National Association of Insurance Commissioners & The Center for Insurance Policy and Research

MEMORANDUM

TO: David Altmaier, Chair, Capital Adequacy (E) Task Force

FROM: Kevin Fry, Chair, Valuation of Securities (E) Task Force

CC: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Robert Carcano, NAIC Consultant

RE: Referral to the Capital Adequacy (E) Task Force – Request for Assignment of Risk-Based Capital (RBC) Charges for Funds That Predominantly Hold Bonds

DATE: May 10, 2019

1. Introduction – The Valuation of Securities (E) Task Force requests that the Capital Adequacy (E) Task Force consider formally integrating the comprehensive instructions for mutual funds recently adopted for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) into the NAIC RBC framework. The mutual funds for which integration is sought: 1) are issued by investment companies registered with and regulated by the U.S. Securities and Exchange Commission (SEC); 2) whose offering is registered with the SEC; 3) whose published investment objective is to invest solely in bonds or solely in preferred stock; 4) are all within scope of the *Accounting Practices and Procedures Manual* (AP&P Manual); 5) cannot be purchased and reported as filing exempt (FE) on the basis of a nationally recognized statistical rating organization (NRSRO) credit rating; and 6) are subject to *a pre-purchase review and identification procedure* performed by the SVO.[1]

2. Background – The primary financial solvency tool of the Valuation of Securities (E) Task Force is a number of related analytical methodologies for the quantification of non-payment risk. These tools have often been used to identify and facilitate investments that provide insurers a needed return at a lower non-payment risk. The Task Force first recognized that bond mutual funds could be structured to perform much better than equity in 1991. Over the next (almost) 30 years, the Task Force developed specific narrow exceptions where the SVO could analyze the cash flow from these specific bond fund types and determine if there would be lower non-payment risk than that associated with shares of common stock. Two Task Force exceptions adopted prior to the adoption of the AP&P Manual and one adopted afterward sought to characterize shares of such funds as being "bond-like" and were accommodated by including them as in scope of *Statement of Statutory Accounting Principles SSAP No. 26R—Bonds*. Over time, it became increasingly clear that the reporting of non-bond instruments in a framework developed for bonds produces reporting problems that can be avoided if it is recognized that the intent is to provide regulatory treatment consistent with credit risk.

[1] The Valuation of Securities (E) Task Force's procedure permits the sponsor of a fund or an insurer to request an SVO assessment of a fund to determine if it meets requirements imposed by the Task Force for more appropriate treatment and if the fund is in scope of the AP&P Manual. If the fund is eligible, the SVO adds the name of the fund to the relevant list with a *preliminary* NAIC designation. The various lists are published. If an insurance company buys a fund on a list, it files that security with the SVO for an official NAIC designation. The SVO assigns an official NAIC designation and enters the security and designation into NAIC systems only after it confirms that nothing has changed since its initial assessment.

EXECUTIVE OFFICE • 444 North Capitol Street NW, Suite 700 • Washington, DC 20001-1509 p | 202 471 3990 f | 816 460 7493
CENTRAL OFFICE • 1100 Walnut Street, Suite 1500 • Kansas City, MO 64106-2197 p | 816 842 3600 f | 816 783 8175
CAPITAL MARKETS & INVESTMENT ANALYSIS OFFICE • One New York Plaza, Suite 4210 • New York, NY 10004 p | 212 398 9000 f | 212 382 4207
www.naic.org

