TO: Carrie Mears, 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: Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the “P&P Manual”) regarding Subsidiary, Controlled and Affiliated (SCA) Debt or Preferred Stock Investments

DATE: September 16, 2022

**Summary –** On June 10, 2022 the Statutory Accounting Principles (E) Working Group sent a referral to the Task Force resulting from the Working Group’s May 24, 2022 adoption of agenda item *2021-21: Related Party Report* which revised both *SSAP No. 25 – Affiliates and Other Related Parties* and *SSAP No. 43 – Loan-Backed and Structured Securities* which raised comments about eligibility for filing exemption for various affiliated structures.

The amendment required new reporting information for investments that involve a related party as sponsor, originator or other similar transaction party, regardless of whether the investment is captured on the affiliate reporting line. The referral further explained that because the definition of affiliation is determined by an evaluation of control of the issuer, which for structure securities is typically a special purpose entity (SPE), it is possible for an investment that involves an affiliate or related party issuer to not be considered affiliated (because the insurer has no control over the issuing SPE), while it is also possible for an affiliated debt investment to lack underlying affiliated credit exposure (because the underlying obligors are not affiliate or related parties).

The Working Group referred this matter to the Task Force stating that, “the SVO may need to develop additional procedures to add a methodology to designate this type of asset-backed security investment structure, or to clarify that affiliated investments that do not have underlying affiliated credit exposure [meaning the affiliate exposure is to the SPE issuer, originator, sponsor or servicer rather than the underlying obligor] qualify for FE.”

The Subsidiary, Controlled and Affiliated (SCA) Debt or Preferred Stock Investments section of the P&P Manual currently only requires insurers to file with the SVO bonds or preferred stock issued by an insurance or non-insurance SCA entity. Therefore, a transaction with an affiliate or related party obligor, sponsor or underlying obligor, as opposed to issuer, or other non-issuer party which transfers risk, directly or indirectly, to the reporting insurance company, would not constitute an SCA investment as currently defined. Transactions in which the issuer is not an affiliate or related party could, nonetheless, and as stated in SSAP No. 25, be “subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic reality or may not be fair and reasonable to the reporting entity or its policyholders.” For example, an affiliated or related entity could originate several loans to unaffiliated and unrelated obligors and, for various reasons, sell those loans to a SPE which could then issue a note to the reporting insurance company. The fact the reporting insurance company is assuming the risk of the loans originated by an affiliate or related party could pose risks of abuse or unfairness even though the underlying loan obligors (the credit exposure) are not affiliates or related parties. A similar risk of possible abuse exists if the underlying credit exposure has a relationship to the reporting insurance company, even if the issuer does not. Therefore, the amendment would also make investments ineligible for filing exemption if the underlying credit exposure would qualify as a related party pursuant to paragraph 4.a. in *SSAP No. 43R – Loan-Backed and Structured Securities*, even if the issuer is not an SCA or related party*.*

Transactions with an affiliate or related party that is not the issuer (typically a securitization or other structured finance structure) are currently eligible for filing exemption. Such investments, however, would likely be in scope of *SSAP No. 25—Affiliates and Other Related Parties* and subject to reporting as an affiliate or related party transaction in the appropriate investment schedules. State insurance regulators could, based upon the reporting of an affiliate or related party relationship, require that the reporting insurance company file an investment with the SVO for analysis and/or assignment of an NAIC Designation.

Additionally, while we are opening up the SCA section for revisions, the SVO proposes clarifying that SCA investments, according to the P&P Manual, has always referred not only to affiliate transactions in which there is direct or indirect control between the reporting insurance company and a transaction entity, but referred also to related parties where relationships other than control, as listed in SSAP No. 25, might exist. For example, the SVO reviewed a transaction in which the there was no direct or indirect control between the reporting entity and the issuer, but there was a father/son relationship between the owner of the issuer and CEO of the reporting insurance company, a relationship which poses a risk of abuse, unfairness, or unreasonableness.

