has been achieved.
* **NAIC Staff recommends the Working Group consider modifying the filing certification** requirements and allowing the SVO to determine if a first priority perfected interest has been obtained.

1. Default date – (Reference SSAP No. 105, paragraph 28)

**SSAP No. 105** – A WCFI program is in default and nonadmitted when payments are uncollected within 15 days.

**Industry proposal –** Extend default and nonadmission date to 30 days.

* NAIC Staff **recommends that the Working Group consider modifying** the default provisions from 15-30 days as it is more practical to have the default date and the cure period be consistent. Key discussion points are:
* Waiting 30 days for a short-term asset can be material in relation to the life of the asset.
* Fifteen (15) days was previously chosen to be consistent with settlement guidance in *SSAP No. 21—Other Admitted Assets,* which nonadmits and reclassifies receivables for securities not settled within 15 days.
* The “cure period” noted in paragraph 11.b on confirmed supplier receivables is not to exceed 30 days so it may make sense for the default date and the end of the cure period to be consistent.

1. Change to Statutory Reporting
2. **Change Reporting Category** – (Reference SSAP No. 105 – paragraph 22)

**SSAP No. 105 –** Requires WCFI receivables to be on annual statement Schedule BA- Other Long-term Assets on specifically created reporting lines. Capital Adequacy (E) Task Force reviewed the asset class and requires specific (relatively low) RBC charges based on the NAIC SVO WCFI program designation.

**Industry proposal –** Move the statutory reporting of Working Capital Finance Investments from Schedule BA- Other Long-term Assets to Schedule DA, Short Term Investments because the receivables within the rated WCFI programs are required to be less than one year.

* **NAIC Staff does not recommend the Working Group change the reporting requirements to move the WCFI investments from Schedule BA – Other Assets, to Schedule DA Short term Investments (points for consideration are in discussion below). Key reasons include:**
* This is an unique class. Issue Paper No. 147, documents the VOSTF recommendation for Schedule BA reporting. The Task Force discussed the relative benefits between Schedule BA and DA and concluded that WCFIs should be reported as Other Invested Assets and therefore Schedule BA provides an enhanced disclosure framework deemed more appropriate for the investment.
* This reporting was intentional because the long-term programs are designated, even though the different investments are short term.
* Annual statement lines and RBC charges have already been established and the current RBC charges based on program designation would not be functional if the reporting was on Schedule DA, because that schedule does not include designations.

**Status:**

On August 3, 2019, the Statutory Accounting Principles (E) Working Group received a referral from the Valuation of Securities (E) Task Force and directed staff to proceed with drafting revisions for subsequent exposure using the staff Summer 2019 recommendations. During this discussion additional industry proposed revisions were presented, but not captured in the direction for initial revisions to SSAP No. 105.

**For Fall 2019 National Meeting Discussion:**

**NAIC staff recommends exposing the substantive revisions to *SSAP No. 105—Working Capital Finance Investments* incorporating the industry proposed language for the specific items directed by the Working Group and illustrated in the attached. The revisions in response to the industry request are summarized below. NAIC staff recommends directing Staff to prepare an issue paper for discussion at the 2020 Spring National Meeting.**

1. **Functionally Equivalent Foreign Regulators -** Removed the requirement that the SVO determine if the International Finance Agent is the functional equivalent of the U.S. Regulator. (paragraph 10.a)
2. **Commingling Prohibitions** - Removed the finance agent prohibitions on commingling. (paragraph 10.b)
3. **Investor Rights Edit -** Removed duplicative text regarding exercise of investor rights. (paragraph 11.b)
4. **Requirements for filer to Certify Perfected Interest –** Removed requirements, with revisions allowing the SVO to determine if a first priority perfected interest has been obtained. (paragraphs 14 & 15)
5. **Finance Agent Validation Requirements –** The independent review requirements were broadened to allow independent review of the finance agent by either audit or through an internal control report. (paragraph 16)
6. **Default Date -** Changed the default provisions from 15 to 30 days so the default date and the cure period are consistent. This has the effect of changing the date of nonadmission for an investment in default for a period up to 30 days instead of up to 15 days. (paragraph 28)