Since 2013, the SVO has expressed concern that it was frequently presented with bond mutual funds it could not designate, *solely* because they were not issued by an investment company operating as open-end management companies (the only company in scope of *SSAP No. 30R—Unaffiliated Common Stock*). Significant staff resources were being expended by the SVO and the NAIC Financial Regulatory Services (FRS) Division to manage the situation. In 2017, the SVO and the FRS Division asked the Task Force for permission to draft a clarifying amendment to the P&P Manual, explaining that mutual funds should not be filed with the SVO unless they strictly comply with the rules in the P&P Manual and AP&P Manual. The SVO staff also cautioned that the lack of a comprehensive approach to this asset class posed a significant risk to state insurance regulation because credit rating organizations were assigning credit ratings to funds that insurers could use to report fund shares as bonds under the FE rule. Therefore, the SVO urged the Task Force to consider modernizing the rules for bond mutual funds. On Sept. 27, 2017, the Task Force directed NAIC staff to develop a comprehensive proposal to ensure consistent treatment for investments in funds that only hold bond portfolios across all the schedules. About the same time, the Statutory Accounting Principles (E) Working Group announced a project to expand the scope of SSAP No. 30R to bring in scope funds issued by closed-end management companies and unit investment trusts. Subsequently, and in partial response to the Task Force's fund initiative, the Working Group and the Blanks (E) Working Group expressed support for adding a column to Schedule D, Part 2, Section 2 that would permit funds designated by the SVO (and only funds designated by the SVO) to be reported on that schedule, but with an NAIC designation that could, in turn, align with an RBC factor to be determined by the Capital Adequacy (E) Task Force.

3. Referral – The Valuation of Securities (E) Task Force received and considered 18 comment letters: 15 in support and three opposed. The letters in support emphasized that the continued designation of bond funds assists financial solvency objectives of all insurers, but it is especially important for small and medium-size insurers, who face significant challenges and incur significant costs when purchasing individual bonds.

One letter opposed to the instructions argued that C-1 for bonds is based on default which bonds held by a fund will never experience because fund managers have an incentive to sell any bond that is downgraded. (The commenter's observation that bonds in a portfolio would be sold before the default would seem to the SVO staff to be a positive attribute and in alignment with financial solvency objectives.) The point of this commenter was that funds are more likely to experience losses attributable to credit deterioration than to default, with the conclusion being that funds are not a proper subject for RBC. A second comment letter agreed that the current C-1 treatment for funds could be refined, but expressed concern that adopting a credit rating methodology could trigger materially lower, and potentially inadequate, life RBC charges without proper consideration of the risks to statutory surplus. Both of these arguments interpose highly technical arguments that not only ignore that the NAIC, through the Task Force and the SVO, have been assessing the cash flow and risk characteristics of bond funds for almost 30 years, but also ignores that the Task Force intentionally made a policy decision to use NAIC designations as a proxy to represent those risk characteristics of bond funds. They also ignore that while RBC factors are derived from an assessment of corporate bond defaults, they are applied to municipal and structured securities, as well as many other instruments that are not corporate bonds and do not have the cash flow or default risk characteristics of corporate bonds. The proposed continued use of the RBC framework for bond mutual funds is a similar recognition of the need to use available tools to provide workable (if imperfect) solutions to real-world challenges. Concerns expressed in a third comment letter were factually clarified in a number of public discussions, and the factual clarifications are summarized below for your convenience.[2]

[2] The comprehensive instructions do not expand bond treatment or permit funds not in scope of the SSAPs. The proposal expands the existing framework to funds issued by investment companies organized as closed-end management companies and unit investments trusts. This was done to recognize that such U.S. Securities and Exchange Commission (SEC)-regulated funds may be identical to those issued by open-end management companies and to align the SVO framework with the AP&P Manual SSAPs, *which bring these entities in scope of SSAP No. 30R as common stock reported on Schedule D, Part 2, Section 2.* Investments in SVO-verified money market funds would still be reported as cash equivalents under *SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments* without a designation. SVO-identified bond exchange-traded funds (ETFs) would still be reported as bonds under SSAP No. 26R with an SVO-assigned NAIC designation, as has been the case since 2006. Investments in ETFs not captured on an SVO listing would continue to be reported as common stock under SSAP No. 30R without an NAIC designation. Private funds would still be reported as joint ventures under *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* captured on