**Recommendation** – The SVO proposes renaming the Subsidiary, Controlled and Affiliated (SCA) Debt or Preferred Stock Investments section of the P&P Manual to Subsidiary, Controlled and Affiliated (SCA) and Related Party Debt or Preferred Stock Investments to clarify that it includes non-control relationships, and amending SCA investment, SCA debt and SCA preferred stock definitions to include related parties.

The SVO also proposes expanding the definition of SCA and related party debt to include structures in which the non-issuer underlying credit exposure would qualify as a related party pursuant to paragraph 4.a. in *SSAP No. 43R – Loan-Backed and Structured Securities*.

Lastly, the SVO also proposes creating a new category of SCA and related party investment called SCA and Related Party Filing Exempt Investments which would mean any investment (i) issued by an affiliate or related party special purpose entity (SPE) which itself is not an obligor or ultimate source of the investment repayment, or (ii) issued as part of a structure in which the originator, sponsor, manager, servicer, other influential transaction party is an affiliate or related party of the reporting insurance company. SCA and Related Party Filing Exempt Investments would be eligible for filing exemption unless otherwise ineligible (for reasons other than their affiliate or related party status). The P&P Manual would also be amended to clarify that state insurance regulators are permitted, as specified in Part One of the P&P, to require an insurance company to file what would otherwise be an SCA and Related Party Filing Exempt Investment for analysis and/or assignment of an NAIC Designation only by the SVO, thereby making it ineligible for filing exemption in the future.

**Proposed Amendment -** The proposed text changes to P&P Manual are shown below with additions in red underline, deletions in ~~red strikethrough~~ as it would appear in the 2022 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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### Subsidiary, Controlled and Affiliated (SCA) and Related Party Investments

1. SCA and related party bond and preferred stock investments (each, as defined in Part Three) in the form of a debt instrument purchased (or otherwise acquired) from an insurance or non-insurance entity ~~(SCA debt)~~ and preferred stock issued by an insurance or non-insurance entity ~~(SCA preferred~~ may be assessed by the SVO to determine eligibility for reporting as an Investment Security as defined in this Manual. The SVO is required to determine that a filed SCA and related party investment has terms, structure, complexity and purpose like those in transactions between unaffiliated parties so that credit risk assessment methodologies applied to transactions between unaffiliated parties can be meaningfully applied to transactions between affiliated parties; as a condition to assigning an NAIC Designation to the investment.

**Note**: See “Subsidiary, Controlled and Affiliated (SCA) and related party ~~Debt~~ Bond or Preferred Stock” in Part Three for filing instructions, documentation requirements and methodology applicable to SCAs.

**Part Three**

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

## **Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities**

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### FE Securities

#### **Filing Exemption**

1. 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**

1. The filing exemption procedure does not apply to:

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* **SCA and Related Party Bond and Preferred Stock Investments** – SCA and related party bond and preferred stock investments (each, as defined in this Part) are transactions between insurance company ~~affiliates~~SCA’s (as defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*) ~~(called~~ or other related parties~~)~~ (as defined in *SSAP No. 25—Affiliates and Other Related Parties*) that are subject to special regulatory considerations identified in *SSAP No. 25—Affiliates and Other Related Parties*. This Manual specifies that such SCA and related party bond and preferred stock investments ~~transactions~~ are not ~~subject to~~eligible for filing exemption and can only be assigned an NAIC Designation if the SVO has first concluded that the transaction is like those the SVO typically assesses for credit risk. See the SCA and Related Party section in this Part for further information about how the SVO determines whether an SCA and Related Party investment will be assigned an NAIC Designation and how a state insurance regulator can require an insurance company to file an otherwise filing exempt structure containing an SCA or related party with the SVO.

## **Subsidiary, Controlled and Affiliated (SCA) and Related Party ~~Debt~~ Bond or Preferred Stock Investments**

**Note**: See “Policies Applicable to Specific Asset Classes” in Part One for the 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.

