



MEMORANDUM

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, Investment Counsel, NAIC Securities Valuation Office (SVO)

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

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)* to Incorporate Updates Made to SSAP No. 105R – Working Capital Finance Investments.

DATE: September 10, 2020

1. Summary – The Statutory Accounting Principles (E) Working Group adopted updates to SSAP No. 105R Working Capital Finance Investments on May 20, 2020. Key revisions are summarized as follows:

- Functionally Equivalent Foreign Regulators - Removed the requirement that the Securities Valuation Office (SVO) determine if the International Finance Agent is the functional equivalent of the U.S. regulator.
- Commingling Prohibitions - Removed the finance agent prohibitions on commingling.
- Investor Rights Edit - Removed duplicative text regarding exercising of investor rights.
- 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.
- Finance Agent Validation Requirements – Broadened the independent review requirements to allow independent review of the finance agent by either audit or through an internal control report.
- Default Date - Changed the default provisions from 15 to 30 days so the default date and the cure period are consistent.
- Possible Domestic Regulator Approval – Removed the statement that the reporting entity may need to seek approval from the domestic regulator.

2. **Revisions** - The SVO submitted a proposed amendment to the Valuation of Securities (E) Task Force (the Task Force), dated June 15, 2020, to amend the Working Capital Finance Investments (WCFI) section of the P&P Manual to remove any inconsistencies with SSAP No. 105R, as revised. The proposed amendment was received and exposed on July 1, 2020 for a 45-day public comment period that ended on August 17, 2020. The American Council of Life Insurers (ACLI) submitted a detailed comment letter, dated August 17, 2020, recommending additional updates to this section. The SVO staff has reviewed the ACLI's recommendations and has attached an updated proposed amendment that reflects where the SVO agrees with the ACLI and, as explained below, where it does not.

Generally, the ACLI's recommendations fall into two categories: (1) those which remove inconsistencies between SSAP No. 105R and the WCFI section of the P&P Manual, thereby adhering to the original purpose of this amendment and, (2) those which would amend WCFI provisions in the P&P Manual which are not identified in SSAP No. 105R and which would impede the SVO's ability to assess investment risk in WCFI transactions. These analytic provisions were intentionally included in the P&P Manual's WCFI guidelines to enable the SVO to more accurately assess investment risk in WCFI transactions and they reflect the functional differences between the Accounting Practices & Procedures Manual (AP&P), which is intended to define accounting standards, and the P&P Manual, which is intended guide the assessment of investment risk. The AP&P is not intended to be a substitute for the P&P Manual as only the Task Force is charged to, "... establish and maintain all aspects of the NAIC's credit assessment process for insurer-owned securities." The SVO staff has identified the analytical issues below that should be retained in the P&P Manual. These changes are outside of the scope of the SSAP 105R revisions and are necessary for the SVO to perform its responsibility to assess investment risk.

- a. **A Certification** (paragraph 102, bullet 5) from the insurance company Investment Officer that the insurance company, in its capacity as an Investor, is not affiliated with the Obligor or with any Supplier in the Working Capital Finance Program, and that the Working Capital Finance Program does not include any insurance or insurance related assets. *This certification relates to the requirements of SSAP No. 105R, paragraph 19 and provides a means by which the SVO can verify that a transaction meets those requirements.*
- b. **Process and Methodology** (paragraphs 121) - An NAIC Designation shall be assigned to a Working Capital Finance Program on the basis of a thorough assessment of credit, dilution, operational and other risks, an assessment of protections provided by operative documents to the Investor and the quality of transaction participants. *The assessments of credit, dilution and operational risk are core components of the SVO investment risk assessment for WCFI transactions and none of them conflict with SSAP No. 105R.*
- c. **Credit Risk** (paragraphs 122) – The NAIC Designation for a Working Capital Finance Program shall be linked to the credit quality of the Obligor, which may be determined by reference to a credit rating assigned by a NAIC CRP or by an NAIC Designation assigned by the SVO. Credit risk is assessed by the SVO analyst in accordance with any permitted methodology set forth in this Manual for corporate obligors. *The assessments of credit is a core component of the SVO investment risk assessment for WCFI transactions and does not conflict with SSAP No. 105R.*
- d. **Dilution Risk** (paragraphs 107, 121, and 123) – *This element of the SVO's analysis is crucial for an accurate assessment of investment risk because it is necessary for the SVO to consider the risk that disputes or certain contractual provisions may reduce the amount of the obligation owed by the obligor to the supplier and thereby impact the insurance company investor.*

- e. **Operational Risk** (paragraphs 111, 121, and 124) – *This element of the SVO’s analysis is crucial for an accurate assessment of investment risk because it is necessary for the SVO to consider the risk that the parties involved in the program will not fulfill their contractual responsibilities. This is a common investment analysis consideration as reflected in the methodology to review Power Generation Projects in Part Three of the P&P Manual.*
3. **Recommendation** – The SVO staff recommends re-exposure of this amendment with the changes recommended by the ACLI, excluding the analytically necessary items identified above, to align with the adopted updates to *SSAP No. 105R – Working Capital Finance Investments*.
4. **Proposed Amendment** – The following shows the proposed revisions in Part Three with text in red identifying the changes proposed on July 15, 2020 and additional revisions and comment letter responses in yellow highlight.

