



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

RE: Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the "P&P Manual") to the clarify the exclusion of Residual Tranches and Interests from Schedule D-1 reporting and to provide temporary NAIC Designation instructions

DATE: November 1, 2021

Summary – The Statutory Accounting Principles (E) Working Group (the "Working Group") identified inconsistencies in how residual tranches and interests were being reported with some entities reporting them on Schedule BA – Other Long Term Invested Assets and others reporting them on Schedule D-1: Long-Term Bonds with either self-assigned NAIC 5GI or NAIC 6 Designations. To prevent further inconsistency and direct appropriate reporting, on September 9, 2021, the Working Group exposed an amendment to *SSAP 43R – Loan Backed and Structured Securities* to clarify that residual tranches and interests shall be report on Schedule BA. The Working Group plans to consider adoption of this amendment at their November 10, 2021, meeting.

The amendment creates a December 31, 2022 effective date for all residual tranches and interests to be reported on Schedule BA without an NAIC Designation. To accommodate the timeframe needed for Blanks (E) Working Group proposal 2021-21BWG to expand reporting lines on Schedule BA to capture residual tranches and interests, the Working Group's amendment permits residual tranches and interests currently reported on Schedule D-1 to continue to be reported on Schedule D-1 for reporting year 2021 but only with an NAIC 6* Designation and not an inappropriate NAIC 5GI Designation.

The NAIC 5GI Designation is not appropriate for residual tranches and interests (see definition from *SSAP 43R* below). Pursuant to the "P&P Manual, an insurance company is permitted to self-assign an NAIC 5GI to an obligation if it meets all of the following criteria:

1. Documentation necessary to permit a full credit analysis of the security by the SVO does not exist or an NAIC CRP rating for an FE or PL security is not available.
2. The issuer or obligor is current on all contracted interest and principal payments.
3. The insurer has an actual expectation of ultimate payment of all contracted interest and principal.

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Assignment of an NAIC 5GI Designation for residual investments is an incorrect application of the guidance as (a) there are no contracted interest and principal payments to certify as current and (b) the insurer cannot have an actual expectation of receiving all contractual principal and interest of the underlying collateral as these tranches absorb the losses first for the securitization structure. Although cash flows may pass through to the residual holders at periodic intervals pursuant to the waterfall, ultimate returns depend on continued performance so, therefore, there can be no actual expectation that future payments will be received.

The proposed amendment to *SSAP 43R – Loan Backed and Structured Securities* section 26.c., says:

For residual tranches or interests^{FN} captured in scope of this statement, all reporting entities (regardless of AVR) shall report the item on Schedule BA: Other Long-Term Invested Assets at the lower of amortized cost or fair value. Changes in the reported value from the prior period shall be recorded as unrealized gains or losses.

Footnote: Reference to “residual tranches or interests” intends to capture securitization tranches and beneficial interests as well as other structures captured in scope of this statement, that reflect loss layers without any contractual payments, whether principal or interest, or both. Payments to holders of these investments occur after contractual interest and principal payments have been made to other tranches or interests and are based on the remaining available funds. Although payments to holders can occur throughout an investment’s duration (and not just at maturity), such instances still reflect the residual amount permitted to be distributed after other holders have received contractual interest and principal payments.

The SVO recommends amendments to the P&P Manual to clarify the reporting requirements for residual tranches and interests in line with *SSAP 43R*, if and as amended.

Proposed Amendment - The text changes to include reporting instructions for residual tranches and interests is shown below with additions in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2021 P&P Manual format. The SVO requests the Task Force’s permission to remove the paragraph with the “NOTE REGARDING RESIDUAL TRANCHES OR INTERESTS” from the December 31, 2022 version of the P&P Manual, without further authorization from the Task Force, as it will become obsolete at that time.

PART TWO

OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTIONS
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27. An insurance company that self-assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.
28. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met.
29. Securities with NAIC 5GI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC 5GI Designation incurs the regulatory treatment associated with an NAIC 5 Designation.
30. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.
31. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation.
32. Securities that are residual tranches or interests, as defined in SSAP 43R – Loan Backed and Structured Securities, shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation.

NOTE REGARDING RESIDUAL TRANCHES OR INTERESTS: For 2021 year-end reporting only, residual tranches or interests previously reported on Schedule D-1: Long-Term Bonds shall be permitted to be reported on Schedule D-1 with an NAIC 6* Designation, however an NAIC 5GI is not permitted.

NOTE: The GI after the quality indicator 5 refers to General Interrogatory and distinguishes NAIC 5GI from an NAIC 5 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS

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FE SECURITIES

Filing Exemption

3. Bonds, within the scope of SSAP No. 26R and SSAP No. 43R (excluding RMBS and CMBS subject to financial modeling) and Preferred Stock within scope of SSAP No. 32, that have been assigned an Eligible NAIC CRP Rating, as described in this Manual, are exempt from filing with the SVO (FE securities) with the exception of Bonds and/or Preferred Stock explicitly excluded below.

Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:
 - ...
 - **Residual tranches or interests - As defined in SSAP 43R – Loan Backed and Structured Securities, residual tranches or interests shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are therefore not eligible for filing exemption.**

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/02 - Remove Residual Tranches/2021-043.01 Task Force 2021 Amend PP To Remove Residuals v3.docx>