



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

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

RE: Purposes and Procedures Manual amendment to permit un-guaranteed and unrated subsidiary obligors in WCFI transaction, with SVO discretion

DATE: November 24, 2021

Summary – The SVO has received comments from certain insurers and other interested parties that it should assign NAIC Designations to Working Capital Finance Investments (WCFI) with unguaranteed and unrated obligors, based on the implied support from an obligor’s NAIC Credit Rating Provider (CRP) rated parent.

In November 2020, the Task Force exposed a proposed amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the “P&P Manual”) to direct the SVO to rely upon the NAIC Designation or NAIC CRP Rating equivalent of the subsidiary obligor’s parent entity, with allowance for the SVO to notch down from the parent’s rating or NAIC Designation due to its assessment of certain factors regarding the parent/subsidiary relationship. In response to feedback from some Task Force members and interested parties, the SVO subsequently presented a revised proposal to the Task Force at the Summer 2021 National Meeting to remove its discretion to notch because, as demonstrated in its memorandum to the Task Force of October 16, 2020, the SVO found no generally accepted analytical technique or methodology to support the assumption that a parent entity will necessarily support its subsidiary in times of financial distress. This revised amendment was also not adopted by the Task Force.

The SVO is now proposing a new clean amendment which is substantially similar to the original and reflects the comments from some Task Force and Statutory Accounting Principles (E) Working Group members that they would like the SVO to retain discretion to notch down, as they deem appropriate. Like the November 2020 amendment, the Task Force would direct the SVO to imply the parent’s support of its subsidiary and would give the SVO discretion to assign an NAIC Designation to the subsidiary which is lower than that of the parent based on its assessment of the parent/subsidiary relationship. However, this new proposal clarifies that if the SVO notches the NAIC Designation of a subsidiary obligor down from that of its parent resulting in a credit assessment below an NAIC 2, the WCFI program would not be eligible for an NAIC Designation because it would no longer meet the definition of an eligible “Obligor” in Statements of Statutory Accounting Principles 105R – Working Capital Finance Investments.

Proposed Amendment – The proposed text changes directing the SVO to assign NAIC Designations to WCFI programs with unguaranteed and unrated subsidiary obligors are shown below with additions in red and deletions in ~~red strikethrough~~, as it would appear in the 2021 P&P Manual format.

PART ONE

POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE

POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES

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WORKING CAPITAL FINANCE INVESTMENTS (WCFI)

Description

118. As described in SSAP No. 105R - Working Capital Finance Investments, WCFI represents a confirmed short-term obligation to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program for which an NAIC Designation is assigned by the SVO. Pursuant to the working capital finance investment program, this short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third-party investor.

Obligor

119. The Obligor for WCFI transactions is the party that purchases the goods or services that generates the original supplier receivable (which is the payable for that Obligor). The obligor must have an NAIC Designation of “1” or “2” or an NAIC Credit Rating Provider (CRP) Rating equivalent.

Unrated Subsidiaries

120. Many WCFI programs are structured in a way whereby unrated subsidiaries of a rated parent entity are involved as transaction participants, including as the Obligor. Such programs may have strong operational and strategic linkages between the rated parent entity and its unrated subsidiaries.

121. Given (i) the short-term (less than one year) payment terms of each of the underlying receivables arising from the sale of goods or services, (ii) WCFI investors’ option to stop funding a working capital finance program, and (iii) the necessity of working capital finance programs to obligors due to obligors’ reliance on their suppliers, the Task Force has concluded there is a low probability of default of WCFI investments. Accordingly, the Task Force deems it reasonable to establish a principle to direct the SVO, in its assessment of WCFI programs, to rely upon a parent entity’s rating for purposes of determining the NAIC Designation of the overall WCFI program.

122. Solely for purposes of WCFI transactions, the Task Force directs the SVO to rely upon the NAIC Designation or NAIC CRP Rating equivalent of the obligor, subsidiary or affiliate’s parent entity if the obligor, subsidiary or affiliate does not have an NAIC CRP Rating and the SVO cannot assign an NAIC Designation to it.

123. The Task Force authorizes the SVO, based on its analytical judgement and in its sole discretion, to notch such NAIC Designation down or decline to assign an NAIC Designation, based on factors including, but not limited to, whether:
- a) the unrated subsidiaries or affiliates that serve as key transaction participants cannot reasonably perform the functions expected of them; and/or
 - b) the rated entity does not have significant documented operational control over the performance of the unrated subsidiaries or affiliates that also serve as obligors in the program; and/or
 - c) documentary evidence in the program documents or appended thereto does not sufficiently demonstrate the importance of the inter-relationship between the rated entity and the unrated subsidiaries or affiliates; and/or
 - d) the resulting NAIC Designation would, upon application of notching, be lower than an NAIC 2 Designation.
124. For the avoidance of doubt, though the Task Force directs the SVO to use the NAIC Designation or NAIC CRP rating equivalent of the obligor's parent entity, due to the SVO's authority to notch such NAIC Designation or rating, the SVO, based on its analytical judgement and in its sole discretion, may assign an NAIC Designation to the obligor which differs from the correlated NAIC CRP rating equivalent of the obligor's parent entity or choose not to assign any NAIC Designation to the working capital finance program, based on aspects of the working capital finance program which are unrelated to the relationship between the obligor, subsidiary or affiliate and its parent entity.
125. The Task Force acknowledges that reliance upon the NAIC Designation or NAIC CRP rating equivalent of the obligor's parent entity in the absence of a binding legal obligation for the parent to assume the financial obligations of the obligor, such as a guarantee, is not a generally accepted technique or methodology (as explained in "Use of Generally Accepted Techniques or Methodologies" in Part One of this Manual) and is inconsistent with the credit substitution guidelines detailed in "Credit Substitution" in Part Three of this manual, but it is directing the SVO to so rely.

NOTE: See "Working Capital Finance Investments" in Part Three for filing instructions, documentation requirements, definitions and methodology applicable to Working Capital Finance Investments.

PART THREE

SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

WORKING CAPITAL FINANCE INVESTMENTS

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122. **Obligor** – An entity that purchases the goods or services from the Supplier and thereby generates the original supplier receivable—and which Obligor has, or can be designated, **NAIC 1** or **NAIC 2** by the SVO or has been assigned an equivalent credit rating by a NAIC CRP or, if not so designated, the SVO can assign such NAIC Designation, as directed by the VOS/TF pursuant to the “Working Capital Finance Investments (WCFI)” section in Part One of this Manual.