PART THREE

**SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS**

WORKING CAPITAL FINANCE INVESTMENTS

NOTE: See “Specific Populations of Securities Not Eligible for Filing Exemption” in “Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities” above.

Initial Filing Requirements

102. An insurance company requesting an analysis of a proposed Working Capital Finance Program shall provide the SVO with the documentation described in this subparagraph:

- An RTAS Application.
- The Obligor’s Audited Financial Statements, if the Obligor is not rated for credit risk by a NAIC CRP.
- The insurance company’s Investment Committee Memorandum for the proposed Working Capital Finance Program.
- ~~The audited consolidated financial statements of the group of which the Finance Agent for the Working Capital Finance Program is a part, and o~~One of the following:
 - An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment.
 - An annual audit of the financial statement and internal controls of the consolidated group of which the Finance Agent is part, which does not note any material weakness related to servicing working capital financial investments.
- A Certification from ~~an the~~ insurance company’s Chief Investment Officer that the insurance company, in its capacity as an Investor, is not affiliated with the Obligor or with any Supplier in the Working Capital Finance Program, and that the Working Capital Finance Program does not include any insurance or insurance related assets.
- ~~A Certification from the insurance company’s Legal Counsel.~~
- ~~In the case of a participation, that it has a commercially reasonable belief that its participation interest meets the Uniform Commercial Code’s standards for creating and preserving first priority security interests in the payments due and in the Confirmed Supplier Receivables.~~

- ~~In the case of a certificate, note or other manifestation, representing a right to payment from a trust, other special purpose entity, or special purpose pool holding confirmed supplier receivables, that it has a commercially reasonable belief that the documents establishing and governing the Working Capital Finance Program create and preserve interests in the Confirmed Supplier Receivables capable of being enforced by the trustee or other entity holding Confirmed Supplier Receivables as first priority perfected security interests under the Uniform Commercial Code.~~

~~NOTE: Please refer to SSAP No. 105 – Working Capital Finance Investments for the definition of a “commercially reasonable belief.”~~

- A copy of:
 - The document(s) that create the Working Capital Finance Investments (i.e., the short-term receivables) that is the subject of the RTAS – Emerging Investment Vehicle Service Application, and establishes the obligations of the Obligor to, and the protection afforded owners of, Working Capital Finance Investments (including the Investors). This agreement is sometimes referred to as the Invoice Payment Terms Acknowledgement, the Payable Services Agreement or the Paying Services Agreement.

NOTE: Please refer to “The Regulatory Treatment Analysis Service – Emerging Investment Vehicle” in Part Two for guidance regarding the filing of an RTAS Application with the SVO.
 - The agreement(s) between the Obligor and the Finance Agent governing the administration of the Working Capital Finance Program and the Working Capital Finance Investments issued thereunder. These agreements may be included in the documents mentioned above or may be a stand-alone agreement which are sometimes referred to as the Settlement Services Agreement or the Invoice-Related Electronic Services Agreement.
 - The agreement governing the sale of the Working Capital Finance Investments from the Supplier to the Finance Agent. This agreement is sometimes referred to as the Receivables Purchase Agreement or the Supplier Agreement. The agreement governing the ongoing purchase of Working Capital Finance Investments or an interest in Working Capital Finance Investments by the Investor from the Finance Agent. This agreement is sometimes referred to as the Agency Agreement, the Participation Agreement or the Program Trust Agreement.

Subsequent Filing Requirements

103. Subsequent filing requirements include:
- Copies of any of the documents originally submitted with the RTAS Application subsequently amended.
 - ~~The audited consolidated financial statements of the group of which the Finance Agent for the Working Capital Finance Program is a part, and~~ One of the following:
 - An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment; or
 - An annual audit of the financial statements and internal controls of the consolidated group of which the Finance Agent is part, which does not note any material weakness related to servicing working capital financial investments.

Definitions in *SSAP No. 105R—Working Capital Finance Investments*

104. Please refer to *SSAP No. 105R—Working Capital Finance Investments*, for the definitions and associated definitional guidance insurance companies must understand and comply with before applying for an NAIC Designation for Working Capital Finance Programs that would permit them to purchase Working Capital Finance Investments.
105. With the exception of the definitions for Dilution Risk and Operational Risk below, the definitions shown below are summaries of those contained in *SSAP No. 105R—Working Capital Finance Investments* intended only to facilitate a discussion and in all cases subordinate to the definitions in *SSAP No. 105R*.