#### **Filing Instructions**

1. **Common Stock** – An investment in the form of common stock issued by an insurance or non-insurance subsidiary, controlled or affiliated (SCA) entity of the reporting insurance company or an investment in the form of a preferred stock issued by an insurance subsidiary, controlled or affiliated company of the reporting insurance company **is required to be filed with the NAIC Financial Regulatory Services Division** in the manner and form and with the documentation provided for in the Appendix to *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*.
2. **Bonds** – An investment in the form of a bond (i) *issued* by an insurance or noninsurance SCA ~~entity~~ or related party of the reporting insurance company (except for issuers that fit the example in subclause (i) of the “SCA and Related Party Filing Exempt Investments” section), or (ii) issued as part of a structure which would, pursuant to paragraph 4.a. of *SSAP No. 43 – Loan-Backed and Structured Securities*, qualify as a related party investment due to the reporting insurance company’s relationship with the underlying credit exposure (“SCA and related party bond”), is filed with the SVO. To file an SCA and related party bond investment, the reporting insurance company files an Audited Financial Statement for the subsidiary, a copy of the corporate resolution authorizing the issuance of the debt, written evidence that the transaction has been approved by the state of domicile or that no such approval is necessary and, if the subsidiary is an insurance company, the subsidiary’s most recent NAIC Financial Statement Blank, together with the reporting insurance company’s NAIC Financial Statement Blank, internal investment committee memorandum for the investment and loan documentation appropriate to the transaction.
3. **Preferred Stock** – An investment in the form of a preferred stock (i) *issued* by a noninsurance SCA ~~entity~~ or related party of the reporting insurance company (except for issuers that fit the example in subclause (i) of the “SCA and Related Party Filing Exempt Investments” section), or (ii) issued as part of a structure which would, pursuant to paragraph 4.a. of *SSAP No. 43 – Loan-Backed and Structured Securities*, qualify as a related party investment due to the reporting insurance company’s relationship with the underlying credit exposure (“SCA and related party preferred stock”), is filed with the SVO. To file an SCA and related party preferred stock issued by a non-insurer, the reporting insurance company files an Audited Financial Statement for the issuer of the preferred stock, a copy of the corporate resolution authorizing the issuance of the preferred stock, written evidence that the transaction has been approved by the state of domicile or that no such approval is necessary, together with details of the terms of the preferred stock, as well as the NAIC Financial Statement Blank for the reporting insurance company.

**Note**: Please see the section on preferred stock in this Part for additional analytical procedures applicable to that asset class.

1. **SCA and Related Party Filing Exempt Investments** – Certain investments might contain SCA or related party relationships with non-issuer or non-credit exposure entities. For example, an investment could be (i) issued by an SCA or related party special purpose entity (SPE) which itself is not an obligor or credit exposure, or (ii) issued as part of a structure in which the originator, sponsor, manager, servicer, other influential transaction party, is an affiliate or related party of the reporting insurance company. Such investments are eligible for filing exemption unless otherwise ineligible pursuant to guidance in this Manual unrelated to SCA or related party status. However, such investments may be in scope of *SSAP No. 25—Affiliates and Other Related Parties* and subject to reporting as an affiliate or related party transaction in the appropriate investment schedules. For the avoidance of doubt, nothing in this section prohibits a state insurance regulator, in accordance with Part One of this Manual, from requiring its domiciled insurance company to file an otherwise filing exempt investment with the SVO for analysis and/or assignment of an NAIC Designation, thereby making it ineligible for future filing exemption.