The Task Force requests that the Capital Adequacy (E) Task Force consider attributing the bond RBC factors to all bond and preferred stock funds. This approach is easy to implement and consistent with past NAIC practice; including both the role of the Valuation of Securities (E) Task Force in identifying the risks in securities and the practical approach expressed in the administration of the RBC framework, which is based on default characteristics of corporate bonds but applied to many other instruments with risk and default characteristics unlike those of corporate bonds. The recommended approach is sought for an NAIC activity successfully conducted for almost 30 years and for an asset class that is heavily regulated, has been successful for 85 years in many differing economic environments and provides potentially significant efficiencies to insurers.

Schedule BA, and annual financial statement instructions will continue to permit life and fraternal companies to report an NAIC designation for fixed-income investments.

National Association of Insurance Commissioners & The Center for Insurance Policy and Research

MEMORANDUM

To: David Altmaier, Chair, Capital Adequacy (E) Task Force

From: Kevin Fry, Chair, Valuation of Securities (E) Task Force

Cc: Robert Carcano, Senior Counsel, NAIC Investment Analysis Office
Julie Gann, Senior Manager, NAIC Financial Regulatory Services Division

Date: September 21, 2018

Re: Referral to the Capital Adequacy Task Force - Comprehensive Fund Proposal

1. Introduction – In mid-2017, the SVO and FRS asked for an instruction to draft guidance for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to clarify eligibility of fund investments for assignment of NAIC Designations. The SVO explained that many funds are excluded from designation eligibility but are structurally identical to those permitted under the P&P Manual and the Accounting Practices and Procedures Manual (AP&PM). On Sept. 27, 2017, the Valuation of Securities (E) Task Force (VOS TF) directed NAIC staff to develop a comprehensive proposal to ensure consistent treatment for investments that involved funds that invest in bond portfolios.

2. Background – The VOS TF has permitted more appropriate treatment to funds that invest in bonds and possess other defined characteristics since 1991, as summarized below:

- 1991 – Money market mutual funds that hold short-term U.S. Treasuries - exempted from reserve.[1]
- 1992 – Funds holding U.S. direct and full faith and credit obligations - exempted from reserving
- 1992 – Funds holding high quality corporate bonds & U.S. Government obligations - reserve as NAIC 1 bonds[2].
- 1995 – Short-term bond funds - holding high quality corporate & U.S./GSO obligations) - Schedule D; market value & reserved as bonds for AVR and RBC[3].
- 2003 – Exchange Traded Funds that held bonds – report as bonds.[4]
- 2005 – BA assets with fixed income characteristics can be assigned NAIC Designations.[5]
- 2017 – SVO authorized to assign NAIC Designations to private Schedule BA funds, joint ventures or partnership interests if underlying investments are fixed-income like to align with Annual Reporting Instruction.[6]

Significant efforts have also been made to align guidance in the P&P Manual and the AP&PM for this investment, as summarized below:

- Investments in money market mutual funds are reported as cash equivalents under SSAP No. 2R without an NAIC Designation.
- SVO-Identified Bond ETFs are reported as bonds under SSAP No. 26R with an NAIC designation as assigned by the SVO.
- SVO-Identified Preferred Stock ETFs are reported as preferred stock under SSAP No. 32 with an NAIC designation as assigned by the SVO.

[1] NAIC Proceedings 1991 Vol I-A pages 505, 520, 531
[2] NAIC Proceedings, 1993 Vol 1B, page 770; and Nov. 9, 1992 minutes of the IMR/AVR Study Group
[3] NAIC Proceedings, 1995 2Q, pages 419, 437, 467 – 472
[4] NAIC Proceedings 2003 1Q, page 730; 2003 2Q, pages 810 - 813; 4Q page, 1859
[5] NAIC Proceedings, 2001 3Q, page 802, 834, 841 and 845; 4Q Vol II, page 1302 and 2005, 4Q page 2067.
[6] See the minutes of the Valuation of Securities (E) Task Force conference call held November 13, 2017