Summary of Key Definitions

106. **Confirmed Supplier Receivable** – A receivable sold by a Supplier to a Finance Agent or Investor (or by a Finance Agent to an Investor) under a Working Capital Finance Program designated by the SVO that requires the Obligor to confirm to the Finance Agent or Investor, prior to the sale of the receivable from the Supplier to the Finance Agent or Investor, that it has no defenses to payment of the monetary obligation represented by the receivable against the Supplier and, therefore, no defenses to payment of the same monetary obligation to the Finance Agent and/or Investor after such sale. The confirmation by the Obligor that it has no defenses to payment includes confirmation that the Obligor does not have a right to refuse payment that it may have acquired with respect to underlying commercial trade transaction and that, if it has such a right, it will not assert such defenses against the Finance Agent or Investor.
107. **Dilution Risk** – With respect to any Working Capital Finance Program, dilution risk refers to disputes or contractual provisions that may reduce the amount of the obligation owed by the Obligor to the Supplier under the original receivable or the obligation owed by the Obligor to the Finance Agent and/or Investor under the Confirmed Supplier Receivable. Examples of dilution risk are credit for returns of defective goods or an allegation of fraud, such as that the invoice is not legitimate or is a duplicate invoice.
108. **Finance Agent** – A bank, financial institution, financial intermediary or service provider that facilitates the Working Capital Finance Program that arranges the sale, assignment or transfer of the Confirmed Supplier Receivable to the Investor and administers payment.
109. **Investor** – The insurance company that files the RTAS Application with the SVO in order to obtain an NAIC Designation for a proposed Working Capital Finance Program.
110. **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.
111. **Operational Risk** – With respect to any Working Capital Finance Program, operational risk refers to the combined effect of the procedures and parties employed to implement the program and their responsibility under the documents and to the determination by the SVO of whether these procedures and parties will ensure full and timely performance by the Obligor of the payment obligation to the Investor. An example of an operational risk is the confirmation process employed to verify that the Obligor has no defenses to payment.

112. **Supplier** – The entity that sells the goods or services to the Obligor, obtains a receivable from the Obligor in exchange and subsequently chooses to sell the right to receive the payment associated with the receivable to the Finance Agent or Investor under the terms of a Working Capital Finance Program designated **NAIC 1** or **NAIC 2** by the SVO.
113. **Working Capital Finance Program** – The program created for the Obligor and its Suppliers by a Finance Agent the terms of which permits Suppliers to the Obligor to negotiate the sale of a right to receive payment from the Obligor (which is associated with and evidenced by a receivable) to the Finance Agent or an Investor.
114. **Working Capital Finance Investment** – The right to receive the payment associated with a Confirmed Supplier Receivable purchased by an Investor under a Working Capital Finance Program designated **NAIC 1** or **NAIC 2** by the SVO and is the subject of *SSAP No. 105R—Working Capital Finance Investments*.

NOTE: *SSAP No. 105R—Working Capital Finance Investments* imposes reporting and statutory accounting requirements on insurance company investments in Working Capital Finance Investments ~~and specifies analytical procedures to be applied or analytical controls to be verified by the SVO that are not detailed above~~. Insurance companies are strongly advised to become familiar with *SSAP No. 105R* before filing an RTAS Application with the SVO.

Direction and Program Parameters

115. The SVO may assign an NAIC Designation to a Working Capital Finance Program that would generate Working Capital Finance Investment that meet the criterion and standards identified in this Section.
116. **RTAS Submission Required** – A request that the SVO assign an NAIC Designation to a Working Capital Finance Program is made by filing an RTAS Application. The RTAS Application is available at www.naic.org/documents/svo_rtas_app.pdf.
117. Upon completion of its risk assessment, the SVO will issue an RTAS Letter indicating a preliminary NAIC Designation; i.e., the NAIC Designation that would be assigned if the Investor enters into a Working Capital Finance Program with a Finance Agent and sought to report it to the SVO.
- NOTE:** A preliminary NAIC Designation cannot be used for statutory reporting purposes.
118. The SVO shall issue a final NAIC Designation to the Investor for the Working Capital Finance Program and the Working Capital Finance Investments generated thereunder upon receipt of fully executed final copies of the required documentation.

Variations in Structure

119. Working Capital Finance Programs may differ in structure and in the protection afforded the Investor. Structural strength and weaknesses of various structures in such programs will be reflected in the NAIC Designation assigned by the SVO.