#### **Purpose**

1. This section applies to credit assessment of any SCA and related party investment in the form of a debt instrument purchased (or otherwise acquired) from an insurance or non-insurance entity (SCA and related party ~~debt~~ bond) and preferred stock issued by an insurance or non-insurance entity (SCA and related party preferred stock). This procedure is used to determine whether an SCA and related party ~~debt~~ bond or SCA and related party preferred transaction is eligible for reporting as an Investment Security pursuant to this Manual. The determination of “Investment Security” and credit assessment provided by the SVO shall not be construed to reflect assessments specific to affiliated transactions contained in *SSAP No. 25—Affiliates and Other Related Parties*. As such, an SVO-assigned NAIC Designation for affiliated and related party transactions:

* Does not reflect collectability based on independent payment ability of a parent reporting entity.
* Does not reflect whether the transaction was conducted at arm’s-length.
* Does not reflect whether the transaction is considered “economic” under SSAP No. 25.

#### **Notification Procedure**

1. Prior to applying the procedures required below, the SVO shall:

* Confirm that the SCA relationship has been reported to the NAIC Financial Reporting Services Division, if required.
* If the SCA common and preferred stock transaction was reported (or if not required to be reported), the SVO shall:
  + Inform the state insurance department of the reporting insurance company’s state of domicile that the SCA ~~debt~~ bond or ~~SCA~~ preferred stock has been filed with the SVO.
  + Evaluate whether the SCA ~~debt~~ bond or ~~SCA~~ preferred stock transaction is circular within the meaning of that phrase as discussed in this Manual.
  + In the case of SCA preferred stock, determine the SCA preferred stock issuer’s senior unsecured debt designation and obtain the appropriate designation level for the preferred stock by applying the methodology specified in this Manual.

1. Although an NAIC Designation does not provide assurances regarding arm’s-length or economic, if the SVO becomes aware of any information that indicates further review is warranted, the SVO shall contact the reporting entity to discuss, with subsequent notification (by the reporting entity or SVO) to the domiciliary state regulator, as needed. Pursuant to SSAP No. 25, affiliate transactions that are not arm’s-length and/or economic are subject to additional accounting and reporting guidelines and each reporting entity is required to be knowledgeable about its domiciliary state regulatory requirements for approval of these transactions.

#### **Definitions**

1. The following definitions/concepts are from SSAP No. 25:

* **Arm’s-Length** – An arm’s-length transaction is defined as a transaction in which willing parties—each being reasonably aware of all relevant facts and neither under compulsion to buy, sell or loan—would be willing to participate.
* **Economic** – An economic transaction is defined as an arm’s-length transaction which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof; i.e., “permanence.” The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. An economic transaction must represent a bona fide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance, not the form of the transaction.

#### **Procedure for Credit Assessment of Filed SCA Transaction**

1. The procedure specified in this section applies to bonds and preferred stock whose terms, structure, complexity and purpose are like those in transactions between unaffiliated parties filed with the SVO so that credit risk assessment methodologies applied to transactions between unaffiliated parties can be meaningfully applied to transactions between affiliated parties.
2. A determination that a bond or a preferred stock submitted for an assessment under this section is not like a transaction between unaffiliated parties and/or that analytical methodologies applied to transactions between unaffiliated parties cannot be meaningfully applied to the filed transaction shall be in the sole discretion of the SVO.
3. An insurer apprised of the SVO’s determination may request a conference call with the SVO to evaluate whether focused disclosure and documentation pertaining to the terms, structure, complexity and purpose of the transaction may enable the SVO to develop a credit assessment methodology specific to the transaction. If the insurer and the SVO agree that a transaction specific credit assessment approach can be developed, administrative details pertaining to the conduct of the assessment shall be as negotiated between the SVO and the insurer.
4. Instead of filing a transaction under this section, an insurer may choose to file an RTAS submission (discussed in this Manual) to solicit an opinion and rationale from the SVO whether or not an SCA and related party transaction would be considered to be like those between unaffiliated entities or ask its domiciliary state regulator to consider requesting that the SVO assist the department in the determination of an NAIC Designation for the transaction under the Regulatory Transactions procedure discussed in this Manual.

## https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-10-20 - Interim Meeting/03-Related Parties/2022-008.04\_VOSTF\_Amend\_SVO\_RelatedParties\_v5.docx