**In accordance with the Working Group direction, the following industry requested revisions were not incorporated:**

1. **Possible Domestic Regulator Approval -** The statement that the reporting entity mayneed to seek approval from the domestic regulator was maintained (paragraph 18). **Points for consideration:**
   * Issue Paper No. 147 documents that requiring domestic regulator approval was an intentional decision because of concerns regarding the ability of smaller entities to monitor the investments in such programs on an ongoing basis.
   * The current guidance in SSAP No. 105 is not an explicit requirement, but only identifies that a domiciliary commissioner **may** require a company to receive initial permission.
   * These investments may not fit into the normal investment law categories.
   * The industry proposal notes:
     + the asset class is not for most insurers as it requires relationships with finance agents beyond the traditional dealer insurer.
     + the investor needs specialized knowledge, asset management operations and the ability to book and supervise the assets.
     + the filing fees require sizable commitments to justify the costs, which would make it cost prohibitive for smaller players.
   * Fall 2019 industry comments noted that state approval is not a practical risk mitigant. In addition, the speaker commented that he questioned the evaluation criteria that would be used by a state.
2. **Only High-Quality Obligors** – The current requirement which restricts designations of programs and obligors to being of high quality was maintained. NAIC Staff continues to **not recommend** lowering the credit quality of the acceptable obligors from NAIC 1 (highest quality) and NAIC 2 (high quality) to allow NAIC designations of 3 (medium quality) and NAIC 4 (low quality). Points for consideration:
   * The descriptions of NAIC designations in the *Purposes and Procedures Manual of the Investment Analysis Office* note that both NAIC designations of 3 and 4 have speculative elements (see Authoritative Literature).
   * Assets that reflect “factored receivables” are nonadmitted in statutory accounting. This program is the sole exception to the factored receivable rule. By lowering the allowable credit standards, an expanded class of factored receivables would be admitted, further deviating from statutory accounting concepts.
   * The SAPWG created SSAP No. 105 to allow admission for only high-quality programs, from high quality obligors. Allowing obligors with lower credit assessments would be a fundamental change in program requirements. (paragraphs 6 &7)
3. **Unrated subsidiaries / Credit substitution -** NAIC Staff **does not recommend** the proposed credit substitution methodology for unrated subsidiaries as it is overly complex, broad and difficult to apply. Further, credit substitution does not adequately address credit risk for an unrated affiliate. SVO staff memos also highlighted the difficulty in applying the industry proposed credit substitution methodology (paragraph 7). **Excerpts VOSTF October 2018 memo to the SAPWG**:

SVO evaluated whether analytical discretion would enable it to designate WCFI programs with unrated obligors of a rated or designated parent. SVO evaluated whether operational and strategic linkages between a rated parent and unrated obligor can provide a basis to attribute the credit rating of one entity to the other. **It concluded that no principle exists to permit an assumption that a legal entity can be held responsible for the debt of another without having contractually agreed to do so. While WCFI arrangements may be inherently different than the credit situations SVO assesses SVO lacks the experiential basis to opine on the idea that the difference permits attribution.**

**Industry proposal for credit substitution has two aspects:**

1. **Credit substitution for unrated subsidiary obligors of a rated obligor** – Industry proposes to attribute the credit strength of the rated parent to the unrated subsidiary obligor without the rated parent being a guarantor of the unrated subsidiary’s WCFI obligations. This aspect envisions the rated entity having some of its own obligations in the program
2. **Credit Substitution of rated obligor for its unrated subsidiaries which are key transaction participants, but not obligors.** The industry proposal is to create criteria to allow the “program” to obtain an acceptable NAIC designation by evaluating if the unrated “key transaction participant” is able to perform its functions. Industry proposes several different ways to attribute the rated entity’s credit rating to the unrated entity including:
   * Documented operational control of unrated obligor, or
   * An important inter-relationship with unrated obligor, or
   * If the unrated key transaction participants are reasonably expected to perform their functions.

**NAIC Staff Credit Substitution Recommendation – Reference SVO P&P Requirements –** The *Practices and Procedures Manual of the Investment Analysis Office* (P&P) contains existing credit substitution methodology, however the industry is proposing to diverge from the existing methodology for this asset class. **NAIC staff recommends referencing the existing credit substitution methodology in the P&P.**

1. **Change Reporting Schedule -** NAIC Staff **does not recommend** the Working Group change the reporting requirements to move the WCFI investments from Schedule BA – Other Assets, to Schedule DA ­ – Short term Investments (paragraph 22). Points for consideration:

* This reporting was intentional because the long-term programs are designated, even though the different investments are short term. Issue Paper No. 147, documents the VOSTF recommendation for Schedule BA reporting. The Task Force discussed the relative benefits between Schedule BA and DA and concluded that WCFIs should be reported as Other Invested Assets and that Schedule BA provides an enhanced disclosure framework deemed more appropriate for the investment.
* Annual statement lines and RBC charges have already been established on Schedule BA.
* Capital Adequacy (E) Task Force reviewed the asset class and requires specific designations (relatively low - just slightly higher than a bond of similar credit risk). RBC charges are based on the NAIC SVO WCFI program designation. The current RBC charges based on program designation would not be functional if the reporting was moved to Schedule DA, because that schedule does not include designations.

On December 7, 2019, the Statutory Accounting Principles (E) Working Group exposed substantive revisions to *SSAP No. 105—Working Capital Finance Investments* to incorporate industry revisions to program requirements, as previously directed by the Working Group during the Summer National Meeting. The Working Group directed NAIC staff to prepare an issue paper.

On March 18, 2020, the Statutory Accounting Principles (E) Working Group re-exposed *SSAP No. 105—Working Capital Finance Investments* with a proposed/anticipated effective date of June 30, 2020 and exposed *Issue Paper 16X: Working Capital Finance Investment Updates* for comment. This item was exposed with a May 1, 2020 comment period deadline.

G:\FRS\DATA\Stat Acctg\3. National Meetings\A. National Meeting Materials\2020\Spring\NM Adoptions\19-25 - WCFI.docx