Program Quality

120. The SVO shall only assign an NAIC Designation to Working Capital Finance Programs that can be designated **NAIC 1** or **NAIC 2**. Credit quality is measured by reference to a NAIC CRP credit rating or an NAIC Designation assigned by the SVO. The SVO shall withdraw the NAIC Designation assigned to a Working Capital Finance Program on the date the Obligor's NAIC CRP credit rating or NAIC Designation is downgraded to **NAIC 3** or its NAIC CRP equivalent.

NOTE: *SSAP No. 105R—Working Capital Finance Investments* provides that Working Capital Finance Investments generated under a Working Capital Finance Program of an Obligor that falls below the equivalent of **NAIC 1** or **NAIC 2** becomes nonadmitted.

Process and Methodology

121. An NAIC Designation shall be assigned to a Working Capital Finance Program on the basis of a thorough assessment of credit, dilution, operational and other risks, an assessment of protections provided by operative documents to the Investor and the quality of transaction participants.

Risk-Assessment Process

122. **Credit Risk** – The NAIC Designation for a Working Capital Finance Program shall be linked to the credit quality of the Obligor, which may be determined by reference to a credit rating assigned by a NAIC CRP or by an NAIC Designation assigned by the SVO. Credit risk is assessed by the SVO analyst in accordance with any permitted methodology set forth in this Manual for corporate obligors.
123. **Dilution Risk** – To achieve an **NAIC 1** or **NAIC 2** Designation, the Working Capital Finance Program must eliminate dilution risk in the Working Capital Finance Investment proposed to be eligible for purchase by the Investor. The terms governing the Investor's Working Capital Finance Investment must eliminate Obligor recourse to its Supplier as a condition to payment of the obligation to the Investor so as to result in an unconditional right to receive payment on a full and timely basis.
124. **Operational Risk** – To achieve an **NAIC 1** or **NAIC 2** Designation, all operational risks shall be identified and assessed. Key participants shall have a NAIC CRP credit rating or an NAIC Designation assigned by the SVO at a level at least that of the Obligor.

Legal, Structural and Regulatory Considerations

125. Events of default remedies should provide the Investor at least those rights and privileges, unimpaired, of a trade creditor upon default with no Obligor defenses that could cause dilution of principal.
126. ~~The SVO shall verify that either, (i) the Finance Agent is ~~must be~~ an entity regulated or supervised by a financial regulator in one of the countries in the List of Foreign (non-US) Jurisdictions Eligible for Netting for Purposes of Determining Exposures to Counterparties for Schedule DB, Part D, Section 1 ~~and that the regulator is the functional equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC) or the Federal Deposit Insurance Corporation (FDIC). In the alternative,~~ or (ii) the SVO shall verify that payments due the Investor are made directly by the Obligor (a) to the Investor or (b) into an account maintained by a regulated financial institution for the benefit of Investors in the Working Capital Finance Program, and, in either case, the Finance Agent cannot be the beneficiary of such payment. ~~with no commingling of funds or assets with those of the Obligor, Supplier, Servicer or Trust Administrator or other Investors.~~~~
127. The SVO will verify that the Certification from the insurance company's Chief Investment Officer confirms that the Investor is not affiliated with Obligor and that Working Capital Finance Investment excludes insurance or insurance-related assets.
128. ~~The SVO will verify that the Certification from the insurance company's Legal Counsel confirms the existence of a commercially reasonable belief that the documents establishing and governing the Working Capital Finance Program establishes the rights and UCC code standard for preserving first priority perfected interest in Confirmed Supplier Receivables.~~
129. The remedies available to the participants in the Working Capital Finance Program should be expressly identified in the documentation for the Working Capital Finance Investment.
130. Characteristics that shall be present in a proposed Working Capital Finance Investment include, but are not limited to, the following, or a substantial equivalent:
131. ~~The Obligor makes payments directly to the (a) Investor; (b) Finance Agent; or (c) servicer for the Working Capital Finance Program.~~
132. ~~The Investor must have the option, and not an obligation, to purchase subsequent Working Capital Finance Investment so as to ensure the Investor can exit the Working Capital Finance Investment by permitting existing investments to mature.~~

133. *SSAP No. 105R—Working Capital Finance Investments* provides that the documentation governing Working Capital Finance Programs must provide that disputes arising under the agreements shall be submitted to a court of competent jurisdiction in the U.S. or be subject to an alternative dispute resolution process sanctioned by state law. Given the nature of Working Capital Finance Programs, the SVO anticipates that documentation governing Working Capital Finance Investments will be subject to the laws and jurisdiction of the courts of California, Delaware or New York, or a similar legal jurisdiction with significant exposure to sophisticated institutional financial transactions.
134. Events of default must be clearly defined, and provide a mechanism that gives the Investor the ability to pursue collection unfettered by actions taken or not taken by participants such as the Servicer or Trustee, or other named persons performing similar functions.

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