EXECUTIVE OFFICE • 444 North Capitol Street NW, Suite 700 • Washington, DC 20001-1509 p | 202 471 3990 f | 816 460 7493
CENTRAL OFFICE • 1100 Walnut Street, Suite 1500 • Kansas City, MO 64106-2197 p | 816 842 3600 f | 816 783 8175
CAPITAL MARKETS & INVESTMENT ANALYSIS OFFICE • One New York Plaza, Suite 4210 • New York, NY 10004 p | 212 398 9000 f | 212 382 4207
www.naic.org

- Investments in ETFs (not captured on an SVO listing) are reported as common stock under SSAP No. 30 without an NAIC designation.
- SVO-Identified Bond Mutual Funds are reported under SSAP No. 26R with an NAIC 1 designation.
- All other mutual funds (regardless of what they hold, if they are not on an SVO listing) are reported under SSAP No. 30 without an NAIC designation.
- Under a current initiative related to a review of SSAP No. 30 the SAP WG is considering whether all investments in a registered investment company should be captured in scope of SSAP No. 30. (This would expand the current reference to "mutual funds" to also include closed-end funds and unit investment trusts within scope of SSAP No. 30.) *(A related initiative is discussed in this footnote.[7])*
- Guidance for non-SEC registered funds is not explicit within the AP&PM, but industry has reported such investments as joint ventures pursuant to *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. These investments are captured on Schedule BA, with an NAIC designation permissible for fixed-income investments held by life and fraternal companies.

The Comprehensive Fund Proposal would unify guidance for all fund investments in a new section in the P&P Manual. All existing procedures for fund investments developed by the VOS TF since 1991 would be retained.[8] The proposal would expand existing policy to funds issued by an investment company that is a closed end fund or a unit investment trust type registered with and regulated by the U.S. SEC. This tracks the SAPWG's proposed expansion of SSAP No. 30 discussed above and the blanks initiative discussed in footnote 7. The policy that fund investments are not eligible for filing exemption would be extended to the new fund procedure and to private (Schedule BA) funds. Analytical definitions, criteria, methodology and instructions are modernized. Greater detail on analytics provides enhanced transparency to insurers.

3. Referral – The VOS TF refers to the CAD TF a recommendation that it conduct a comprehensive review of all funds (as described above) that can be assigned NAIC Designations by the SVO and consider how those NAIC Designations should be included into the RBC calculation; specifically, for the CAD TF to consider what RBC changes they would like to make once NAIC Designations are added to Schedule D-2-2. Currently, bond ETFs and private funds receive different RBC treatment than other similarly structured funds. Equalizing the RBC treatment for assets with similar credit risk, represented by the SVO assigned NAIC Designation, when joined with the proposed changes in the P&P Manual and those made in the AP&PM over the last several years would provide a consistent and uniform NAIC process consistent with regulatory needs for an asset that has experienced significant evolution since 1991.

G:\DATA\Vos-tf\Meetings\2018\October\Task Force 2018 Referral To CAD TF Re Fund Proposal.docx

[7] In furtherance of its consideration of SSAP No. 30, on August 15, 2018, the SAP WG sent a referral to the Capital Adequacy (E) Task Force, Valuation of Securities (E) Task Force and the Blanks (E) Working Group noting support for the consideration of revisions to permit NAIC designations on Schedule D-2-2 – Common Stock. As detailed within that referral, the SAPWG defers to each of the noted groups in determining whether it is appropriate and feasible to incorporate the revisions.

[8] In each of the above assignments, if the SVO confirms that criteria and characteristics specified by the VOS TF are met, it places the name of the fund on a published List. An insurer can purchase any fund on the List and then files the fund shares with the SVO for an NAIC Designation. If the criteria and characteristics have not changed in the interim, the SVO assigns an NAIC Designation to the fund and annually reviews the Designation.

This page is intentionally left blank.