



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

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

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

RE: Update the Definition of Other Non-Payment Risk Assigned a Subscript "S" in the P&P Manual

DATE: November 15, 2021

---

**Summary** – Securities that possess “Other Non-Payment Risks” are intended to be reviewed by the SVO but these investments have not been explicitly included on the list of Specific Populations of Securities Not Eligible For Filing Exemption in Part Three of the *Purposes Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). Securities with other non-payment risks are identified through assignment of the Administrative Symbol “S” as a subscript to the NAIC Designation. This amendment adds “Securities with Other Non-Payment Risks” to the list of securities that are ineligible for filing exemption.

As noted in Part One, paragraph 90, of the P&P Manual, *“An objective of the VOS/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. The SVO is required to identify securities that contain such contractual modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurer, so this can be reflected in the NAIC Designation assigned to the security through the application of the notching process.”*

The proposed amendment further clarifies through additional illustrations that securities that:

- a) incorporate the performance of other assets to determine their contractual payments, either directly or indirectly through reference pools, equity baskets, or indices;
- b) receive payments as the remainder or residual cashflow after all other payment obligations have been made;
- c) receive additional performance or bonus cashflows; or
- d) have no contractual events of payment default;

would also be considered as having “Other Non-Payment Risks”.

Executive Office | 444 North Capitol Street NW | Suite 700 | Washington, DC 20001 | (202) 471-3990

Central Office | 1100 Walnut Street | Suite 1500 | Kansas City, MO 64106-2197 | (816) 842-3600

Capital Markets & Investment Analysis Office | One New York Plaza | Suite 4210 | New York, NY 10004 | (212) 398-9000

[www.naic.com](http://www.naic.com)

**Proposed Amendment** - The text changes to update the definition of “Other Non-Payment Risks” and include Securities with Other Non-Payment Risk as a security type ineligible for filing exemption is shown below with additions in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2021 P&P Manual format.

**PART TWO**  
**OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS**  
**APPLICABLE TO THE SVO**

<b>NAIC DESIGNATION SUBSCRIPT S</b>
-------------------------------------

**Description of Other Non-Payment Risk**

32. It may not be practical, desirable or possible to specifically define other non-payment risk given the assumption that it originates as a result of a contractual agreement or the presence of a structural element of a transaction that is agreed upon between the issuer and the insurer. Accordingly, what follows is intended as general guidance to insurers and others.
33. Most typically, other non-payment risk has been associated with contractual agreements between the insurer and the issuer in which the issuer is given some measure of financial flexibility not to make payments that otherwise would be assumed to be scheduled, given how the instrument has been denominated, or the insurer agrees to be exposed to a participatory risk.
34. Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a schedules basis (defined in the contract) is an event of default (in the case of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).
35. Using the broad concepts identified above, non-payment risk may be present when:
  - A reporting insurance company takes on a participatory risk in the transaction;
    - *Illustration* – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield foreign currency sufficient to buy a defined principal amount of U.S. dollars. The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.
  - The contract governing the loan provides for a degree of permanence in the borrower's capital structure that is incompatible with notions of a loan that is expected to be repaid;

- *Illustration* – A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.
- *Illustration* – An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity date\* (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.
- The governing agreements permit irregular or conditional payments that are incompatible with the notion of an issuer making scheduled payments of interest and repaying principal in full to the insurer on a date certain;
  - *Illustration* – A security that incorporates the performance of other assets to determine contractual payments, principal or interest, either directly or indirectly through references to asset pools, equity baskets, or non-interest rate indices.
  - *Illustration* – A security that receives payments as the remainder or residual cashflow after all other payment obligations have been made.
  - *Illustration* – A security that receives performance or bonus cashflows in addition to scheduled payments of principal and interest.
  - *Illustration* – A security with no contractual events of payment default.
- Agrees to an exposure that has the potential to result in a significant delay in payment of contractually promised interest and/or a return of principal in an amount less than the original investment.

### Meaning of the Subscript S Symbol

36. An SVO determination that a specific security contains other non-payment risk is communicated by assigning the NAIC Designation subscript S to the specific CUSIP and applying the notching procedure described below. The subscript follows the NAIC Designation as follows: **NAIC 2S**.
37. The SVO shall assess securities for other non-payment risk:
  - Routinely, for any security or financial product filed with the SVO.
  - As part of the analysis of a security or financial product submitted to the SVO under the RTAS – Emerging Investment Vehicle process discussed in of this Manual.
  - When requested to do so by any state insurance regulator acting pursuant to this Manual, and:
    - When requested by the VOS/TF; or

- In support of any other NAIC group engaged in the analysis of investment risks in new securities.

**NOTE: SEE “NAIC DESIGNATION SUBSCRIPT S” IN PART ONE.**

**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**

#### **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:

...

- **Securities with Other Non-Payment Risks** – As noted in Parts One and Two of this Manual, the regulatory assumption of a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A security that is inconsistent with this assumption contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption.

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/Exposed/2021-047.01 Task Force 2021 Amend PP Other Non-Payment Risk.docx>